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Robert G. Skinner

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## VI

## Reasonable Needs of the Business

Robert G. Skinner\*

THE TWO FUNDAMENTAL factors in an accumulated earnings tax case are the *subjective intent* responsible for the accumulation and the *objective test* to determine whether or not the accumulation is "beyond the reasonable needs of the business."<sup>1</sup> Failure of the objective test may be determinative of the proscribed purpose in the subjective test.<sup>2</sup> The discussion that follows relates primarily to the objective test — the proper measurement of the reasonable needs of the business for accumulated earnings tax purposes.

The treasury regulations indicate that the reasonable needs of the business depend upon what a prudent businessman would consider appropriate for the present and reasonably anticipated future needs of the business.<sup>3</sup> In a speech delivered almost twenty years ago,<sup>4</sup> Deputy Commissioner E. I. McLarney stated:

Undistributed income is properly accumulated if it is retained for working capital needed in the business or if it is invested in additions to plant reasonably required in the business. Where a corporation can show that all of the capital and surplus on hand would be required for the proper conduct of the business the tax will not be incurred. The Bureau will take into consideration every fact and prospect that a prudent businessman would consider in determining what surplus is reasonably needed for any enterprise.<sup>5</sup>

\* The author requests that this article be read in conjunction with that of Mr. Fred D. Kidder which appears at 17 W. RES. L. REV. 724 (1966).

<sup>1</sup> INT. REV. CODE OF 1954, §§ 532(a), 533(a) [hereinafter cited as CODE §].

<sup>2</sup> CODE § 533(a). Cf. *Vuono-Lione, Inc.*, P-H 1965 TAX CT. REP. & MEM. DEC. (34 P-H Tax Ct. Mem.) § 65096 (April 23, 1965), where Judge Bruce stated: "The fact that the accumulation of earnings is not unreasonable in light of the corporation's business needs is repugnant to the existence of a purpose to avoid tax and, although not conclusive, is substantial evidence that such a purpose did not exist." *Id.* at 571. This language was based upon the opinion in *United States v. R. C. Tway Coal Sales Co.*, 75 F.2d 336 (6th Cir. 1935).

<sup>3</sup> Treas. Reg. § 1.537-1(a) (1959) [hereinafter cited as Reg. §]. See also CODE § 537.

<sup>4</sup> Speech by E. I. McLarney delivered at a meeting of the Tax Executives' Institute in Los Angeles, November, 1946.

<sup>5</sup>*Ibid.*

This policy should be as appropriate today as it was when it was expressed by Mr. McLarney.

### I. DETERMINING THE REASONABLE NEEDS FOR RETAINED EARNINGS

It cannot be overemphasized that although the primary thrust of section 531 in this area appears to be toward accumulated *earnings*, the application of the accumulated earnings tax penalty in most instances depends upon the accumulated *liquid capital* such as cash and other liquid assets.<sup>6</sup> In too many instances, the important distinctions between the opposite extremities of a corporate balance sheet — liquid and equity capital — are not understood, with the result that accumulated earnings tax controversies arise in many cases where no such problem should exist.<sup>7</sup>

From an accumulated earnings tax standpoint, there is a great deal of confusion regarding methods of determining the amounts of corporate earnings that may be safely retained for the reasonable needs of the business. The regulations,<sup>8</sup> as well as a multitude of cases,<sup>9</sup> have stated that earnings may be retained to provide for the payment of debts, for the replacement of capital assets, for expansion, for necessary working capital, for reasonably foreseeable contingencies, and for other business purposes.<sup>10</sup> The most difficult question in this area, of course, concerns the amount of earnings required for these purposes. In answering this question, some cases have held that the accumulation of funds to meet operating ex-

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<sup>6</sup> In cases where substantial amounts are invested in assets which are not readily convertible into cash and which are not directly connected to the bona fide business needs of the corporation, the absence of substantial liquid assets will not necessarily prevent the imposition of accumulated earnings tax. 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).

<sup>7</sup> See *Kidder, Accumulating Surplus for Business Needs*, 17 W. RES. L. REV. 724, (1966). For additional authorities holding that a large surplus, per se, is not sufficient to justify an imposition of accumulated earnings tax, see *Bremerton Sun Publishing Co.*, 44 T.C. 566 (1965); *Ted Bates & Co.*, P-H 1965 TAX CT. REP. & MEM. DEC. (34 P-H Tax Ct. Mem.) ¶ 65251 (Sept. 17, 1965); *Sandy Estate Co.*, 43 T.C. 361 (1964), *acq.*, 1965 INT. REV. BULL. NO. 23, at 6.

<sup>8</sup> Reg. §§ 1.537-1 to -2 (1959).

