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AN ANALYSIS OF THE POLICIES AND PRACTICES OF THE INTERNAL  
REVENUE SERVICE IN IMPLEMENTING THE ACCUMULATED EARNINGS  
TAX

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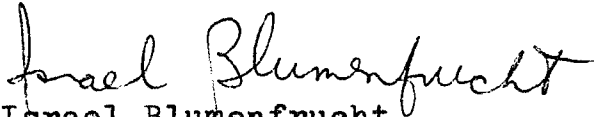
Sponsoring Committee: Professor Mary R. Sumner, Chairperson  
Professor Robert T. Johnson  
Professor Nathan Kahn

AN ANALYSIS OF THE POLICIES AND PRACTICES  
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Israel Blumenfrucht

Submitted in partial fulfillment of the  
requirements for the degree of Doctor of Philosophy in the  
School of Education, Health, Nursing, and Arts Professions of  
New York University

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Sponsoring Committee: Professor Mary R. Sumner, Chairperson  
Professor Robert T. Johnson  
Professor Nathan Kahn

An Abstract of  
AN ANALYSIS OF THE POLICIES AND PRACTICES  
OF THE INTERNAL REVENUE SERVICE IN  
IMPLEMENTING THE ACCUMULATED EARNINGS TAX

ISRAEL BLUMENFRUCHT

Submitted in partial fulfillment of the  
requirements for the degree of Doctor of Philosophy in the  
School of Education, Health, Nursing, and Arts Professions of  
New York University

1981

A handwritten signature in cursive script, reading "Mary R. Sumner". The signature is written in black ink and is located in the bottom right corner of the page.

## ABSTRACT

The accumulated earnings tax is a penalty tax levied in addition to the regular corporate income tax and is imposed on any corporation which satisfies two conditions:

(1) The corporation accumulated earnings beyond the reasonable needs of the business (referred to as the objective condition) and (2) the corporation is formed or availed of for the purpose of avoiding income taxes with respect to its shareholders (referred to as the subjective condition).

The basic purpose of this penalty tax is to eliminate corporate shareholders' propensity to avoid the double taxation on corporate income by having the corporation accumulate earnings within the corporation instead of distributing them as dividends.

Although the Internal Revenue Code specifically states that "every corporation" could be subject to the accumulated earnings tax, the Internal Revenue Service has levied the tax only against closely-held corporations. Closely-held corporations contend that by merely applying the accumulated earnings tax against their corporations, the Internal Revenue Service has, in effect, stunted their ability to grow and expand.

Accordingly, this study provided a thorough review and analysis of the accumulated earnings tax in order to

determine whether the accumulated earnings tax could be, and indeed should be, applied to publicly-held corporations.

This was accomplished in a three step process. First, an analysis was presented of the historical development, interpretation and evolution of the tax legislation that has resulted in the current application of the provisions of the Internal Revenue Code which relate to the accumulated earnings tax.

Second, the results of the analysis obtained in reviewing the legislative history of the accumulated earnings tax were applied to help understand and identify the specific criteria used by the Internal Revenue Service when determining if a particular corporation is subject to the accumulated earnings tax. The criteria were developed from the twenty-five factors listed in the Tax Audit Guidelines, which are supposed to be referred to by IRS agents when determining whether to pursue an audit of a corporation with respect to the accumulated earnings tax.

Third, a model was developed for determining which specific publicly-held corporations could be subject to the accumulated earnings tax. The model consists of four test questions which were formulated on the basis of the criteria previously identified.

The model was applied to the universe of all corporations listed on the New York and American Stock Exchanges whose financial statement data are included on the COMPUSTAT

computer tape. Each corporation was tested for a six year period beginning with calendar or fiscal year 1972 and ending with 1977. Forty-six publicly-held corporations were found to have answered all four of the model's test questions in the affirmative and therefore could be subject to the accumulated earnings tax.

Thus, this study showed that publicly-held corporations could be subject to the accumulated earnings tax if the same criteria used to determine whether a closely-held corporation is subject to the accumulated earnings tax are applied to publicly-held corporations. In addition, this study illustrated the important role research should play in the area of tax education, as well as detailing the various procedures to be followed in the process of researching and analyzing a particular tax law.

## ACKNOWLEDGMENTS

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Dr. Robert T. Johnson carefully reviewed the entire manuscript and provided unwavering support throughout the period of the study.

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## CHAPTER I

### INTRODUCTION, PURPOSE AND SCOPE OF THE STUDY

#### Introduction

In its recently completed study on the Future of Small Business in America, the House of Representative's Committee on Small Business concluded that "the role of small business in our economy is declining at an alarming rate. As the number of small businesses in industries declines and the concentration ratios [of assets held by large corporations] increase, the continuing viability of small firms is severely threatened."<sup>1</sup>

One of the major reasons cited in the study for the decline of small business is "the inequities of the tax code which often discriminates against the small business."<sup>2</sup> Moreover, the subjective manner in which the Internal Revenue Service implements certain tax laws can have a profound effect on any taxpayer, business or going concern.<sup>3</sup>

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<sup>1</sup>U.S., Congress, House, Committee on Small Business, Future of Small Business in America, 96th Cong., 1st sess., (Washington, D.C.: Government Printing Office, 1979), p. 17.

<sup>2</sup>Ibid., p. 24.

<sup>3</sup>Robert W. Merry, "Small Business, Irked by Taxes and Rules, Develops Political Savvy to Press Its Case," Wall Street Journal, 27 July 1979, p. 36.

Although not specifically cited in the study, the accumulated earnings tax is an example of a tax which, it appears, is being applied in a discriminatory manner. The Internal Revenue Service has levied the tax only against closely-held corporations, i.e., generally small business corporations with relatively few shareholders, and not against large publicly-held corporations.

It is for this reason that shareholders, and those advocating the position of closely-held corporations, have consistently urged Congress to repeal this tax in its entirety.<sup>4</sup> However, closely-held corporations have heretofore been unable to persuade Congress to change the law or convince the Internal Revenue Service to apply the tax in a manner which would subject either both closely-held corporations and publicly-held corporations or neither to the accumulated earnings tax.

This study provides a thorough review and analysis of the accumulated earnings tax in order to determine whether the accumulated earnings tax could be, and indeed should be, applied to publicly-held corporations. Furthermore, this study may enable small business corporations to present a forceful argument that the accumulated earnings tax is being applied in a discriminatory and subjective manner and that the tax should therefore either be applied evenhandedly or entirely abolished. Lastly, this study illustrates for

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<sup>4</sup>Kenneth Greenhut, "The Accumulated Earnings Tax--A Call for Repeal," CPA Journal, 66 (August 1977): 23.

educators and students engaged in scholarly research the general procedures which must be followed in the process of researching and analyzing a particular tax law.

### Problem

The problem of this study is to determine the policies and practices of the Internal Revenue Service in implementing the accumulated earnings tax and the application of those policies and practices to publicly-held corporations.

### Sub-problems

1. To review and analyze the legislative history of the accumulated earnings tax in order to clearly understand the intent and purpose of the tax.

2. To identify the specific criteria being used by the Internal Revenue Service in determining if a particular corporation is subject to the accumulated earnings tax.

3. To determine which specific publicly-held corporations could be subject to the accumulated earnings tax based on the criteria identified in sub-problem 2.

