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The Accumulated Earnings Tax and the Problem of Diversification

Although recent unprecedented growth in the nation's economy has resulted in increased profits for many corporations,[1] the rapidity of technological change and the intensity of competition are making it increasingly difficult for the executives of financially successful corporations to rest on their achievements. Lines of products and even entire businesses may become outmoded over a short period of time. The stability of a static industry may be shaken by the entry of a progressive new firm. In this context of uncertainty, businessmen must continually seek means of ensuring continued corporate success. One common means is to expand corporate operations into diverse markets. Diversification is not always easy, however. New business opportunities are not always readily available, and when a new opportunity does arise a corporation must be prepared to move swiftly. Thus, liquid funds must be immediately obtainable.[2] Corporations planning internal financing of diversification encounter an additional problem. Where funds for diversification are accumulated before specific plans are devised for their use, the corporation—especially a relatively small, family enterprise[3]—risks violating section 531 of the Internal Revenue Code.[4]

The purpose of section 531, prevention of the use of the corporate form to avoid shareholder taxation, is accomplished by forcing corporations, under threat of a severe penalty tax, to distribute their earnings and profits. Were it not for section 531, corporations could accumulate funds in the corporate coffers so that shareholders could avoid the income tax on dividends, but could later take the funds out at capital gains rates. Shareholders could also use corporate accumulations as a means of income deferral, or, in some cases, as

1. U.S. Bureau of the Census, U.S. Dep't of Commerce, Statistical Abstract of the United States 498 (86th ed. 1965).

2. This may be a problem primarily of close corporations since acquisitions by other corporations are frequently accomplished by means of an exchange of stock. This method is usually unavailable for close corporations, however, because of the possibility of dilution of control of the corporation.

3. As is often noted, as a practical matter the § 531 tax is applicable only to closely held corporations since shareholder tax saving is not likely to be the motive for retention where stock is widely held in relatively small lots. In 1954 it was proposed that corporations with more than 1500 shareholders, no one of which held more than 10% of the stock, be specifically exempted from the operation of § 531. The Senate Finance Committee rejected the proposal, however, since it might be difficult for some "public" corporations to show that no shareholder owned more than 10% of the stock when constructive ownership was considered, and also because § 531 was not usually applied to such corporations. S. Rep. No. 1622, 83d Cong., 2d Sess. 69 (1954).

4. "Section 531" is a term commonly used to describe generally the provisions of the Code which deal with improper corporate accumulation of surplus, and the term will be so used in this comment. In actuality, it is §§ 531-37 which work together to determine the applicability of the accumulated earnings penalty tax.

a way of awaiting a stepped-up basis of the stock upon death. Section 531 combats these tax avoidance devices by imposing a penalty tax on corporations "formed or availed of for the purpose of avoiding" taxes on shareholders.[5] Although the purpose of tax avoidance is the ultimate test of the applicability of section 531,[6] the real controversy central to almost all section 531 cases is whether an accumulation of earnings and profits is for the reasonable needs of the business. The reasonableness issue is crucial for two reasons. First, a finding that an accumulation is unreasonable is, under section 533,[7] determinative of the purpose to avoid tax, in the absence of a showing to the contrary by the taxpayer. Second, a taxpayer is given credit under section 535(c)[8] against its accumulated taxable income for so much of its accumulation as is shown to be "for the reasonable needs of the business."

While diversification is now considered a legitimate corporate need authorizing the accumulation of earnings and profits,[9] the present standards of the Regulations under section 531, which, in general, test the reasonableness of corporate accumulations by the requirement of "specific, definite, and feasible plans"[10] for use of

5. The operative provision is § 532(a): "The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b) [personal holding companies, foreign personal holding companies, and exempt organizations]) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed."

6. There is some conflict whether the purpose to avoid tax must be the "dominant purpose" or merely one of the purposes. The Eighth and Tenth Circuits hold that it must be one of the "determinating" purposes. Kerr-Cochran, Inc. v. Commissioner, 253 F.2d 121 (8th Cir. 1958); World Pub. Co. v. United States, 169 F.2d 186 (10th Cir. 1948). The Second and Fifth Circuits state that it is unnecessary to decide whether it is the dominant or primary purpose. Trico Prods. Corp. v. Commissioner, 137 F.2d 424 (2d Cir. 1943); Barrow Mfg. Co. v. Commissioner, 294 F.2d 79 (5th Cir. 1961). The First Circuit holds that it must be the "dominant" purpose. Commissioner v. Young Motor Co., 316 F.2d 267 (1st Cir. 1963). In the Ninth Circuit, it is sufficient if tax avoidance is "one" of the purposes. Cummins Diesel Sales, Inc. v. United States, 321 F.2d 503 (9th Cir. 1963).