<sup>9</sup> See, e.g., *Duke Labs., Inc. v. United States*, 222 F. Supp. 400 (D. Conn. 1963); *John P. Scripps Newspapers*, 44 T.C. 453 (1965); *Bardahl Mfg. Corp.*, P-H 1965 TAX CT. REP. & MEM. DEC. (34 P-H Tax Ct. Mem.) ¶ 65200 (Aug. 23, 1965).

<sup>10</sup> See, e.g., Reg. § 1.537-2(b) (1959); *Duke Labs., Inc. v. United States*, 222 F. Supp. 400 (D. Conn. 1963); *John P. Scripps Newspapers*, 44 T.C. 453 (1965); *Bardahl Mfg. Corp.*, P-H 1965 TAX CT. REP. & MEM. DEC. (34 P-H Tax Ct. Mem.) ¶ 65200 (Aug. 23, 1965).

penses for at least one year is reasonable.<sup>11</sup> While this is at best only a convenient general rule, it is noteworthy that the rule has still been accorded weight in two cases decided within the past year where the earned surplus was approximately two-thirds<sup>12</sup> and three-fourths<sup>13</sup> of the annual operating costs. These two cases both point out that the working capital requirements of one business are not necessarily the same as those of another business and that, therefore, the one year's operating expenses rule of thumb should not be given any greater weight than a rule of administrative convenience. Other cases have taken the position that the nature and size of the business involved and other circumstances directly related to the specific case have to be taken into account in making this determination.<sup>14</sup> Still other cases indicate that cash expected to be generated from future earnings, from depreciation allowances, from borrowing, and from equity financing, also have to be taken into account in answering the question as to the amount of accumulated earnings which should be allowed.<sup>15</sup>

## II. TESTS BY WHICH TO DETERMINE THE AMOUNT OF ALLOWABLE ACCUMULATION

The approach described in the following discussion represents an effort to suggest a more appropriate test for the determination of the reasonable needs of a manufacturing business, and is believed to be valid and supportable from a sound business as well as from a technical tax standpoint.<sup>16</sup>

### A. Factors for Consideration

The retention of earnings in order to finance continuing corpo-

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<sup>11</sup> See *Bremerton Sun Publishing Co.*, 44 T.C. 566 (1965); *J. L. Goodman Furniture Co.*, 11 T.C. 530 (1948), *acq.*, 1949-1 CUM. BULL. 2.

<sup>12</sup> *John P. Scripps Newspapers*, 44 T.C. 453 (1965).

<sup>13</sup> *Bremerton Sun Publishing Co.*, 44 T.C. 566 (1965).

<sup>14</sup> See, e.g., *United States v. McNally Pittsburgh Mfg. Corp.*, 342 F.2d 198 (10th Cir. 1965); *The Dixie, Inc. v. Commissioner*, 277 F.2d 526 (2d Cir.), *cert. denied*, 364 U.S. 827 (1960).

<sup>15</sup> In this connection, see *Smoot Sand & Gravel Corp. v. Commissioner*, 241 F.2d 197 (4th Cir.), *cert. denied*, 354 U.S. 922 (1957), *aff'd on remand*, 274 F.2d 495 (4th Cir.), *cert. denied*, 362 U.S. 976 (1960); *Nemours Corp.*, 38 T.C. 585 (1962), *aff'd per curiam*, 325 F.2d 559 (3d Cir. 1963); *Shaw-Walker Co.*, P-H 1965 TAX CT. REP. & MEM. DEC. (34 P-H Tax Ct. Mem.) ¶ 65309 (Nov. 30, 1965); *Sears Oil Co.*, P-H 1965 TAX CT. REP. & MEM. DEC. (34 P-H Tax Ct. Mem.) ¶ 65039 (Feb. 25, 1965). Reliance upon such sources of funds by a management which is seeking to minimize its operating risks seems questionable.

<sup>16</sup> This approach has been developed after careful consideration of practical business management factors in consultation with Mr. B. J. Belda, partner in charge of Ernst & Ernst's Management Services Division.

rate operations and growth is a well-established practice. Most of the major corporations in the United States have obtained the bulk of their equity funds from retained earnings, rather than from capital contributed directly by their shareholders. In addition to the need for adequate funds to meet the financial requirements for continuing operations, for facility replacements, and for expansion, businesses generally have experienced an ever-increasing need for additional funds to protect against the hazards of today's highly competitive economic climate which is marked by accelerating technological changes.