### Definitions

Accumulated earnings tax. The accumulated earnings tax is a penalty tax imposed upon corporations which accumulate earnings beyond the reasonable needs of the business in order to avoid having its shareholders pay income taxes on such earnings. If imposed, the penalty tax must be paid in

addition to the regular corporate income tax.<sup>5</sup>

Bureau of Internal Revenue. Commonly referred to as the Bureau, it was charged with the responsibility of administering and enforcing Federal tax laws until it was reorganized in 1953 and renamed the Internal Revenue Service.<sup>6</sup>

Cash equivalents. This refers to any short-term marketable security which can be converted into cash either by demanding cash from the issuer of the security or selling the security on a secondary market. Examples include short-term commercial paper and Treasury notes.

Capital gains. "A capital gain is one which results from a sale or exchange of property which is a capital asset" such as stocks or bonds held for investment purposes.<sup>7</sup> Capital gains are accorded special tax treatment in that individual taxpayers may generally exclude 60% of such gains from inclusion in their taxable income.

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<sup>5</sup>J. William Lewis, Accumulated Earnings Tax, ed. Leonard L. Silverstein, (Washington, D.C.: Tax Management Inc., 1979), p. A-1.

<sup>6</sup>U.S., Congress, Joint Committee of Internal Revenue Taxation, The Internal Revenue Service: Its Reorganization and Administration, Joint Committee Print, (Washington, D.C.: Government Printing Office, 1955), p. 1; "Goodbye Bureau: Hello Service," Journal of Accountancy, 96 (September 1953): 296.

<sup>7</sup>1980 Federal Tax Course, (Chicago: Commerce Clearing House, Inc. 1979), p. 410.

Closely-held corporation. A corporation whose shares of outstanding stock are owned by a few shareholders and are not traded by the public on any stock exchange.

Code. See definition of Internal Revenue Code of 1954.

Dividend. This is the amount of corporate taxable income distributed to the corporation's shareholders.

Income Tax Regulations. The Department of the Treasury, under authority granted to it by Congress, issues the Income Tax Regulations, referred to as the Regulations, which amplify, explain and interpret the tax laws cited in the Code. The Regulations generally have the same legal effect and force of law as the Code itself.<sup>8</sup>

Internal Revenue Code of 1954. All income, estate, gift and excise tax laws, along with administration and procedure rules enacted by Congress are codified into this instrument, referred to as the Code. This is the Code in existence today, and all new laws enacted since 1954 merely amend the Internal Revenue Code of 1954.<sup>9</sup>

Internal Revenue Service. The responsibility for administering the Federal tax laws rests with the Department of the Treasury. The Internal Revenue Service, referred to as the IRS, is part of the Treasury Department and is responsible

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<sup>8</sup>Lawrence Philips and William Hoffman, ed., West's Federal Taxation: Individual Income Taxes, (Minnesota: West Publishing Co., 1978), p. 34.

<sup>9</sup>Ibid., p. 9.

for determining, assessing and collecting Federal taxes, and enforcing the tax laws.<sup>10</sup>

Penalty tax. As used in this study, the term penalty tax is synonymous with accumulated earnings tax. See definition of accumulated earnings tax.

Publicly-held corporation. A corporation whose shares of outstanding stock are traded by the public on a stock exchange.

Working Capital. Working capital is "the excess of current assets over current liabilities and identifies the relatively liquid portion of the total enterprise capital which constitutes a margin or buffer for meeting obligations within the ordinary operating cycle of the business."<sup>11</sup>

#### Limitations

All publicly-held corporations are required by law to publish their financial statements and make them available to the public. However, they are not required to do the same for their corporate income tax returns. Accordingly, all data used in this study, whether pertaining to tax related concepts or financial accounting concepts, must be derived from the corporations' published financial statements. This is not, however, a critical limitation since most of the data

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<sup>10</sup>1980 Federal Tax Course, p. 119.

<sup>11</sup>Accounting Research Bulletin No. 43, (New York: American Institute of Certified Public Accountants, 1953), chapter 3, section A, para. 2.



necessary to determine if a corporation has accumulated earnings beyond the reasonable needs of a business (and thereby have it subject to the accumulated earnings tax) must be derived from the data presented in the corporation's financial statements.

A second limitation concerns the validity of determining IRS policy and practice by analyzing court cases. In most instances, if the IRS assesses a tax deficiency and the taxpayer disagrees with the assessment, a compromise is proposed and the case is generally settled out of court. Thus, court cases, at best, represent only a minority of situations in which the IRS assesses a tax deficiency and therefore may not reflect the entire spectrum of IRS policies and practices. However, this is not a critical limitation since court cases were found which discussed each major issue reviewed and analyzed in this study. Moreover, analyzing court cases was only one of the methods used for determining IRS policy and practice.

#### Significance of the Study

The United States economy is currently experiencing an unusually prolonged period of high inflation and high interest rates. In this economic climate entrepreneurs find it extremely difficult to organize and establish small businesses. Moreover, even established businesses are now finding it difficult to survive.<sup>12</sup>

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<sup>12</sup>Daniel Hertzberg, "Smaller Businesses Fear They Will Bear Brunt of Right-Credit Policy," Wall Street Journal, 16 October 1979, p. 10.

Indeed, the data from various studies indicate that small businesses are on the decline. For example, the chart in Figure 1, which is based on data compiled by the Federal Trade Commission, illustrates that the largest manufacturing concerns (with assets of \$1 billion or more) controlled approximately 29% of the total manufacturing assets in 1960 and nearly 52% in 1976 - a 79% increase.<sup>13</sup> Furthermore, by 1976 manufacturing concerns (with assets of \$50 million or less) controlled 30% of the total manufacturing assets in 1960 and only 18% in 1976 - a 40% decrease.

Among the major reasons cited as causes for the decline of small businesses are three interrelated factors: (1) inflation, (2) capital formation and (3) taxation.<sup>14</sup>

#### Inflation

While both small and large businesses are adversely affected by high inflation rates, small businesses are hit first and hardest. As costs for materials, wages and overhead are pushed upward by the inflationary spiral it becomes more difficult for small businesses to absorb even a portion of these increased costs. Thus, they are forced to pass along the increased costs in the form of higher prices, thereby placing them at a disadvantage and requiring them to contribute

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<sup>13</sup>U.S., Congress, House, Future of Small Business in America, p. 12.

<sup>14</sup>Ibid., pp. 22-26.