7. INT. REV. CODE OF 1954, § 533(a) provides: "For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary."

8. INT. REV. CODE OF 1954, § 535(c) provides in pertinent part: "(1) . . . [T]he accumulated earnings credit is (A) an amount equal to such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business, minus (B) the deduction allowed by subsection (b) (6) [which deduction is not relevant to the scope of this comment]. . . . (2) The credit allowable under paragraph (1) shall in no case be less than the amount by which $100,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year."

9. Altman, *Recent Litigation Shows 531 Cases Can Be Won Despite Growing Pressure by the IRS*, 20 J. TAXATION 130 (1964). Altman suggests that acceptance of diversification as a legitimate corporate need is one of the three major developments in § 531 in the past decade.

10. Treas. Reg. § 1.537-1(b)(1) (1959).

the funds, seem too restrictive in terms of the problems of diversification as outlined above. In light of this criticism and of recent developments, the purposes of this comment are (1) to indicate the basic principles of section 531, an understanding of which is vital to corporations anticipating retention of funds for the purpose of diversification; (2) to identify, with respect to the standards guiding the imposition of the accumulated earnings tax, the problems which Congress, the Internal Revenue Service, and the courts have for some time skirted but must now consider forthrightly; and (3) to outline a more realistic approach for testing the application of the accumulated earnings penalty tax.

I. The Requisite Corporate Understanding of Section 531

Much of the difficulty that close corporations encounter in section 531 cases comes from a conceptual confusion arising from the peculiar nature of close corporations. Officers of close corporations are usually the major shareholders, and the corporate form itself is frequently a mere technicality.[11] For instance, a business operated for many years as a proprietorship is often managed in exactly the same manner after incorporation. As a result, there is frequently a failure by the corporate officers to distinguish between the business of the corporation and the business of the shareholders, and, in addition, between legitimate corporate diversifying activities and those investment activities which are proper only for individuals.[12] Each of these distinctions is vital to a proper understanding of section 531.

The necessity for the distinction between the business of the corporation and the business of its shareholders arises because excessive accumulation is allowed under section 531 only for the reasonable needs of the business of the corporation itself.[13] In the case of an "incorporated proprietorship" (or partnership), when the business is operated as a proprietorship its operations could be said to be the business of the proprietor. The earnings of the business are taxed to him, and he is free to use the remainder of the funds as he pleases. Once the business is incorporated, however, the manu-

11. It has been suggested that treating close corporations as partnerships would go a long way toward solving accumulated earnings problems. See Chommie, *Surtax Avoidance and Extra Taxation of Corporate Earnings in the United States, United Kingdom, and Canada*, 12 Tax L. Rev. 279 (1957).

12. See, *e.g.*, Cummins Diesel Sales, Inc. v. United States, 321 F.2d 503 (9th Cir. 1963); Bardahl Mfg. Corp., P-H 1965 Tax Ct. Rep. & Mem. Dec. ¶ 65200; Robert R. Walker, Inc., P-H 1965 Tax Ct. Rep. & Mem. Dec. ¶ 65028. It must be recognized, however, that in some cases the corporate bounds of proper activity are so obviously overstepped as to indicate a deliberate violation of the statute rather than simply a confused concept of the corporation's business. See, *e.g.*, Robert R. Walker, Inc., *supra* (corporation built a house for its sole shareholder to entertain "business guests").

13. Treas. Reg. § 1.537-1(a) (1959).

facture or sale of the goods or services is technically the business of the corporation, while the business of the shareholder is merely ownership of the corporation. Since the earnings of the corporation are taxed only at preferential corporate rates, use of the funds is limited to the business purposes of the corporation alone until the funds are distributed as dividends to the shareholder and taxed to him. It is this distinction that the officer-shareholders of some close corporations fail to make.

A second consideration of which corporate officers must be aware is the limitations on the type of business upon which a corporation may properly embark to diversify and still avoid the imposition of a penalty tax under section 531. In the past the scope of corporate diversification was circumscribed and uncertain as a result of the very limited view of the business of a corporation taken by the Regulations, the Commissioner's litigation policy, and the courts in section 531 cases. The Regulations under the 1939 Code provided that radical changes in the business of a corporation on the basis of an accumulation of earnings and profits might themselves show a violation of the statute.[14] Accordingly, the Commissioner attempted to limit corporations to the particular lines of activity in which they were then engaged.[15] Courts sought to determine the "regular" business of corporations and warned of "blind acceptance of marked sweeps from previous rudder course"[16] and undertakings "which seem to represent business anachronism."[17] While it may be true that a corporation will avoid shareholder taxation if it uses its retained earnings and profits to embark upon a new business rather than distributing the funds as dividends, it must be recognized that the attitude expressed by the Regulations, the courts, and the Commissioner inhibits legitimate growth and is thus unrealistic and unjustified. In 1959 the Regulations were changed to the present form, which states simply that "the business of a corporation is not merely that which it has previously carried on but includes, in gen-

14. Treas. Reg. 118, § 39.102-3(b) (1939).

15. The Commissioner has taken this position even recently. See Electric Regulator Corp. v. Commissioner, 336 F.2d 339 (2d Cir. 1964), *reversing* 40 T.C. 757 (1963). "If the Treasury decides that the manufacture of 'Regohm' is the 'business,' then it would forever consign petitioner to the manufacture of that product and view its need accordingly." *Id.* at 345.