Risk and competition, both of which are accepted because of the profit incentive, comprise the essence of business in our private enterprise economy. The commitment and expenditure of funds are the first steps in the order of business operation. Ordinarily, it is only after facilities have been acquired, materials and components purchased, and labor and other costs expended, that salable products can be delivered, and the manufacturing business can hope for a profit on its investment. It is, of course, the profit incentive that justifies the risk and encourages business owners to hazard corporate funds. This profit objective is not only a major factor in the development of corporate and personal wealth in our nation, it is also one of the most important factors in the generation of revenue for the federal government through the corporate income tax system.

The risks of a manufacturing enterprise are, accordingly, closely associated with (1) the extent and nature of commitments and responsibilities for the payment of liabilities incurred for bona fide business purposes, (2) the amount of money and the time required to procure and fabricate materials into salable products and to deliver these products to customers, and (3) the amounts needed to protect against contingencies that could threaten the survival of the enterprise.

These three risk factors — debts, fund commitment cycle, and protection against contingencies — together with the requirements for the replacement or expansion of operating facilities, constitute the principal considerations in developing and maintaining adequate funds for the conduct of a manufacturing enterprise.

### *B. Sources of Funds*

In addition to paid-in capital and retained earnings, corporations ordinarily have opportunities to obtain funds through borrowing. Borrowed funds not only consist of bank loans, debentures,

mortgages, and other forms of indebtedness which may be incurred for general business purposes, but also include credit for goods and services received from suppliers, and unpaid compensation earned by employees. Even the portion of federal income taxes payable but not yet due constitutes a part of a corporation's borrowed funds. Successful corporations regularly make use of all of these sources of funds. Furthermore, such corporations, as a result of their financial strength and well-established reputations for profitable operations, are able to obtain additional funds through the public sale of their stock or other securities.

The methods by which thousands of corporations in the United States provide the cash resources they require are almost as varied as their number. Some managements tend to be conservative and are opposed to operating on borrowed capital.<sup>17</sup> Others, by choice or by necessity, endeavor to operate with minimum cash balances, borrowing as much as their credit standing will allow. Corporations following either of these extreme policies, as well as those corporations whose resource policies fall somewhere between these extremes, have meritorious profit records. In considering these varying policies, however, the risks of financial difficulty, of credit limitations, of inability to take advantage of business opportunities, and even of bankruptcy, are obviously greater where the cash resources of a business enterprise are maintained at minimum levels.

### C. *Determination of the Reasonable Needs of the Business*

A study of the various sources of cash funds still leaves open the basic question: *How much cash can and should a prudent management retain before such funds reach such proportions that they are considered in excess of the reasonable needs of the business?* This question can be at least partially answered in a quantitative manner by considering the debt and fund commitment cycle risk factors together with the requirements for the replacement or expansion of operating facilities. Before dealing with these factors in detail, a few additional background observations should be made.

It is a fundamental responsibility of corporate management to maximize profits and to minimize the risks of loss. The achievement of both of these objectives may well depend upon the building of financial strength through the retention of corporate earnings

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<sup>17</sup> See *Central Motors, Inc.*, 23 P-H Tax Ct. Mem. 744 (1954).

and profits. The acceptance of the risks and hazards inherent in the pursuit of profits in today's highly competitive economy necessitates the allowance of considerable freedom of managerial decision-making to those responsible for placing corporate funds in jeopardy. This freedom has already been substantially circumscribed by governmental regulations. Extreme care should be exercised, therefore, in imposing additional restraints on business managers who have to weigh and balance all of the elements of risk and profit potential before investing corporate funds. It is unfair and inequitable to force the extraction of more and more cash resources from corporate businesses under circumstances where there has been no reduction in the operational risks involved, and where no additional safeguards are introduced to compensate for the weakening of the corporate financial structure.

The courts have recognized that the accumulated earnings tax provisions are penal in nature and that these provisions were never intended by Congress to harass business management or to prevent such management from retaining profits for bona fide business purposes.<sup>18</sup> In fact, some of the most recent court decisions in this area have expressed a hesitancy to attribute tax avoidance motives to business managers unless the facts and circumstances clearly warrant the conclusion that the accumulation of earnings and profits was unreasonable and for the proscribed purpose.<sup>19</sup>

In the accumulated earnings tax area, both the Government and business would be better served by the establishment of more definite criteria to prevent or shorten the duration of costly, time-consuming controversies and to enable corporate managers to operate with less fear of the penalty tax. No two businesses are exactly alike. For this reason, in measuring the reasonable needs of businesses, it is difficult to devise a technique which will have wide applicability and, at the same time, contain the flexibility necessary to take into account such factors as the nature and size of the various enterprises involved.