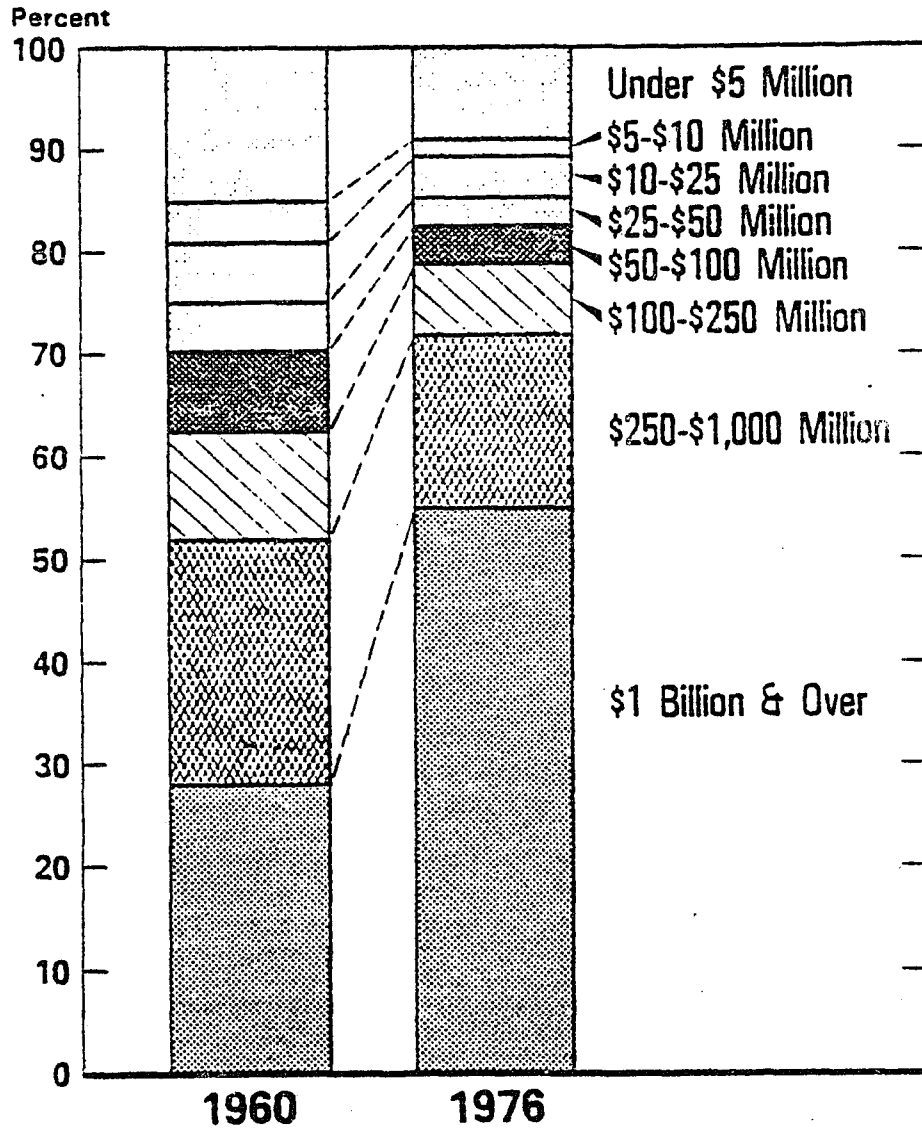


Fig. 1. Concentration of total assets for manufacturing corporations, 1960 and 1976.

to the inflationary spiral that may ultimately be their undoing.<sup>15</sup>

Furthermore, as noted by James McKeivitt, the Chief Washington Counsel for the National Federation of Independent Businesses, inflation gives rise to an additional problem:

The second major problem caused by inflation is cash flow. To illustrate its importance let me point out that approximately one of two small businesses borrows regularly. Much of that borrowing would occur regardless of the inflation rate. However, inflation takes a difficult problem and makes it often acute because inflation not only heightens the extent of cash needed, but also requires its financing at higher rates. This situation is particularly devastating in firms with relatively high inventory and low turnover.<sup>16</sup>

#### Capital formation

The interrelationship between inflation and the ability of businesses to raise capital is quite clear. Inflation causes interest rates to rise, which in turn reduces the flow and amount of money in the economy.

While high interest rates and tight monetary policies affect the ability of both large and small businesses to raise needed capital, the impact on small businesses is more severe. John Kenneth Galbraith emphasized the effect of a tight monetary policy on the ability of small businesses to pay for and raise capital as follows:

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<sup>15</sup>Daniel Hertzberg, "Smaller Businesses Fear They Will Bear Brunt of Tight Credit Policy," p. 1.

<sup>16</sup>U.S., Congress, House, Committee on Small Business, Future of Small Business in America, Hearings before a subcommittee on Antitrust, Consumers and Employment, 2 vols., 95th Cong., 2nd sess., 1978, 1:34.

The initial effect [of monetary policy] is obviously on those who borrow money. The industries that depend on borrowed money are characteristically the small firms . . . . Credit is generally vital for the small firm. So it is the small firm that is hit first and hardest by monetary policy. Being small and subject to the market, such firms cannot pass the higher interest costs of money on to their customers. The large corporation, in contrast, is far more likely . . . to have resources from its own earnings. If it must borrow, it can use its market power to pass the higher costs of money on to the public. And, needless to say, it is always the first in line at the bank.<sup>17</sup>

### Taxation

As a result of the manner in which certain tax laws have been formulated and implemented, small businesses often carry a greater tax burden as compared to large corporations. This is particularly true with regard to the large corporations' ability to take advantage of tax incentives, "loop-holes" and shelters.

For example, the 1976 Annual Corporate Tax Study, released by Congressman Charles Vanik, revealed that the effective tax rate of the major corporations examined had been reduced by 8% from the previous year and that numerous multi-billion dollar firms had completely escaped paying any effective Federal corporate income tax.<sup>18</sup> Furthermore, although the investment tax credit, which is designed to encourage capital investment by offering tax benefits, is available to both small and large businesses, 66%, or \$2.7 billion, of the credit

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<sup>17</sup>Ibid., 2:34-35.

<sup>18</sup>U.S., Congress, House, 95th Cong., 1st sess., 26 January 1978, Congressional Record 124:E168-E176.

was claimed by only 1,300 corporations--less than one-tenth of 1 percent of all U.S. corporations.<sup>19</sup>

An inflationary economy compounds the problems facing small businesses. As previously noted, capital becomes scarce in periods of inflation and while taxation has the effect of draining capital from all businesses and corporations, it is considered "a major factor in the reduced flow of capital to smaller firms."<sup>20</sup>

Furthermore, the problem of taxation becomes more acute for small businesses if any tax is applied solely against them and not against large corporations. The result of such a discriminatory practice is to place small businesses at an even greater competitive disadvantage.

One tax law which has the potential of adversely affecting the viability of small business corporations is the accumulated earnings tax.<sup>21</sup> Historically, the accumulated earnings tax has been merely imposed upon small business corporations, owned by relatively few shareholders, referred to as "closely-held corporations." Thus, unless a valid reason can be given for applying the tax against closely-held corporations and not against the larger publicly-held corporations, the accumulated

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<sup>19</sup>U.S., Congress, House, Future of Small Business in America, p. 26.

<sup>20</sup>Ibid., p. 25.

<sup>21</sup>Robert S. Holzman, Accountant's and Treasurer's Complete Guide to the Accumulated Earnings Tax (New Jersey: Prentice-Hall, Inc., 1974), p. 4.

earnings tax should be characterized as a discriminatory-type tax which could be contributing to the decline of small business.

#### The Accumulated Earnings Tax

The accumulated earnings tax has been in effect since 1913, the year in which Congress passed the first official income tax in the United States.<sup>22</sup> Since its original enactment, the tax has been consistently revised and amended. In its current form, the accumulated earnings tax is a penalty tax levied in addition to the regular corporate income tax and is imposed on any corporation which satisfies two conditions: (1) The corporation is formed or availed of for the purpose of avoiding income taxes with respect to its shareholders and (2) the corporation has accumulated earnings beyond the reasonable needs of the business.<sup>23</sup>

Determining whether the corporation has satisfied the first condition generally requires a subjective test of corporate intent and purpose. The second condition can be verified by a more objective test which compares the reasonable needs of the business with the corporation's accumulated earnings.<sup>24</sup>

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<sup>22</sup>George E. Lent, The Impact of the Undistributed Profits Tax 1936-1937 (New York: Columbia University Press, 1948), pp. 11-12.

<sup>23</sup>Don Farmer, "Accumulated Earnings Tax: How to Anticipate the Service's Position and Thus Avoid a Penalty," Taxation for Accountants 19 (July 1977):4.