16. Kerr-Cochran, Inc. v. Commissioner, 253 F.2d 121, 124 (8th Cir. 1958).

17. *Ibid.* See also Automotive Rebuilding Co., 27 P-H Tax. Ct. Mem. 835 (1958). In holding an accumulation unreasonable, the Tax Court confined the taxpayer's needs to those of its "regular" business, although it suggested that an accumulation might be reasonable if the taxpayer had already engaged in another business or "immediately contemplated" so doing. However, in Jacob Sincoff, Inc. v. Commissioner, 209 F.2d 569 (2d Cir. 1953), the taxpayer was engaged in a securities business in addition to being a jobber in the paper business; nevertheless, the court thought that since investment in securities was one way of avoiding a tax on shareholders, the taxpayer could not argue that the needs of the securities business justified accumulating funds.

eral, any line of business which it may undertake."[18] There is no requirement in this Regulation that the new activity be related to the former, and the courts have implied no such limitation. Thus, a corporation may change businesses, or it may take on more than one business without being held automatically accountable under section 531.[19] Although courts seem to be somewhat more willing to approve accumulations for a second business which is related to the first,[20] even accumulations for totally unrelated endeavors are sanctioned if the second business is actively carried on.[21]

The requirement that the second business be "actively" carried on is an important qualification, however. While an individual may generally engage in any business or make any investment, corporate diversification is more circumscribed because of the possibility of tax avoidance. Legitimate corporate diversification under section 531 contemplates only *active* entry into new businesses or lines of products.[22] Passive investment in activities unrelated to the corporation's business, on the other hand, indicates that the funds so used are not needed in the business, and that under the theory of section 531 they should be distributed as dividends to the shareholders, who can then invest them, if they desire, to diversify their own holdings. While recognizing that "inactive employment" of corporate earnings ordinarily indicates an intent to assist stockholders in tax avoidance and thus calls for scrutiny, courts do acknowledge that mere passiveness does not of itself make accumulation unreasonable if the investment can be classed as a liquid asset and if the taxpayer can show that the accumulation was dictated by a business need requiring the maintenance of a liquid position.[23] For example, a temporary

18. Treas. Reg. § 1.537-3(a) (1959).

19. Sandy Estate Co., 43 T.C. 361 (1964).

20. See, *e.g.*, Havens & Martin v. United States, 65-1 U.S. Tax Cas. ¶ 9417 (E.D. Va. 1965); Buffalo Batt & Felt Corp. v. United States, 64-2 U.S. Tax Cas. ¶ 9724 (W.D.N.Y. 1964); Carolina Rubber Hose Co., P-H 1965 TAX CT. REP. & MEM. DEC. ¶ 65229; Alma Piston Co., 32 P-H Tax Ct. Mem. 1075 (1963); Youngs Rubber Corp., 31 P-H Tax Ct. Mem. 1766 (1962), *aff'd*, 331 F.2d 12 (2d Cir. 1964).

21. See, *e.g.*, Sandy Estate Co., 43 T.C. 361 (1964). The magnitude and character of petitioner's mortgage loan activities were found sufficient to constitute a legitimate "business" even though entirely unrelated to petitioner's apartment house business.

22. The requirement of "active" conduct of the new business is the clear import of the Treasury's re-definition of the "business" of a corporation in 1959. See Treas. Reg. § 1.537-3 (1959). See generally Altman, *supra* note 9; Altman, *Corporate Accumulation of Earnings*, 36 TAXES 933, 952 (1958). Where an entire business is passive, moreover, it is policed through the provisions of the Internal Revenue Code dealing with personal holding companies, §§ 541-47. See generally Libin, *Personal Holding Companies and the Revenue Act of 1964*, 63 MICH. L. REV. 421 (1965).

23. See, *e.g.*, Oyster Shell Prods. Corp. v. Commissioner, 313 F.2d 449 (2d Cir. 1963); R. Gsell & Co. v. Commissioner, 294 F.2d 321 (2d Cir. 1961), *reversing* 34 T.C. 41 (1960); Carolina Rubber Hose Co., P-H 1965 TAX CT. REP. & MEM. DEC. ¶ 65229. Investments in real estate activities, however, are usually considered tainted. See, *e.g.*, Bardahl Mfg. Corp., P-H 1965 TAX CT. REP. & MEM. DEC. ¶ 65200; J. Gordon Turnbull, Inc., 41 T.C. 358 (1963).

investment of funds was sanctioned where the necessity of paying a future tax liability was shown and considered a reasonable need of the business.[24] Similarly, the purchase of another corporation's stock which was readily convertible into cash was approved where the purchase was made with money retained under a profit-sharing plan and was intended as a partial funding of the corporation's liability under the plan.[25] Of course, if a permanent passive investment can itself be shown to be for the reasonable needs of the business, there is no question of its propriety, as, for instance, in situations involving the purchase of stock of a supplier to ensure a reliable source of supply,[26] loans to assist a company with which the taxpayer does business,[27] an investment in a bank with which the taxpayer does business,[28] or the purchase of government bonds for use as collateral to obtain outside financing.[29] While passive investments may thus be approved for limited purposes, it is otherwise clear that diversification of the corporate enterprise is proper only through the *active* carrying on of the new trade or business.