#### *D. A Possible Solution to the Problem*

The following approach offers a possible solution to the reasonable needs of the business problem and is intended to accomplish

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<sup>18</sup> See *F. E. Watkins Motor Co.*, 31 T.C. 288, 300 (1958), *acq.*, 1959-1 CUM. BULL. 5; *Fotocrafters, Inc.*, 29 P-H Tax Ct. Mem. 1554, 1561 (1960).

<sup>19</sup> See *Bremerton Sun Publishing Co.*, 44 T.C. 566 (1965); *John P. Scripps Newspapers*, 44 T.C. 453 (1965).

this objective from the perspective of a management which seeks to keep its financial operating risks at a minimum. The author does not intend to imply that all corporate managers, or even the majority of them, actually plan their companies' financial affairs along the lines suggested. However, it is submitted that any corporation which retains profits for the purposes and to the extent hereinafter suggested could not properly be considered guilty of accumulating earnings beyond the reasonable needs of the business.

(1) *Corporate Debts.*—All businesses are responsible for the payment of their debts. Although funds for such payments may, in some instances, be obtained through the collection of outstanding accounts receivable, these accounts are subject to the risks of delayed collection or non-collection. A management which seeks to reduce this risk to a minimum should strive to develop and maintain sufficient cash resources to meet all of the debt obligations of the business enterprise without having to rely upon the timely disposition or liquidation of other business assets, such as inventories or accounts receivable, which are generally "locked in" on a going concern basis. The debt obligations herein referred to include loans, vendor accounts payable, accrued payrolls, tax liabilities, and all other accrued liabilities. A management which is able to and does maintain cash resources for the purpose of paying all of these debts could not be regarded as imprudent; nor could such a management be properly considered to be retaining cash resources over and above the reasonable needs of the business. The cash requirements to meet and pay these liabilities are capable of ready quantification, since the bookkeeping systems of most corporations record the debts as they are incurred.

(2) *Cash Cycle Requirements.*—In addition to the cash required to meet debt obligations, responsible managers must be able to provide cash resources to meet the risks associated with the ongoing operations of the business. The basic business principle of "spending money to make money" is an important consideration in the development of a fiscal policy that will minimize the risks relating to the raising of sufficient funds for this purpose.

Although there are several general approaches to the determination of the amount considered necessary for this purpose, such as the use of one year's operating expenses<sup>20</sup> or the expenses associated

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<sup>20</sup> Bremerton Sun Publishing Co., *supra* note 19; J. L. Goodman Furniture Co., 11 T.C. 530 (1948), *acq.*, 1949-1 CUM. BULL. 2.



with one business or operating cycle,<sup>21</sup> a more valid approach would seem to be one that will meet the commitments necessary to provide for the maximum cash cycle requirements of an enterprise. The cash cycle referred to here is the amount of costs and expenses, excluding depreciation, that is likely to be incurred during the procurement, production, and delivery period under which the corporate enterprise operates. Ordinarily, it would not include the collection period — the period between the delivery of the product to the customer and the receipt of the cash therefor — which is generally recognized as part of the operating cycle. If, however, the collection cycle of an enterprise is longer than its procurement-production-delivery period, then the cash cycle for that enterprise should take into account the longer collection period. In the usual case, the collection cycle — the accounts receivable turnover period — operates contemporaneously with the procurement-production-delivery cycle which, for convenience, will hereinafter be sometimes referred to simply as the “cash cycle.”

Both the cash cycle and the operating cycle concepts are hypothetical rather than functional business phenomena. These cycles are measures of the normal or average period of time required to acquire, produce, and deliver to customers and, in the case of the operating cycle, the time required to collect the proceeds of sales of the products of the business. The cash cycle is determined by dividing the average inventory (the aggregate procurement and production costs on hand) into the cost of sales for a representative period (usually one year). The quotient of this simple arithmetical process indicates the number of times that the inventory has “turned over” during the period or, stated in different terms, the period of time required to procure, produce, and sell the volume of the corporation’s products normally handled. Thus, an average inventory of 500,000 dollars divided into an annual cost of sales of two million dollars produces a quotient of four. This, of course, indicates that the period of time required to procure, produce, and sell the volume of the corporation’s products normally handled is one-fourth of a year, or three months.