<sup>24</sup>J. William Lewis, Accumulated Earnings Tax, ed. Leonard L. Silverstein, (Washington: Tax Management, Inc., 1979), p. A-1.

In order for the penalty tax to be imposed, both conditions must be satisfied. Thus, the Internal Revenue Code does not prohibit a corporation from accumulating earnings and profits, but rather prohibits a corporation from accumulating earnings and profits beyond its reasonable business needs in order to avoid having its shareholders pay income taxes on such earnings and profits.

#### The Purpose of the Accumulated Earnings Tax

The basic purpose and premise of this penalty tax has not substantially changed in the nearly seven decades since its enactment--to eliminate corporate shareholders' propensity to avoid being subject to tax on income earned by their corporation. An understanding of how corporate income is taxed under our Federal income tax system will make clear how shareholders may avoid the imposition of tax and how the accumulated earnings tax attempts to thwart this objective. Corporate profits are generally subject to double taxation--once at the corporate level when the corporation earns the income and again at the shareholder level when the corporation distributes its net income as dividends to its shareholders. In order to avoid the double tax on dividend income, shareholders may attempt to have their corporations not distribute the income it earned (which if distributed would be considered a taxable dividend to the shareholders), but to instead have the corporation retain and accumulate its earnings within the corporation thereby at least postponing the need to pay a tax on a dividend distribution. This scenario would then have



the corporation distribute the corporation's earnings as dividends only when the shareholders are in a more favorable tax position, at which time any tax burden would be lighter.<sup>25</sup>

In fact, shareholders may be able to permanently avoid having such dividends taxed at the higher tax rates applied to ordinary income by converting what would otherwise be ordinary dividend income into capital gains. This may be achieved in one of many ways. For example, if the net worth of a corporation increases as a result of its having accumulated earnings and profits, the value of the corporation's stock generally should increase proportionately, and the shareholder could then sell the appreciated stock for a greater price than he or she would have received had the corporation not retained its earnings and profits but had it distributed as dividends throughout the years. The sale of the appreciated stock would likely subject the taxpayer to a tax liability, but that liability would be substantially less than if the taxpayer had received and paid tax on dividend income. This is true because the sale of stock for a profit gives rise to a capital gain which is taxed at tax rates substantially less than those applied to dividend income.<sup>26</sup>

In order to deter corporations from so accumulating earnings and profits within the corporation, the Internal

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<sup>25</sup>Seymour J. Graubard, "Accumulation of Surplus to Evade Taxes," Taxes 10 (December 1932): 415: 5 CCH 1979 Fed. Tax Reporter par. 3303.011.

<sup>26</sup>Ibid.

Revenue Code imposes a penalty tax of up to 38 1/2%<sup>27</sup> upon "every corporation" which accumulates earnings "beyond the reasonable needs of the business . . . [if] the purpose [is] to avoid income tax with respect to its shareholders."<sup>28</sup>

The Accumulated Earnings Tax and Publicly-Held Corporations

Although the Code specifically states that "every corporation" could be subject to the accumulated earnings tax, historically, the tax has been merely applied to, and imposed upon, closely-held corporations.<sup>29</sup>

The primary reason that publicly-held corporations have been essentially exempt from the accumulated earnings tax is the assumption that even if it could be established that the corporation accumulated earnings beyond the reasonable needs of the business, it would be impossible to substantiate that the accumulation was for the purpose of avoiding income taxes

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<sup>27</sup>Internal Revenue Code of 1954, Section 531; (hereinafter referred to as the Code).

<sup>28</sup>Code, Section 532-3 ; (emphasis added); See Appendix A which contains all the relevant Code sections relating to the accumulated earnings tax--Sections 531-537.

<sup>29</sup>Michael Roth and Allan Pollack, "Section 531 Problems in Connection With Acquisitions" New York University Thirty-Fifth Annual Institute on Federal Taxation, pt. 1 (New York: Mathew Bender, Inc., 1977), p. 798; It must be noted that there have been a few cases in which the IRS has attempted to apply the accumulated earnings tax to a publicly-held corporation. However, in those few isolated cases the publicly-held corporations were equivalent to closely-held corporations in every aspect but name. For example see: Trico Products Corp., 46 B.T.A. 346 (1942) aff'd. 137 F. 2d 424 (2nd Cir. 1943) and Golconda Mining Corp., 58 T.C. 139 (1972).

with respect to its shareholders. This assumption is supported by the contention that since the stock of publicly-held corporations is typically held by thousands of shareholders, the management of publicly-held corporations could not take into account the varied and often conflicting tax positions of the corporation's various shareholders when determining dividend policy.<sup>30</sup>

However, both theoretical and empirical studies have proven this assumption to be incorrect for many reasons. First, many publicly-held corporations are in fact controlled by a small group of shareholders who often own a majority of the corporation's outstanding stock. Second, studies have shown that in determining dividend policy, even widely-held public corporations do consider the tax status of their shareholders when determining dividend policy. For example, the typical shareholder of IBM stock purchases that corporation's stock primarily in anticipation of reaping capital gains from the anticipated appreciation in the price of IBM stock. In order to satisfy these shareholder's expectations, the board of directors of IBM attempt to maintain a pre-determined dividend payout policy such that a designated amount of earnings is distributed to shareholders as dividends, but not more. Even if IBM has excess earnings it will typically not distribute dividends beyond the level

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<sup>30</sup>B. Bittker and J. Eustice, Federal Income Taxation of Corporation and Shareholders, 4th ed., (Boston: Warren, Gorham and Lamont, 1979), pp. 8-5 to 8-6.

specified. In contrast, shareholders of Con Edison stock purchase that utility's stock primarily for the dividends the utility generally distributes. Thus, the board of directors of Con Edison attempts to satisfy its shareholders' expectations by distributing the largest dividend possible.<sup>31</sup>

Accordingly, while the board of directors of a corporation, the corporate body that sets dividend policy for the corporation, cannot take into account each and every shareholder's individual tax status and needs, it can--and does--consider the tax status and expectations of the prototype-shareholder that owns its corporation's stock.

Potential Adverse Effects of  
the Accumulated Earnings Tax

While the basic purpose underlying the need for the accumulated earnings tax may be valid, it appears to have resulted in some undesired side-effects. As early as 1928, Congressman Green of Iowa expressed his concern for the potential adverse effect this tax could have on small corporations:

Take the small corporations just starting. They have to build up a surplus in order to try to compete with the larger institutions. This provision proposed by the advisory committee . . . would penalize those gentlemen who are honestly endeavoring to build up a surplus

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<sup>31</sup>J. Lintner, "Distribution of Income of Corporations Among Dividends, Retained Earnings and Taxes," American Economic Review Papers and Proceedings 46 (May 1956): 97-115; E. Elton and J. Gruber, "Marginal Stockholder Tax Rates and the Clientelle Effect," Review of Economics and Statistics 35 (February 1970): 68-74.

which they need in their business, and without which they could not make a success of their business, and they are hit as hard or harder than those trying to avoid tax.<sup>32</sup>

Curiously, and understandably, closely-held corporations are raising the very same argument today against the penalty tax. Closely-held corporations contend that the Internal Revenue Service, by merely applying the accumulated earnings tax against their corporations, has, in effect, stunted their ability to grow and expand and has discriminated against them.<sup>33</sup> The following scenario illustrates the problem faced by closely-held corporations. A corporation is successful and records large earnings from its business operations. Since it has no specific plan for expansion at the time, it is required to distribute such earnings to its shareholders. At a future date, when it ultimately prepares a plan for expansion or growth it no longer has the funds with which to effect the plan.