II. THE STANDARDS OF SECTION 531

While the difficulty of distinguishing carefully between the business of a corporation and that of the shareholders, and also between legitimate corporate diversification and mere diversion of corporate funds, may be a cause contributing to the problems of diversification within the framework of section 531, it is the responsibility of Congress, the Internal Revenue Service, and the

24. See Mead's Bakery, Inc., P-H 1965 TAX CT. REP. & MEM. DEC. ¶ 64104. See also Barrow Mfg. Co. v. Commissioner, 294 F.2d 79 (5th Cir. 1961); Bardahl Mfg. Corp., *supra* note 23.

25. See John P. Scripps Newspapers, 44 T.C. 453 (1965); Bremerton Sun Publishing Co., 44 T.C. 566 (1965).

26. See Bremerton Sun Publishing Co., *supra* note 25.

27. See Metal Office Furniture Co., 21 P-H Tax Ct. Mem. 952 (1952) (loans made to benefit the taxpayer through business relations). *But see* Raymond I. Smith, Inc. v. Commissioner, 292 F.2d 470 (9th Cir. 1961), where an investment was found unreasonable because of a gross disproportion between commitments made and prospective benefits to taxpayer. In Henry van Hummell, Inc., P-H 1964 TAX CT. REP. & MEM. DEC. ¶ 64290, though the benefit to be derived from an investment was said to be unclear, the investment was held to be reasonably related to taxpayer's business since it had been motivated by business negotiations and was liquidated when the negotiations were broken off.

Treas. Reg. § 1.537-2(c) suggests three types of loans which may indicate unreasonable accumulation: loans to shareholders, loans unrelated to the conduct of the business made to persons other than shareholders, and loans to corporations controlled by the shareholders of the taxpayer.

28. See Metal Office Furniture Co., *supra* note 27. *But see* Henry van Hummell, Inc., *supra* note 27, where it was held that since the taxpayer acquired only 2% of the bank's stock and gained no representation on the board of directors, there was no advantage to be derived from the investment.

29. See Bremerton Sun Publishing Co., 44 T.C. 566 (1965); Sandy Estate Co., 43 T.C. 361 (1964).

courts to accord recognition to corporate realities in designing and applying standards to test the reasonableness of corporate accumulations. From time to time overtures have been made in this direction, but the efforts have unfortunately fallen short of an adequate appraisal of the factors involved.

A. *Congress and the Internal Revenue Service*

When Congress was considering revision of the Internal Revenue Code in 1954, complaints were received that the section 531 tax was "prejudicial to small business," was "applied in an arbitrary manner," and was "a constant threat to expanding business enterprises."[30] The heart of the problem was the lack of adequate standards as to what constituted the reasonable needs of a business. Some of the standards which had been used to test the reasonableness of business needs were regarded by Congress as "erroneous or irrelevant."[31] Indeed, it was noted that revenue agents often "applied their individual concepts as to business needs."[32] One test in particular which was thought to warrant specific correction was the requirement that there must be an immediate need for the funds in the business before a retention of earnings could be justified.[33] To make it clear that a corporation committed to an expenditure of funds should not be subject to the section 531 tax while it accumulated sufficient funds to carry out its plans, section 537 was added to the Code, defining the reasonable needs of the business so as to include the *reasonably anticipated* needs of the business. The thrust of the congressional intent regarding application of this new section was embodied in a revision of the Regulations in 1959. The Regulations now state that the reasonableness of an accumulation is to be

30. S. REP. No. 1622, 83d Cong., 2d Sess. 68 (1954). In an effort to remedy this situation, several new provisions were enacted. First, § 534 was added to shift the burden of proof to the Commissioner in certain cases. It was felt that the prior procedure of placing the burden of proof on the taxpayer in all cases had had a number of undesirable consequences, such as insufficient screening of cases before assertions of deficiencies asserted, considerable expense and effort by taxpayers in proving accumulations reasonable, use of the tax as a threat to force settlement on other issues, and submission to the tax by taxpayers to avoid the expense of litigation. See *id.* at 70. For a discussion of how § 534 has failed to live up to the hopes for it, see generally Pye, *Section 534 and the Shiftless Burden of Proof*, 51 A.B.A.J. 784 (1965). Second, an accumulated earnings credit was provided for in § 535(c). See note 8 *supra*. The $60,000 (now $100,000) minimum credit was specifically designed to give small corporations an opportunity to accumulate for expansion without fear of the § 531 tax. The credit for so much of an accumulation as is shown to be for the reasonable needs of the business was included to avoid the harsh situation where most of an accumulation could be justified, but a small portion could not be.