This indicator can be useful in ascertaining the extent to which a manufacturing enterprise should be prepared to commit itself for operating expenditures. Recognizing that the continuity of operations is an important responsibility of management, it is evident

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<sup>21</sup> Cf. *Bardahl Mfg. Corp.*, P-H 1965 TAX CT. REP. & MEM. DEC. (34 P-H Tax Ct. Mem.) ¶ 65200 (Aug. 23, 1965).

that a prudent manager must reckon with the risk of some interference in the supply of funds necessary to maintain this continuity. The failure to collect accounts receivable in the anticipated course of business or some other interruption of the normal flow of incoming funds could force a corporation into difficulty in discharging its own debt obligations for payroll, for vendor materials, and for other goods and services. For these reasons, the costs and expenses incurred or likely to be incurred during the cash cycle period constitute a measure of cash resources that should be retained in order to assure the continuity of business operations. These costs and expenses cover not only material, labor, supplies, and other elements directly associated with the manufacturing of products, but also include the ongoing sales and administrative expenses that a corporation can expect to incur during the course of time required to complete the cash cycle. Noncash costs, such as amortization and depreciation, should be excluded from the costs and expenses allocable to the cash cycle.

Using the same illustration suggested above<sup>22</sup> in which the cash cycle duration was three months and in which the manufacturing costs were 500,000 dollars (three-twelfths of two million dollars), and assuming further that the aggregate selling, general, and administrative expenses (exclusive of all noncash costs) amounted to 400,000 dollars during the year, the indicated commitment requirements of the enterprise for these expenses would amount to one-fourth of the 400,000 dollars or 100,000 dollars, which when added to the cash cycle manufacturing costs of 500,000 dollars would, of course, indicate a total cash cycle fund commitment requirement of 600,000 dollars.

The prudent corporate manager who seeks to keep operating risks at a minimum level should maintain cash resources sufficient to meet the expenditures for which he commits the corporation during the course of at least one cash cycle. In the case of a business subject to fluctuating seasonal changes, or a business operating during a period of growth, the management must recognize and plan, not only for the average cash cycle period, but rather for the *maximum* term of the cash cycle for the particular enterprise under the specific circumstances applicable to its situation. For this reason, prudent management should take cognizance of and determine the cash cycle requirements for its business on the basis of the maximum financial risk to which the particular business might be exposed.

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<sup>22</sup> See p. 744 *supra*.

(3) *Problems Arising Under the Cash Cycle Concept.*—The cash cycle concept, because of its hypothetical nature, understandably generates some practical problems. The first is whether the cash cycle should be differentiated from the operating cycle by the exclusion of the collection period. The answer depends upon the fundamental approach taken to the basic concept. If the problem is viewed from the standpoint of an enterprise which is beginning its *first* procurement-production-delivery cycle or from the standpoint of a business which reasonably can foresee a risk of complete non-collection of at least the costs of operating during one inventory turnover period, then the cash cycle should include the collection period. The reason for this inclusion is that funds will have to be collected to minimize the risks of beginning the next procurement-production-delivery cycle. On the other hand, if the problem is viewed from the standpoint of an already established business with a separately operating and constantly recurring accounts receivable collection cycle, it would seem fundamentally preferable to exclude the collection period from the cash cycle. An exception is in order in those cases where the collection cycle itself is longer than the procurement-production-delivery cycle. The basic premise for the determination of a cash and an operating cycle includes and requires an inventory turnover period which, of course, presupposes an established business.<sup>23</sup>

A second practical problem is whether, under the cash cycle concept, federal income taxes allocable to the cash cycle period should be included with or excluded from the selling, general, and administrative expenses which are added to the manufacturing costs also allocable to that period. The answer to this question also depends

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<sup>23</sup> *Bardahl Mfg. Corp.*, P-H 1965 TAX CT. REP. & MEM. DEC. (34 P-H Tax Ct. Mem.) ¶ 65200 (Aug. 23, 1956), recognizes the *operating cycle* concept, including the collection period, in determining the taxpayer's working capital requirements for its "reasonably anticipated costs of normal operations." The Tax Court in this case, however, seems to have overlooked the important distinction between available *liquid capital* (cash, readily marketable securities, and their equivalents) and *working capital* (excess of total current assets over total current liabilities). Working capital includes such business-related assets as inventories and accounts receivable, which on a going-concern basis in most manufacturing enterprises remain at relatively constant levels depending upon the volume of business done. It is fundamentally unsound for the purposes here under consideration to treat working capital as liquid capital, since in cases where current assets include nominal amounts of cash or readily marketable securities, the payment of ongoing procurement-production-delivery obligations may necessitate additional borrowing, other financing, or forced liquidation of business-related assets. From the opinion in *Bardahl*, it is not clear whether the Tax Court recognized the nature of the interrelationship between the procurement-production-delivery cycle and the collection cycle, or whether it simply considered the collection period includable per se in determining the period of time for the measurement of Bardahl's operating capital needs.