Thus, a closely-held business corporation which is prohibited from accumulating profits within the corporation and which desires to expand and grow must either (a) borrow the necessary capital and incur large financing costs or

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<sup>32</sup>U.S., Congress, House, 70th Cong., 1st sess., 12 December 1927, Congressional Record 69:520.

<sup>33</sup>Robert B. Barker, "The Accumulated Earnings Tax as a Deterrent to Business Diversification of Close Corporations," University of Kansas Law Review 16 (November 1967): 103-105.

(b) effectively forego such expansion and growth altogether. Particularly in our present inflationary times, with interest rates at record high levels, small closely-held business corporations attempting new business ventures may find the cost of borrowing necessary capital prohibitive. Moreover, the funds of many financial institutions have literally "dried-up" and small business corporations are among the first to be rejected for loans, regardless of the price they are willing to pay for such funds.<sup>34</sup>

Publicly-held corporations, on the other hand, may accumulate, and do accumulate earnings and profits without the fear of being subject to the accumulated earnings tax. The resulting advantage publicly-held corporations maintain thereby has also contributed in part to the increasing number of corporate mergers and acquisitions, many of which are financed either in whole, or in part, by internally generated funds. Such merger and acquisition activity, in turn, further contributes to the elimination of small businesses in our economy.

Indeed, the substantial increase in corporate merger and acquisition activity is viewed negatively by the Senate

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<sup>34</sup>Daniel Hertzberg, Smaller Businesses Fear They Will Bear Brunt of Tight-Credit Policy, p. 1; U.S., Congress, House, Future of Small Business in America, p. 30.

Judiciary Committee,<sup>35</sup> which is currently preparing legislation to curb certain mergers and acquisitions, and the House Committee on Small Business has set forth the view that:

The implications of this upswing in merger activity for small business and its future in the American economy are clear: as concentration continues to increase and as monopolization spreads among the constituent industries of the American economy, small business continues to decline.<sup>36</sup>

Thus, the economic realities are abundantly clear as are the negative implications for small businesses: Big business is consistently supported and encouraged in its desire for growth and prosperity but at the expense of small business. This trend appears to have the imprimatur of our Federal government by virtue of the benefits and burdens it allocates among the business enterprises subject to its regulation. Included in this seemingly inequitable system is the imposition of the accumulated earnings tax, borne solely by closely-held corporations and not by publicly-held corporations.

#### Implications for Business Education

This study has significant and important implications for business education, educators and students. Income tax

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<sup>35</sup>Robert W. Merry, "Small Business, Irked by Taxes and Rules, Develops Political Savvy to Press Its Case," Wall Street Journal, 27 July 1979, p. 36.

<sup>36</sup>U.S., Congress, House, Future of Small Business in America, p. 41.

rules and requirements have become, particularly as of late, exceedingly complex and often incomprehensible. As a result, tax law has come to be viewed as an area to be approached with great caution.

The reason for this can be explained as follows. The intricacy of the tax law, with its numerous statutory provisions, IRS administrative pronouncements and judicial decisions, is in part the result of a federal tax system that is used to accomplish many and different objectives, some of which may directly conflict with others. While the primary objective of our tax system is undoubtedly to raise revenue, the federal government has at times seen fit to use the tax law to promote certain social, economic and political objectives as well. Thus, while there may be a rationale and purpose for most tax rules and principles, they are often not self-evident nor obvious.

However, traditional tax texts used by professors and instructors in the classroom generally do not help the student obtain an insight into the rationale and purpose of a particular tax law. These texts generally start with the tax law and work out from it to the IRS pronouncements and judicial decisions. They do not build up to the law. Thus, the student has little or no knowledge regarding a law's legislative history or Congressional intent in enacting a particular law.



That there is a practical need for students to be able to examine the legislative history of a particular tax law in order to discern Congressional intent has long been recognized. The sole or clinching argument in many a tax case and the sustaining basis for many a ruling have been provided by an explanation of the law made during its course through Congress.

Thus, it is incumbent upon professors and instructors who teach taxation to explain to their students the fundamentals of tax research.<sup>37</sup> This study illustrates the procedures to be followed in the process of researching and analyzing a particular tax law.

Furthermore, this study alerts students to be aware that even accepted policies and practices of the IRS, and interpretations of tax law stated in tax texts, can be challenged. However, the key to any successful research rests in the student's ability to build a case, not by starting from the law, but instead to build up to the law and proceed from there.

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<sup>37</sup>See for example, Patricia King and Samuel Morgan, "Suggested Content for Postsecondary Tax Course," Business Education Forum (March 1978) pp. 34-35, wherein one of the results of their study indicated the need for "teaching students how to utilize the tax services in solving income tax problems."

Methodology

## Sub-problem 1

The solution to sub-problem 1 required an in-depth review and analysis of the historical development, interpretations and evolution of the tax legislation that has resulted in the current application of the provisions of the Internal Revenue Code of 1954, as amended, and the Income Tax Regulations which relate to the accumulated earnings tax.

Towards this end, an examination of all major tax legislation passed by Congress since the inception of the accumulated earnings tax in 1913 is presented. In order to facilitate the presentation and discussion of such legislation, the numerous tax bills enacted by Congress since 1913 are categorized into the following chronological time periods:

1. 1913 - the year in which the first income tax law was enacted, The Tariff Act of 1913.
2. 1914 - 1953 - the years prior to enactment of the Code. The tax legislation enacted during this time period include the Revenue Acts of 1916, 1917, 1918, 1921, 1924, 1926, 1932, 1934, 1936, 1937, 1938, 1939, 1940, 1941, 1942, 1945 and 1951.
3. 1954 - the year in which the Code was enacted.
4. 1955 - present - the years subsequent to enactment of the Code. The tax legislation enacted during this

period include the Revenue Acts of 1958, 1962, 1964, Tax Adjustment Act of 1966, Revenue and Expenditure Control Act of 1968, Tax Reform Act of 1969, Revenue Act of 1971, Tax Reduction Act of 1975, Tax Reform Act of 1976, Tax Reduction and Simplification Act of 1977 and the Revenue Act of 1978.

In addition to examining the foregoing major tax bills, congressional records and proceedings relating to those bills were reviewed for an understanding of Congress' underlying intent in passing the various tax laws.

Furthermore, all relevant tax literature, such as articles published in professional and academic journals and magazines, which shed light on the intent and effect of the various tax laws relating to the accumulated earnings tax were also reviewed. The following indices were used to select those relevant articles:

1) Accountants' Index (New York: American Institute of Certified Public Accountants) -- 1932 to present.

2) Federal Tax Articles (Chicago: Commerce Clearing House) -- 1954 to present.

3) Index to Federal Tax Articles (Boston: Warren, Gorham and Lamont) -- 1913 to present.

Emphasis was thereby placed on reviewing and analyzing the current status of the accumulated earnings tax law in a broad perspective that includes an examination of its genesis and subsequent expansion and development. Since the

Code is the governing Congressional instrument that serves as the cornerstone for the application of current-day tax law, emphasis on the status of the tax law prior to, at the time of and subsequent to the enactment of the Code accurately reflects how the tax law developed and evolved from the time of its inception to its present-day form.