31. For example, it had been the rule that a corporation which distributed 70% of its earnings would not be subjected to the tax. See Treas. Dep't Release, April 13, 1949.

32. S. REP. No. 1622, 83d Cong., 2d Sess. 69 (1954).

33. See, *e.g.*, Kerr-Cochran, Inc. v. Commissioner, 253 F.2d 121 (8th Cir. 1958).

determined, in general, by a "prudent businessman" test.[34] However, in allowing a corporation to justify an accumulation of earnings and profits on the basis of reasonably anticipated future needs, the Treasury Department adopted in the Regulations the congressional committees' language, which requires that further standards be met. Thus, "there must be an indication that the future needs of the business require such accumulation, . . . the corporation must have specific, definite, and feasible plans for the use of such accumulation,"[35] and, finally, execution of such plans must not be "postponed indefinitely."[36]

B. *The Courts*

While three elements—necessity, plans, and execution—are thus required to justify an accumulation for the reasonably anticipated future needs of a business, most section 531 cases have centered on the second of these elements, the corporate plans for the use of an accumulation. It has not been difficult for corporations to formulate some general "need," such as expansion, enlargement of working capital, or diversification,[37] and "execution" has rarely been a critical consideration. When the plans have been found insufficient, the question of execution has of course not been reached;[38] when the plans have been found sufficient, they have in fact usually been implemented.[39] In focusing their attention upon the second element, the plans for the use of the accumulated funds, the courts have placed great reliance on the standard of specificity, definiteness, and feasibility of the plans.[40] Several recent cases, however, indicate a certain degree of judicial disenchantment with the standards for evaluating the sufficiency of the plans.[41] The courts in these cases have felt constrained to talk in terms of the congressional language

34. Treas. Reg. § 1.537-1(a) (1959).

35. Treas. Reg. § 1.537-1(b)(1) (1959).

36. *Ibid.*

37. See, *e.g.*, Egan, Inc. v. Commissioner, 236 F.2d 343 (8th Cir. 1956); Robert R. Walker, Inc., P-H 1965 TAX CT. REP. & MEM. DEC. ¶ 65028. In J. Gordon Turnbull, Inc., 41 T.C. 358 (1963), however, taxpayer's investments in unrelated activities were thought to indicate that there was no need for the funds in the business.

38. See, *e.g.*, Carlen Realty Co. v. Tomlinson, 65-1 U.S. Tax Cas. ¶ 9425 (5th Cir. 1965); Robert R. Walker, Inc., *supra* note 37.

39. See, *e.g.*, Alma Piston Co., 32 P-H Tax Ct. Mem. 1075 (1963).

40. See, *e.g.*, Henry van Hummell, Inc., P-H 1964 TAX CT. REP. & MEM. DEC. ¶ 64290, at 1954-64: "The cases have held repeatedly, and the . . . Regulation requires, that the corporation . . . must have definite and specific plans for this use." See also Barrow Mfg. Co. v. Commissioner, 294 F.2d 59 (5th Cir. 1961); I. A. Dress Co. v. Commissioner, 273 F.2d 543 (2d Cir.), *cert. denied*, 362 U.S. 976 (1960); Robert R. Walker, Inc., P-H 1965 TAX CT. REP. & MEM. DEC. ¶ 65028.

41. Electric Regulator Corp. v. Commissioner, 336 F.2d 339 (2d Cir. 1964), *reversing* 40 T.C. 757 (1963); Oman Constr. Co., P-H 1965 TAX CT. REP. & MEM. DEC. ¶ 65325; Freedom Newspapers, Inc., P-H 1965 TAX CT. REP. & MEM. DEC. ¶ 65248; Carolina Rubber Hose Co., P-H 1965 TAX CT. REP. & MEM. DEC. ¶ 65229; Alma Piston Co., 32 P-H Tax Ct. Mem. 1075 (1963).

and the language of the Regulations, but they have qualified that language in such a way as to indicate a recognition that the standard of specificity holds no magic in itself. Rather, it is merely a frequently convenient measure of the likelihood that a corporation will follow through with an avowed goal. As the courts which have been troubled by the specificity standard recognize, there are other instances where specificity of plans is not a realistic standard by which to test corporate accumulations. It is suggested that this is especially true when the "business need" identified is diversification. As noted previously, opportunities for diversification are not always readily available, and a corporation legitimately planning to undertake diversification out of internally generated funds may often be required to accumulate funds for an indefinite period without specific plans for their use. While the courts must not permit violations of section 531, neither must they ignore these realities of corporate life.