upon the approach taken to the cash cycle concept. If it is assumed that the risk which is to be minimized during the cash cycle period covers only the fund commitments related to and associated with operations during this period, and does not extend to sales of the products manufactured, then federal income taxes allocable to the period probably should be excluded from the costs and expenses for which operating capital should be provided. On the other hand, from the viewpoint of a going concern which contemplates sales and deliveries of products manufactured during the cash cycle, the experience of the enterprise involved will always indicate the amount of federal income tax properly allocable to the period of time and volume of business used for the measurement of the cash cycle. If the enterprise's established operations indicate that federal income taxes are payable on such a going concern basis, then these taxes should be regarded as an expense of doing business during the cash cycle period; therefore, provision for their payment should be as appropriate as in the case of any other indirect expense.<sup>24</sup> This conclusion seems to be supportable from a basic cash flow standpoint, since the estimated revenue derived from corporate income tax increases from 1964 through 1970.<sup>25</sup>

### III. REPLACEMENT AND EXPANSION OF FACILITIES

The dynamic nature of our economy demands that businesses either expand or die. There are few, if any, enterprises that have settled upon a plateau of constant business volume for any appreciable length of time. Furthermore, the universal objective of obtaining ever-increasing profits from business prompts the ambitious and successful manager to constantly seek ways and means of expanding the corporation's capability to handle greater volume. Corporations that fail to grow eventually expire through liquidation or acquisition.

Accordingly, prudent management must always be alert to the opportunities for growth and, as a corollary, must be prepared to spend the funds required to provide the facilities needed for such growth. Moreover, the continuity of an established business is dependent upon its ability to replace equipment and other facilities which have become obsolete. Large, well-established businesses often plan their facility replacement and expansion objectives well in advance,

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<sup>24</sup> The Tax Court in the *Bardahl* case, *supra* note 23, excluded anticipated federal income taxes allocable to the operating cycle.

<sup>25</sup> See CODE § 6154.

and formulate elaborate budget programs to make certain that funds are available when needed. These budgets ordinarily cover a relatively long period of time, and some embrace a term extending as far as ten or fifteen years into the future.

In smaller corporations, formal budgets are often not prepared. This is not because similar forecasting and planning is unnecessary. On the contrary, the astute manager of even the smallest enterprise must think ahead. The real difference is that a small corporation ordinarily does not engage in the degree of record keeping and written communication that is maintained in a large organization. The reason for this lack of recorded data is that it is not considered necessary. Recent court decisions recognize that small closely held corporations cannot be held to the same strict formalities practiced by large public corporations.<sup>26</sup>

Most business managers plan at least one year ahead in formulating policies for operation, facility replacement, and expansion. In the absence of any other definite criteria for quantifying the dollar amount of cash resources required for replacements and additions of facilities, a prudent business manager would be reasonable in attempting to develop and maintain cash resources equal at least to the amounts of depreciation and amortization charges for the current year. Alternatively, in the case of a retrospective determination during the course of a revenue agent's examination, an accumulation in an amount equal at least to the facility expenditures during the ensuing twelve-month period would be reasonable. This latter basis for quantifying the amount of funds required for new facilities seems consistent with the regulations which state that "subsequent events may be considered to determine whether the taxpayer actually intended to consummate or has actually consummated the plans for which the earnings and profits were accumulated."<sup>27</sup>

It should be noted, however, that facility replacement and expansion policies do not usually follow a uniform annual pattern. Furthermore, the distinctions between replacement and expansion equipment are not always clear. Also, while it is evident that cash for replacement of long-term assets, such as buildings, is a factor that should be considered in formulating fiscal policy, it is difficult to establish measures that are universally satisfactory with respect

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<sup>26</sup> See *Bremerton Sun Publishing Co.*, 44 T.C. 566 (1965); *John P. Scripps Newspapers*, 44 T.C. 453 (1965).

<sup>27</sup> Reg. § 1.537-1(b) (2) (1959).

to such replacements. These and other complicating factors make the quantification of reasonably foreseeable facility replacement and expansion costs difficult, if not impossible, to determine precisely.

*A. Difficulties in the Calculation of Replacement and Expansion Costs*

Among the factors complicating the calculation of replacement and expansion costs is the matter of providing cash for long-term replacement on a present value basis, rather than on a basis of simple annual funding of amounts equivalent to depreciation or amortization charges. For example, from a nontax business standpoint, fixed asset replacement funds should probably be invested in income-producing securities. Such investments might be in the corporation itself, as well as in government securities or securities of outside organizations. Regardless of the nature of such investments, it would seem that the investment income, either imputed or actually received, might lessen the amount of cash funding required on the basis of simple, annual funding of amounts equivalent to depreciation or amortization charges. It should be noted, however, that investments in securities of unrelated enterprises are often interpreted, from a tax standpoint, as questionable diversions of corporate assets that could have been used to pay dividends. Corporations, therefore, that are vulnerable to an accumulated earnings tax attack may be well advised to refrain from making such investments.