#### Sub-problem 2

The solution to sub-problem 2 required a review of the Internal Revenue Manual's Tax Audit Guidelines. The Internal Revenue Manual (referred to as the Manual) is an official publication of the Internal Revenue Service. The purpose and objective of the Manual is explained in the "overview" to the Manual as follows:

The Internal Revenue Manual is designed to serve as the single official compilation of policies, procedures, instructions and guidelines relating to the organization, functions, administration and operations of the Service. Component segments of the Manual are policy statements containing the fundamental principles and objectives of the Service . . . <sup>38</sup>

Originally, the Manual was held as confidential material and could only be used by the IRS and its revenue agents. Despite the passage of the Freedom of Information Act by Congress in 1967, whose purpose was to expand citizen access to government information with a minimum of difficulty, the IRS refused to publish the Manual. However, in 1972, the

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<sup>38</sup>Internal Revenue Manual, (Chicago: Commerce Clearing House, Inc. 1979) para 4011.1.

U.S. District Court ruled that, pursuant to the Freedom of Information Act, the IRS was required to publish the Manual and make it available to the public.<sup>39</sup>

Included in the Manual are the Tax Audit Guidelines (referred to as the Guidelines) which contain the standards and techniques IRS agents are supposed to follow and employ in pursuing specific tax audits.<sup>40</sup> As stated in the Guidelines, they represent a compilation of "the common practices and methods which have been successfully employed by experienced agents."<sup>41</sup> Moreover, in an attempt to help the IRS agents develop a working knowledge of specific tax laws, the Guidelines contain a summary of the entire spectrum of tax law, i.e., the Code, Regulations, court decision and IRS pronouncements, relating to each particular tax issue being discussed and reviewed. Accordingly, the Guidelines are purported to be an official expression of how the IRS interprets and implements tax law.

Although the Manual and Guidelines are not legal documents, and therefore do not carry with them the force

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<sup>39</sup>"Effective Tax Procedure," Journal of Taxation 42 (April 1975):224; It is interesting to note that it was not until 1975 that the IRS completed publication of the entire manual.

<sup>40</sup>Internal Revenue Manual, para. 110.

<sup>41</sup>Ibid., para. 120.

of law, they have been considered as being equivalent to "unofficial" regulations.<sup>42</sup> Thus, a study of any specific tax law is not complete unless the Guidelines have also been reviewed.

The Guidelines contain an entire chapter devoted solely to the accumulated earnings tax. At the end of that chapter, the Guidelines present a list of twenty-five "unfavorable" and "favorable" factors which are supposed to serve as a summary of the detailed discussion contained in the chapter. A factor is considered "unfavorable" if it indicates that the IRS will be unable to apply the accumulated earnings tax to the corporation. On the other hand, a factor is considered "favorable" if it indicates that the IRS will be able to apply the accumulated earnings tax. The following is a list of the twenty-five factors:

Unfavorable factors:

1. The corporation has a history of paying good dividends.
2. The payment of a substantial salary to the principal stockholder who is an employee of the corporation.
3. The stock of the corporation is publicly held as opposed to being owned by a small group.
4. The existence of business indebtedness.
5. The need for the corporation to diversify as a result of:
  - (a) One customer business.
  - (b) Business obsolescence factor high.
6. Documentation of the needs of the business.
  - (a) In the corporate minutes.
  - (b) Performing actual work in fulfilling the needs.
7. Low current asset-current liability ratio.
8. Low current asset-current working capital ratio.

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<sup>42</sup>Sylvia Madeo, "The Accumulated Earnings Tax: An Empirical Analysis of the Tax Court's Implementation of Congressional Intent" (Ph.D. Dissertation, North Texas State University, 1977) p. 26.

9. The need for expansion of plant and equipment.
10. There is an actual entry into an unrelated business.

Favorable factors:

1. The business need for the accumulation are vague and indefinite.
2. The need for working capital can be met from current operations.
3. Investments of a passive nature which are in nonliquid form.
4. Diversification into an unrelated business is only contemplated.
5. Stock of the corporation is closely held.
6. Stock redemptions.
7. Loans to shareholders or other businesses of the shareholders.
8. The dividend history of the corporation is unfavorable such as:
  - (a) No cash dividend.
  - (b) Cash dividends related to shareholders tax status.
  - (c) Declaration of stock dividends.
9. Inability to pay dividends.
  - (a) Restriction on dividend payments.
  - (b) Lack of liquid funds.
10. Investments in subsidiaries that are not controlled.
11. The corporation has no outstanding debt obligations or the debts were incurred for nonbusiness reasons.
12. The shareholders are in a high tax bracket.
13. High current asset-current liability ratio.
14. High current asset-working capital ratio.
15. The corporation is aware of the accumulated earnings tax and made a conscious attempt to avoid its application.<sup>43</sup>

There are a few observations which must be made regarding this list. First, although the list contains twenty-five factors, in reality, each individual factor does not necessarily represent a new item. For example, unfavorable factors 7 and 8 (current asset-current liability ratio and current asset-current working capital ratio) are merely different expressions of similar concepts. Moreover, certain favorable factors are mere reciprocals of unfavorable

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<sup>43</sup>Internal Revenue Manual, exhibit 700-5.

factors and vice-versa. For example, unfavorable factor 1, "the corporation has a history of paying good dividends," is the reciprocal of favorable factor 8, "the dividend history of the corporation is unfavorable."

Second, as noted in Chapter III, the Regulations also contain a list of ten items which indicate whether an accumulation of earnings by a corporation is justified.<sup>44</sup> Every item included in the Regulations is either specifically mentioned as, or related to, a factor listed in the Guidelines. Thus, the Guidelines' list is, in reality, an expanded list of the items contained in the Regulations.

Third, the list is not organized in the same order in which the various items are discussed in the Guidelines' chapter, nor does it contain a cross-reference where each factor may be found in the chapter. As noted by Gloria Case:

No distinction is made in this list between factors relating to the tax avoidance purpose question (i.e., the subjective condition) and those relating to the reasonable business needs question (i.e., the objective condition).<sup>45</sup>

Accordingly, to facilitate analysis, the twenty-five factors have been divided into two categories:

Category I: Those factors which relate to the objective condition regarding the reasonable needs of the business.

Category II: Those factors which relate to the subjective condition of corporate intent.

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<sup>44</sup>Income Tax Regulations, Reg. 1.537-3(b);(c).

<sup>45</sup>Gloria Case, "Accumulated Earnings Tax Aspects of Business Expansions and Investments: Tax Law Review 32 (1976) p. 65 footnote 231.



TABLE 1

## CATEGORIZATION OF TWENTY-FIVE FACTORS

Item	Guideline Factor Number	
	Unfavorable	Favorable
Objective Condition: Reasonable Needs Of The Business		
1. Reasonably anticipated needs of the business: specific, definite and feasible.....	6	1
2. Working capital requirements..	7;8	2;13;14
3. Expansion and replacement of plant and equipment.....	9	
4. Investments and diversification.....	5;10	3;4;10
5. Business indebtedness.....	4	11
6. Stock redemptions.....		6
Subjective Condition: Corporate Intent		
1. Motive for accumulation.....		15
2. Loans and salaries to shareholders.....	2	7
3. Dividends.....	1	8;9
4. Shareholders tax brackets.....		12
5. Closely-held vs. publicly-held corporations.....	3	5

Content analysis, via internal criticism, was the primary method employed in analyzing each category. This involved verifying the validity of each unfavorable and favorable factor as well as the related discussion contained in the Guidelines' chapter on the accumulated earnings tax, with the following primary sources:

1. The Internal Revenue Code of 1954
2. Income Tax Regulations
3. Relevant court cases
4. IRS administrative rulings and pronouncements.