III. A New Approach

The approach of the courts in recent cases has been that if a corporation is able to demonstrate, by reference to factors other than specificity of plans, a sufficient likelihood that it will follow through with its expressed intentions for use of accumulated funds, the mere absence of specificity of plans should not warrant section 531 liability. The analysis required by this approach involves a more extended inquiry into the facts of each case than a mere search for specific plans. In addition, if this approach is indicative of a trend, section 531 cases will depend more than ever upon the facts of each case. It is possible, nevertheless, to categorize certain situations and to identify certain factors which would indicate when and to what extent the rigidity of the specificity requirement might be relaxed.

A. *Involuntary Diversification*

When diversification is involuntary—that is, when there are hazards facing a business which would indicate to a prudent businessman the need for diversification—the likelihood of a planned diversification becoming a reality is increased sufficiently to allow a concomitant decrease in the reliance on the specificity of the plans, so long as there is some additional evidence that the taxpayer intends to meet the hazards. Of course, funds may not legitimately be accumulated for unrealistic hazards,[42] for "vague and unsupported premonitions of the future,"[43] or for "unexpected demands" or

42. Treas. Reg. § 1.537-2(c)(5) (1959).

43. Youngs Rubber Corp., 31 P-H Tax Ct. Mem. 1766 (1962), *aff'd*, 331 F.2d 12 (2d Cir. 1964). *Compare* KOMA, Inc. v. Commissioner, 189 F.2d 390 (10th Cir. 1951), *and* Southland Indus., Inc., 15 P-H Tax Ct. Mem. 897 (1946), *with* Havens & Martin v. United States, 65-1 U.S. Tax Cas. ¶ 9417 (E.D. Va. 1965).

"unanticipated emergencies."[44] When the hazards are real, however, the remedial measures undertaken by the taxpayer are likely to be just as real. Furthermore, that the hazard is only a contingency should be immaterial, because regardless of the occurrence of the contingent event, the important points are whether the taxpayer reasonably believes that it will be forced to enter a new business and whether it intends to enter the new business when and if the imminence of the threat should demand such action.[45] Thus, it has been persuasively argued that "a corporation which sees a financial storm on the horizon should be able to accumulate earnings merely to weather the storm, to provide a cushion against a foreseeable drain on earnings and/or capital without having to use the funds for diversification—a diversification which might not be needed when the financial storm has passed."[46] Although it did not arise in the diversification setting, the recent case of *Oman Constr. Co.*[47] is illustrative of this principle. Taxpayer, a heavy construction company, retained earnings in order to protect against the risks of loss which were particularly acute in its foreign construction projects because of transportation hazards, political upheaval, native labor problems, currency exchange limitations, health risks, and communications difficulties. In addition, in taxpayer's business it bid on many jobs but did not know in advance which bids would be successful. Once a bid was accepted, however, taxpayer was committed to complete the job, with the constant possibility of having to buy more equipment. While it has frequently been held in the past that a corporation may reasonably protect against contingencies,[48] here the Commissioner argued that taxpayer must have specific plans for use of its accumulated funds in order to justify their retention. Although taxpayer had no *specific* plans for the use of its accumulated funds for each purpose identified, further analysis showed *sufficient possibility* of use of the funds for equipment, qualification to bid, losses, renegotiation refunds, and maintaining an organization of engineers and superintendents, that the Tax Court found that the accumula-

44. Smoot Sand & Gravel Corp. v. Commissioner, 241 F.2d 197 (4th Cir.), *cert. denied*, 354 U.S. 922, *rehearing denied*, 354 U.S. 943 (1957).

45. Smoot Sand & Gravel Corp. v. Commissioner, *supra* note 44. The court of appeals reversed the Tax Court, which had said that the taxpayer never planned to enter the new business voluntarily and that the contingency which might have forced it to do so never developed. 25 P-H Tax Ct. Mem. 330 (1956). See also Havens & Martin v. United States, 65-1 U.S. Tax Cas. ¶ 9417 (E.D. Va. 1965).

46. Henry van Hummell, Inc., P-H 1964 TAX CT. REP. & MEM. DEC. ¶ 64290, at 1954-64 (dictum); *cf.* Ted Bates & Co., P-H 1965 TAX CT. REP. & MEM. DEC. ¶ 65251.

47. P-H 1965 TAX CT. REP. & MEM. DEC. ¶ 65325.

48. See, *e.g.*, Smoot Sand & Gravel Corp v. Commissioner, 241 F.2d 197 (4th Cir.), *cert. denied*, 354 U.S. 922, *rehearing denied*, 354 U.S. 943 (1957). *But see* Henry van Hummell, Inc., P-H 1964 TAX CT. REP. & MEM. DEC. ¶ 64290 (plans for contingency must be specific).

tion for the "collective" purposes could not be said to be unreasonable.