On the other hand, the impact of inflation, which has been the long-term pattern in our economy for some time, could result in cash requirements for asset replacements that substantially exceed the original costs of the worn-out or obsolete facilities. Similarly, improving technology might mean that manufacturing plants, offices, machine tools, and other equipment acquired to replace older facilities will rarely be of the same design or capability as the assets replaced. As a result, smaller but more efficient plant space can often provide capacity for production and administration equivalent to that provided by larger but obsolete designs of the past. Accordingly, the specifics of asset-for-asset exchanges are not ordinarily planned on a static basis.

In the absence of a ready means of identifying the investments for long-term replacements that may have been made in operating assets or in marketable securities and without further data concerning a pattern of facility additions and a means of segregating ex-

pansion facilities from replacement facilities, it does not seem practicable to attempt to quantify precisely an enterprise's cash requirements for facility replacement. Generally, however, it is suggested that the conservation of cash resources for facility replacement purposes should take cognizance of the ongoing obsolescence and deterioration of depreciable and amortizable assets. In making a *prospective* determination of this nature, the conservation should be in amounts *at least* equivalent to the current year's total depreciation or amortization charges. When the determination is retrospective in nature, the amount set aside should be equivalent to the actual facility expenditures during the ensuing year. The application of this general rule should provide a reasonably sound technique for meeting the ongoing funding requirements for an enterprise's facility replacements on a basis which should bring such funding requirements within the scope of the minimum projections that should be programmed and funded by astute management.

### B. Balance Sheet Analysis

The following hypothetical balance sheet analysis illustrates the application of the above-described quantifiable factors to the difficult "reasonable needs of the business" question in an accumulated earnings tax case.

#### ABC CORPORATION BALANCE SHEET ANALYSIS AS OF DECEMBER 31, 1963

Capital stock — common .....		\$ 25,000
Capital stock — preferred .....		130,000
Capital surplus .....		20,000
Earned surplus .....		1,400,000
Reserve for contingencies (exclusive of reserve for bad debts) .....		60,000
Equity capital available for business needs .....		\$1,635,000
Capital employed in business:		
To carry accounts and notes receivable (after provision for bad debts) .....	\$ 300,000	
To carry inventories .....	650,000	
To carry general business insurance and utility deposits .....	10,000	
Investments in fixed operating facility assets (net) .....	500,000	
		1,460,000
Equity capital excess .....		\$ 175,000

Borrowed capital:		
Current liabilities .....	\$ 350,000	
Notes payable to insurance company (exclusive of current portion of obligation) ----	225,000	575,000
		<hr/>
Available liquid capital .....		\$ 750,000
		<hr/>
Analysis of available liquid capital:		
Cash on hand and in banks .....	\$ 700,000	
Cash value of life insurance policies .....	50,000	\$ 750,000
		<hr/>
Liquid capital required for reasonable needs of business:		
To pay debts (total borrowed capital above)		\$ 575,000
Requirements for one cash cycle (Note A) --		850,000
Requirements for ensuing year capital replacements and additions (Note B) .....		270,000
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Liquid capital required for reasonable needs of business exclusive of needs to meet technological changes and other contingencies .....		\$1,695,000
Available liquid capital (see above) .....		750,000
		<hr/>
Indicated shortage of available liquid capital ----		\$ 945,000
		<hr/>

Note A — Represents the manufacturing costs and the selling, general, and administrative expenses (exclusive of noncash costs, such as depreciation allowances) allocable to the cash cycle period (including income taxes).

Note B — Represents actual expenditures during the ensuing year (1964).

It should be noted that the above analysis simply represents a typical balance sheet in rearranged form. The net worth section is stated first, and this "available equity capital" is followed by the current assets except cash and other liquid assets, the fixed assets, prepaid expenses, deferred charges, etc. which are regarded as the investments in this enterprise's "business-related assets." The difference between these two classifications of accounts indicates the excess or shortage of equity capital. To this amount is added the enterprise's borrowed capital representing all of its creditor liabilities. The resulting amount should represent the enterprise's available liquid capital — the amount of cash and other liquid assets — omitted from its "business-related assets." The remainder of the analysis shows a determination of the enterprise's indicated quantifiable liquid capital requirements for paying its debts, meeting its operating capital needs for one cash cycle, and providing for the maintenance of its operating facilities for the ensuing year. This analysis shows that on December 31, 1963, the ABC Corporation had accumulated earnings of 1,400,000 dollars and available liquid



capital of 750,000 dollars. At the same time, it had a demonstrable need for liquid capital in the aggregate amount of 1,695,000 dollars to meet its requirements for the payment of debts, to carry it through one cash cycle, and to cover its acquisition of production facilities for one year. Thus, the ABC Corporation had an indicated shortage of available liquid capital for these three purposes alone in the amount of 945,000 dollars. It would appear, therefore, that a successful assertion could not be made that the ABC Corporation's management was imprudent in retaining that corporation's earnings to the extent indicated.