With respect to selecting the relevant court cases, the following procedure was followed. First, the Standard

Federal Tax Reporter was consulted. The Reporter, published by Commerce Clearing House, Inc., is a loose-leaf tax service which is updated with weekly supplements. In addition to explaining each section of the Code, the Reporter lists and/or explains all relevant court cases pertinent to the tax area being discussed.

Second, the following other major tax services were consulted:

1. Federal Taxes, published by Prentice-Hall, Inc.
2. Mertens, Law of Federal Income Taxation, published by Callaghan and Co.
3. Tax Coordinator, published by Research Institute of America.
4. Tax Management Portfolios, published by Bureau of National Affairs.
5. Rabkin and Johnson, Federal Income, Gift and Estate Taxation, published by Matthew Bender, Inc.

Third, in order to ascertain that important cases had not been overlooked, the Federal Taxes Citator was also consulted. The Federal Taxes Citator, published by Prentice-Hall, Inc., lists each tax case decided since 1863 and is also an excellent reference for selecting cases. The Citator gives the history of each case; shows whether it affirmed, reversed, modified or otherwise disposed of a lower court decision and whether it in turn was affirmed, reversed or modified by a decision of a higher court; and cites related or companion cases.

Fourth, all relevant tax literature which shed light on the intent and effect of the various tax laws, judicial

decisions and administrative rulings and pronouncements were reviewed.<sup>46</sup>

### Sub-problem 3

The solution to sub-problem 3 required the development of a model to be used in determining and selecting those publicly-held corporations that could, and legitimately should, be subject to the accumulated earnings tax.

The model detected the existence of those criteria analyzed in sub-problem 2 that could be objectively measured and extracted from publicly available information provided by publicly-held corporations. The identification of the desired corporate criteria, and thereby the selection of corporations for analysis, was achieved by obtaining positive responses to certain questions developed from criteria found in sub-problem 2. The specific elements comprising each of the questions incorporated into the model are detailed and described in Chapter V.

The model was applied to the universe of all corporations listed on the New York and American Stock Exchanges whose financial statement data are included in the COMPUSTAT computer tape. The COMPUSTAT tape contains data from the published financial reports of approximately 2,700 publicly-

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<sup>46</sup>The relevant tax literature was selected from the tax indices cited and presented in the methodology for solving sub-problem 1.

held corporations listed on the New York and American Stock Exchanges, the two largest stock exchanges in the country. The model tested all corporations listed on the COMPUSTAT tape for a six year period beginning with calendar or fiscal year 1972 and ending with 1977.

## CHAPTER II

### REVIEW OF THE RELATED LITERATURE

#### Introduction

An extensive search of dissertation listings and the academic and professional literature revealed no study that was identical in purpose to this study.<sup>1</sup> Moreover, while both the professional and academic literature are replete with articles and studies pertaining to the accumulated earnings tax, virtually all of the articles and studies are similar in scope in that they examine judicial decisions arising from litigation relating to the accumulated earnings tax.

The most probable reason researchers have been unable to study other aspects of the accumulated earnings tax is that the Internal Revenue Service does not compile or publish any data on this tax. Furthermore, it is one of the only taxes which must be paid by the taxpayer

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<sup>1</sup>The following sources were consulted: Xerox University Microfilms--a DISS Search was conducted on November 7, 1979 of all Ph.D. dissertations from 1861 until October, 1979; Accountants' Index (American Institute of Certified Public Accountants)--1932-October, 1979; Index to Federal Tax Articles, (Warren, Gorham and Lamont)--1925-1975; Federal Tax Articles (Commerce Clearing House)--1962-October, 1979.

for which the IRS has not printed any specific tax form.<sup>2</sup>

### The Hall Study

The first comprehensive study of the accumulated earnings tax was conducted by James Hall for the Joint Committee on the Economic Report of the Congress. During the two year period of 1950-1951, Hall studied and reviewed every aspect of this penalty tax from its inception in 1913.<sup>3</sup>

Since this study was commissioned by Congress, Hall was able to compel the Bureau of Internal Revenue (the predecessor to the Internal Revenue Service) to compile data on the accumulated earnings tax. The Internal Revenue Service, however, has not compiled or published any other data on the accumulated earnings tax since Hall completed his study in 1952.

In response to Hall's request the Bureau compiled data on every corporation assessed the accumulated earnings tax. The information gathered included which corporations ultimately paid the penalty tax and how much, which disputed cases actually went to court and which were settled out of court, and which cases were won by the Bureau and which were

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<sup>2</sup> Robert S. Holzman, Accountant's Guide to the Accumulated Earnings Tax, p. 29.

<sup>3</sup> U.S., Congress, Joint Committee on the Economic Report, The Taxation of Corporate Surplus Accumulations by James Hall, Joint Committee Print, (Washington, D.C.: Government Printing Office, 1952), p. 1.

lost. In addition, Hall prepared his own questionnaires, surveys and information gathering procedures in order to determine the effect of this tax on the general economy and on particular groups of corporations.

Hall's study found the accumulated earnings tax to be subject to extensive criticism from the corporate, professional and academic communities. Indeed, he noted that the independent National Tax Association had concluded in its committee report that:

The section is one of the most unpopular features of our present corporate tax system, and it is the opinion of this committee that this unpopularity is well deserved.<sup>4</sup>

Some examples cited by Hall with respect to criticisms aimed at the penalty tax were that tax corporations complained of undue pressure to pay out dividends; corporations could not safely accumulate adequately for replacements of existing properties, expansion or likewise; the penalty tax stymies industrial growth; and that the statute had given rise to uncertainties and confusion because of its vagueness and indefiniteness, "hanging over corporations like the sword of Damocles."<sup>5</sup>

Hall's study nevertheless defended the penalty tax and concluded that "protests and cries of anguish" against the

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<sup>4</sup> Ibid., p. 30.

<sup>5</sup> Ibid.

section are evidence that, in some measure, the section is accomplishing its purpose.<sup>6</sup> Hall believed that the penalty tax should be retained despite its inequities because "it is the only available means of dealing with personal tax avoidance as found in corporate hoarding."<sup>7</sup> However, while he advocated the retention of the accumulated earnings tax, Hall fully recognized the inequitable fashion in which it had been applied.

One of the underlying problems Hall attempted to resolve in his study was which, and what type of, corporations were subject to the accumulated earnings tax. For the ten year period between 1939 and 1949, the data revealed that corporations in virtually every type of business were affected by the penalty tax.<sup>8</sup> However, in analyzing the characteristics of the corporations, he pointed out that all the corporations were closely-held corporations and Hall questioned the legitimacy of the Bureau's seemingly discriminatory administrative procedure in not applying the accumulated earnings tax to publicly-held as well as closely-held corporations:

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<sup>6</sup> Ibid., p. 33.

<sup>7</sup> Ibid., p. 191.

<sup>8</sup> Ibid., p. 74.