When the hazards are both realized and permanent rather than merely contingent, the effort to diversify will ordinarily be more intensive, but the problem of specificity of plans is the same. One of the most persuasive evidences that a "permanent hazard" is confronting a corporation is a decline in business. While some business declines might be reversed by cutting costs or increasing sales promotion, often the only way to remedy the decline is to diversify into a new business or line of products. An examination of the reasons for a decline in business is thus necessary in order to determine the probability of diversification taking place because of the decline. The strongest case is a complete cutting off of the taxpayer's business, as, for instance, through loss of a franchise. Here, a corporation's only alternative to dissolution is to enter a new business. Therefore, unless such a taxpayer is making no bona fide effort to find a suitable new business, the absence of specific plans should not warrant a section 531 penalty.[49] Almost as convincing a situation is one involving a technological change which causes the taxpayer's product to become obsolescent. The extent of both the innovation and the resultant obsolescence must be examined, but where they indicate continued decline or eventual termination of the taxpayer's business, the situation is the same as above.[50] In *Electric Regulator Corp. v. Commissioner*,[51] for example, taxpayer argued that technological change in its industry necessitated

49. In Egan, Inc. v. Commissioner, 236 F.2d 343 (8th Cir. 1956), the taxpayer corporation had operated a Chevrolet dealership which was cancelled on October 31, 1948, leaving the taxpayer with $750,000 in idle funds. When the corporation was liquidated in 1953 upon the death of the sole shareholder, however, it still had not undertaken any new business. This delay is of itself, of course, some evidence of an intent to avoid tax. See Treas. Reg. § 1.537-1(b)(2) (1959). In addition, there was little evidence that any real effort had been made to find a new business, except an expression of concern in the minutes of the corporation and a change in the corporate charter to permit the carrying on of a real estate business. While diversification opportunities may not be readily available, certainly it must be recognized that there comes a point at which failure to put idle funds to work must be penalized.

50. In Buffalo Batt & Felt Corp. v. United States, 64-2 U.S. Tax Cas. ¶ 9724 (W.D.N.Y. 1964), an accumulation was held reasonable where, because of the development of substitutes for cotton batting in the furniture industry, and because the furniture and textile industries were moving to the South and thus impairing taxpayer's ability to compete, taxpayer expected severe declines in its business. Taxpayer was "contemplating" production of a synthetic fiber fill and was "considering" acquisition of a furniture company.

In Youngs Rubber Corp., 31 P-H Tax Ct. Mem. 1766 (1962), *aff'd*, 331 F.2d 12 (2d Cir. 1964), taxpayer, a manufacturer of rubber prophylactics, had already diversified into other lines of similar products to meet the competitive threat of oral contraceptives. An accumulation of $500,000 labeled simply for "technological progress," was thus thought by the court to be unreasonable.

51. 336 F.2d 339 (2d Cir. 1964), *reversing* 40 T.C. 757 (1963).

the retention of funds to develop new products. The Court of Appeals for the Second Circuit reversed the Tax Court's finding of unreasonable accumulation, noting that in this day of rapid technological change products may quickly become outmoded and it is not always possible for a corporation to have a specific goal at the time funds are set aside. "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 may have to be appropriately qualified in particular cases."[52] The court noted that taxpayer, a manufacturer of electric regulating devices, was in a field where technological change was a particularly relevant consideration. Indeed, demand for taxpayer's primary product had recently fallen off to the extent that it had been forced to develop a number of new products, necessitating greater space and equipment. The possibility of a recurrence of such a decline required that taxpayer be allowed to accumulate funds to develop new products. Also illustrative of the extent to which technological change will spur diversification is *Alma Piston Co.*,[53] in which taxpayer, a supplier of automotive clutches, suffered a business decline when automatic transmissions were introduced on a large scale. During a four-year period, taxpayer accumulated funds with which it hoped to acquire a new business. The Commissioner assessed a section 531 penalty tax, arguing that taxpayer had no specific plans during the accumulation period, but the Tax Court, noting that a new business had eventually been acquired after lengthy negotiations, stated that "in our view such plans were specific and definite and were clearly feasible as is established by their consummation . . . ."[54] Certainly it can be questioned whether taxpayer's plans were indeed "specific" during all of the years in issue; nevertheless, there would appear, by reason of the nature of taxpayer's business decline and its intensive search for a new business, to have been sufficient likelihood of diversification that the accumulation was properly held reasonable.

Finally, instances may occur where the taxpayer's buyers suffer a decline in business which is then reflected in taxpayer's business. The persuasiveness of this reason for accumulation of funds with a view to diversification depends in turn upon the reason for the buyers' decline, but to the extent that the decline is caused by factors which render the taxpayer's position incapable of improvement by means other than diversification; once again diversification is probable even apart from specific plans. For example, in *Carolina Rubber*

52. *Id.* at 346.
53. 32 P-H Tax Ct. Mem. 1075 (1963).
54. *Id.* at 1094.