Many other considerations are of importance in connection with the retention of corporate earnings for the purposes of business expansion and acquisitions of other business enterprises.<sup>28</sup> It is not considered within the scope of this article to explore the many other technical and practical aspects of this area, which in any given case necessitate a detailed analysis of all of the pertinent facts and circumstances involved.

### C. *Effect of Unpredictable Contingencies*

In addition to the quantifiable elements involved in determining the amount of cash resources that should be developed and maintained by prudent management, another risk factor must be considered. This is the contingencies factor which, while often difficult to measure in terms of dollars, can be as significant as the determinable amounts of liabilities, the amounts required to provide for the ongoing cash cycle, and the amounts necessary for facility replacements.<sup>29</sup>

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<sup>28</sup> For many of these considerations, see Kidder, *supra* note 7, at 206.

<sup>29</sup> See *Smoot Sand & Gravel Corp. v. Commissioner*, 241 F.2d 197 (4th Cir.), *cert. denied*, 354 U.S. 922 (1957), *aff'd on remand*, 274 F.2d 495 (4th Cir.), *cert. denied*, 362 U.S. 976 (1960), which defined a recognizable contingency for accumulated earnings tax purposes as "a reasonable need for which a business may provide, if the likelihood, not merely the remote possibility, of its occurrence reasonably appears to a prudent business firm." This definition was cited with approval by the Tax Court in *Bremerton Sun Publishing Co.*, 44 T.C. 566 (1965), and *John P. Scripps Newspapers*, 44 T.C. 453 (1965). Cf. *Freedom Newspapers, Inc.*, P-H 1965 TAX CT. REP. & MEM. DEC. (34 P-H Tax Ct. Mem.) ¶ 65248 (Sept. 15, 1965). See also Judge Moore's opinion in *Electric Regulator Corp. v. Commissioner*, 336 F.2d 339, 345 (2d Cir. 1964), which states in part:

Courts . . . must not blind themselves to the realities in this age of rapid technological change. The product of today is frequently outmoded tomorrow. . . . Nor is it always possible for a company in advance to set aside a specific sum to achieve a specific goal. Comments made in the past to the effect that a definite plan actually followed through must be on the company's books and records before moneys assigned thereto become anticipated needs many have been appropriately qualified in particular cases. *Ibid.*

The contingencies referred to in this connection include such matters as (1) product acceptability and obsolescence; (2) competitive pressures exerted by domestic and foreign producers; (3) interruptions in production due to labor difficulties in the corporation itself or in plants of important suppliers; (4) failures of important customers; (5) sudden loss of management through death, disability, or resignation; and (6) threatened litigation. If excluded from the cash cycle, anticipated federal income taxes relating to that period should be included within the scope of the contingencies factor.

#### IV. CONCLUSION

Late in 1963, a recognized authority on business solvency and on the financial strength of industrial and commercial enterprises selected the ten "best-managed" corporations in the United States.<sup>30</sup> Eight of these corporations were industrial concerns involved in the manufacture and sale of products.<sup>31</sup> In addition to the recognition given to these organizations as being the "best-managed" in the United States, it should be noted that they were and still are all multi-million dollar corporations, that they were and still are all publicly held, and that they all had and still have their equity securities distributed among a large number of shareholders through the facilities of the New York Stock Exchange. Notwithstanding the size of these "best-managed" industrial corporations and the relative ease with which they are able to obtain any needed additional funds through established security markets, all of them maintain relatively high cash balances. However, the substantial liquid resources of these large organizations cannot be directly related to the situations of all smaller closely held corporations. These latter businesses generally need even more liquidity to maintain competition with industrial giants. In any event, it appears that large, well-managed enterprises have effectively reduced their exposure to operating risks through the maintenance of strong cash positions. This policy seems to be a hallmark of sound management.

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<sup>30</sup> Weiner, *What Makes A "Best Managed" Company?*, DUN'S REV. & MODERN INDUSTRY, Dec. 1963, p. 40.

<sup>31</sup> DuPont, Eastman Kodak, General Electric, General Motors, IBM, Minnesota Mining & Manufacturing, Procter & Gamble, and Standard Oil of New Jersey. The other two companies were American Telephone & Telegraph and Sears Roebuck.