Hose Co.,[55] taxpayer was engaged in the railroad hose business, but planned to convert to the rubber roll business because of the decline of railroads. Once again the Commissioner asserted that the plans were not sufficiently specific. The court, although apparently convinced that taxpayer would eventually consummate its plans, was very much concerned with the specificity requirement of the Regulations. The court finally concluded, however, that the plans were not "so uncertain or vague as to be disqualified."[56] Here again the strict specificity of the plans could probably be drawn into question, but the indicia of the necessity for modernization and diversification were sufficient to indicate the likelihood that taxpayer would accomplish its avowed intention. The court acknowledged that further developments might prove its judgment wrong, but stated that subsequent years must be judged in light of the facts as they then exist.[57]

The mere fact that a business is faced with hazards cannot of course be said to indicate conclusively that an accumulation of funds is for the reasonable needs of the business. However, to the extent that the pressures caused by the hazards indicate that the business must undertake diversification to rectify the situation, and to the extent that the taxpayer indicates that it is embarking on those steps as an alternative to stagnation or dissolution of the business, it seems reasonable that the emphasis placed upon the requirement of specific plans for use of an accumulation should be decreased.

B. *Voluntary Diversification*

It is clear that a corporation may, of its own free will, accumulate funds in order to diversify its operations. When the diversification is purely voluntary, however, the standards for testing the accumulation must be strict. In such cases, requiring specificity of plans may be the best way to ensure that a corporation will follow through with the diversification and not merely accumulate funds, avoid taxation, and yet continue to claim that it intends to diversify. Even here, however, there may be instances when specific plans should not be required. This was the case in *Freedom Newspapers, Inc.*,[58] where taxpayer, which accumulated funds to acquire other newspaper publishing companies, successfully overcame the Commissioner's charge of lack of specific plans by showing that its need for expansion and

55. P-H 1965 TAX CT. REP. & MEM. DEC. ¶ 65229.

56. *Id.* at 1281-65. *But see* Robert R. Walker, Inc., P-H 1965 TAX CT. REP. & MEM. DEC. ¶ 65028. In *Walker*, taxpayer transported Studebaker automobiles, but in 1957 was investigating new lines of business because Studebaker's business was declining. The Tax Court held, however, that since in 1957 the taxpayer had no specific plans for the use of its accumulated earnings, those earnings were unreasonable.

57. P-H 1965 TAX CT. REP. & MEM. DEC. ¶ 65229, at 1282-65.

58. P-H 1965 TAX CT. REP. & MEM. DEC. ¶ 65248.

acquisition of other newspapers was reasonable, in view of a trend in the newspaper business toward consolidation and large chain operations, a desire for greater dissemination of its political views, the need to give promising young executives greater responsibility and financial opportunity, and, finally, taxpayer's history of acquisitions. The Tax Court, in holding the accumulation reasonable, analyzed the specificity requirement in the context of the particular business involved, and concluded that where opportunities for expansion and acquisition are not readily available, plans need not be as definite as might otherwise be required to support a finding of reasonableness. The court recognized the unique nature of the newspaper industry and decided that since newspapers were not fungible commodities, it was not possible for the taxpayer to acquire another newspaper immediately upon a decision to do so. The most a taxpayer in such a situation may be able to do, it was concluded, is to demonstrate "a concurrent course of action . . . directed toward the averred purpose of accumulation,"[59] or, in other words, "actively [to] search out opportunities for acquisitions."[60] Thus, even in the voluntary diversification situation it may be possible for a corporation to set forth sufficient indicia that the likelihood of diversification occurring can reasonably be said to outweigh the possibility of a section 531 violation.[61]

IV. Conclusion

The foregoing discussion has been presented on the basis of reported cases. It may be that, in the many instances which never reach the courts, the attitude of examining agents and regional settlement officers toward the above problems is actually more reasonable than that reflected by the Commissioner's litigation policy. Nevertheless, litigated cases, with the exception of those referred to above, indicate a strict policy on the part of the Service and the courts. Since it is important that taxpayers not be deterred from valid diversification and economic growth, it is suggested that steps be taken to reassure taxpayers that their good faith efforts will not be thwarted by what appear to be the unduly restrictive standards now used to determine the permissibility under section 531 of accumulation of funds. Perhaps what the courts have been doing in the recent cases previously discussed is simply applying the Regulations' general test of the

59. *Id.* at 1465-65.

60. *Ibid.*

61. See also Mead's Bakery, Inc., P-H 1964 Tax Ct. Rep. & Mem. Dec. ¶ 64104, where taxpayer, in order to obtain a loan, was required to agree not to enter any new line of business. The court held reasonable an accumulation of funds with a view to entering the potato chip and frozen baked goods businesses, which taxpayer had entered indirectly through its shareholders with the understanding that it would acquire the businesses directly when the loan restrictions were lifted.

"prudent businessman." If so, it would seem advisable to eliminate the specificity requirement from the regulatory criteria, and to make specificity merely a factor to be employed where useful. In addition, to give some guidance to taxpayers and revenue agents, revenue rulings and examples in the Regulations should be published to show the types of situations in which a mere absence of specific plans should not warrant the imposition of the accumulated earnings penalty tax.

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