Historically, section 102 [the predecessor section to the present day accumulated earnings tax sections 531-537] has been applied to the comparatively closely held and closely controlled corporations rather than to the large public corporations. Admittedly, the existence of the interdicted purpose would be more likely to occur in the case of the private corporation in which there is a close or complete identity of shareholders and corporate officers (i.e., corporate directors). On the other hand, there is much evidence which indicates that many of our large public corporations are subject to control, either directly or indirectly, by small groups of shareholders who, it may be presumed, are not unconscious of personal surtax savings resulting from surplus accumulation. Large numbers of shareholders and a minority stock interest by influential shareholders should not be permitted to disguise the existence of a control group and the possible shaping of corporate policy to serve personal advantage. In view of the purpose and intent of the section, it appears that the Bureau might properly direct attention to public, as well as to private, corporations.<sup>9</sup>

Thus, Hall determined that the accumulated earnings tax could and should be applied to both closely-held and publicly-held corporations, and that the Bureau of Internal Revenue "has been most conservative" by applying the tax to only closely-held corporations.<sup>10</sup> He concluded that:

confined to this restricted corporate area the section may not adequately serve its intended purpose. The Bureau might properly review its administrative policy with respect to this section.<sup>11</sup>

Hall went on to recommend that the Bureau consider expanding the corporate area to which the accumulated

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<sup>9</sup> Ibid., p. 187.

<sup>10</sup> Ibid., p. 190.

<sup>11</sup> Ibid.

earnings tax applies, to include publicly-held corporations even though an increased risk in litigation would be incurred.<sup>12</sup>

Hall's conclusions and recommendations with respect to the inclusion of publicly-held corporations in the realm of the accumulated earnings tax provision were then, and to this day continue to be, ignored.

Judicial Decisions and the  
Accumulated Earnings Tax

Sylvia Madeo conducted a study in which she analyzed tax cases relating to the accumulated earnings tax which were litigated in the Tax Court between 1954 and 1976. She observed that as a result of the Freedom of Information Act the IRS was required to make available to the public the Internal Revenue Manual used by IRS revenue agents, which sets forth Internal Revenue Tax Audit Guidelines reflecting the procedures the IRS agents should follow in pursuing each type of taxpayer audit.<sup>13</sup>

The Tax Audit Guidelines present a list of the various factors the IRS deems significant in determining variables

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<sup>12</sup> Ibid., pp. iv-v.

<sup>13</sup> Sylvia Madeo, "The Accumulated Earnings Tax: An Empirical Analysis of the Tax Court's Implementation of Congressional Intent" (Ph.D. Dissertation, North Texas State University, 1977), p. 25.

which indicate whether a corporation may be subject to the accumulated earnings tax. The list contains both variables which are considered "favorable" to the government in applying the accumulated earnings tax and variables which are considered "unfavorable" to the government. Madeo hypothesized that if the variables listed in the Tax Audit Guidelines were applied to cases litigated in the Tax Court one could accurately predict which taxpayers would be successful in defending against the application of the accumulated earnings tax and which taxpayers would be unsuccessful. When applied to the tax cases under study, her analysis accurately predicted the outcome of ninety-five percent of the decisions.<sup>14</sup>

Thus, Madeo's study clearly indicates that the procedures listed in the Tax Audit Guidelines are excellent indicators of the approach to be followed in determining if a corporation may be subject to the accumulated earnings tax. Accordingly, this study will rely on the procedures listed in the Tax Audit Guidelines for determining if a publicly-held corporation may be subject to the accumulated earnings tax.

Another more limited study of court cases relating to the accumulated earnings tax was conducted by Tierney and

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<sup>14</sup>Ibid., p. 77.

and Torkko in 1975.<sup>15</sup> They examined the ability of taxpayers who satisfied the objective condition for imposing the accumulated earnings tax (i.e., the corporation having accumulated earnings beyond the reasonable needs of the business), to successfully defend against the imposition of the penalty tax by asserting that they did not satisfy the subjective condition (i.e., the corporation having accumulated the earnings with the intent and purpose of avoiding income taxes with respect to its shareholders).

Tierney and Torkko examined court cases decided after the Donruss decision in 1969.<sup>16</sup> In Donruss the Supreme Court issued what is now considered a landmark decision, by holding that in order for the government to prove that a corporation satisfied the subjective condition of the accumulated earnings tax, it need not prove that tax avoidance was "the" dominant motive of the corporation, but rather, it suffices if the government can prove that tax avoidance was "a" or "one" of the motives for accumulating earnings.

In writing for the minority, Justice Harlan warned that the majority opinion in effect mitigated the need for the government to prove that a corporation intended to avoid

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<sup>15</sup>Joseph Tierney and Dennis Torkko, "Examining Recent IRS Victories Imposing Accumulated Earnings Tax: What Can Be Done?" Journal of Taxation 44 (January, 1976): 2-5.

<sup>16</sup>United States v. Donruss Co., 393 U.S. 297 (1969).

taxes by accumulating earnings within the corporation (and not distributing the earnings as dividends) since in virtually every dividend distribution the directors and officers consider, with varying degrees of significance, the tax effect of the dividend on the shareholders.

Tierney and Torkko found that in only one case decided since the Donruss decision was the taxpayer able to prevail on the issue of intent to avoid taxes. They therefore concluded that:

The overall effect of Donruss follows the prediction of the minority opinion . . . [and] the question of the intention to avoid the imposition of the tax on the shareholders has been removed by Donruss. The effect of this removal has been to increase the importance of the determination of whether the earnings and profits have exceeded the reasonable needs of the business.<sup>17</sup>

Accordingly, in determining whether publicly-held corporations may be subject to the accumulated earnings tax, the focal point of this study will be to determine if the corporation has accumulated earnings beyond the reasonable business needs.

Although referred to as the "objective" condition, the determination of whether a corporation has accumulated earnings beyond the reasonable needs of the business in fact requires a subjective evaluation since the "needs" of every business concern is unique and distinct. The Tax Court

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<sup>17</sup>Joseph Tierney and Dennis Torkko, "Examining Recent IRS Victories Imposing Accumulated Earnings Tax," p. 2.

has nevertheless attempted to adopt a general formula applicable to most corporations.

In the Bardahl Manufacturing Corporation<sup>18</sup> case decided in 1965, the Tax Court developed a mathematical formula, referred to as the "Bardahl formula," for determining the amount of working capital a corporation needs to operate during one business cycle. Although in most instances the Bardahl formula must be adjusted to the particular circumstances of the individual corporation under analysis, the courts have consistently relied on that formula.<sup>19</sup>

Moreover, the Internal Revenue Service in its Tax Audit Guidelines instructs its revenue agents to use the Bardahl formula as a guide for determining whether the accumulated earnings tax can be imposed on a corporation being audited.<sup>20</sup> Thus, the study will adopt the Bardahl formula in determining which publicly-held corporations may be subject to the accumulated earnings tax.

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<sup>18</sup>Bardahl Manufacturing Corporation, 24 T.C.M. 1030 (1965).

<sup>19</sup>D. Larry Crumbley, Robert Strawser, and Herbert Jensen, "Accumulated Earnings: A New Calculation," Journal of Accountancy 143 (March, 1977): 75-78.

<sup>20</sup>CCH Internal Revenue Manual, par. 784.

The Subjective Test and  
Publicly-Held Corporations

As previously noted, the subjective test of proving intent to avoid taxes has been severely recast and narrowly construed by the Donruss decision. Particularly when applying the post-Donruss application of this test, a number of studies have shown that publicly-held corporations do in fact consider their shareholders' tax preferences when determining dividend policy.

For example, Lintner conducted an empirical study analyzing corporate dividend policy between 1918-1951. He developed a model for determining what factors are considered by corporations in formulating such dividend policy. Among the factors cited by Lintner as a result of his study were:

The growth prospects of the industry, and more importantly the growth and earnings prospects of the particular company; the average cyclical movements of investment opportunities, working capital requirements and internal fund flows, judged by past experience; the relative importance attached by management to longer term capital gains as compared with current dividend income for its shareholders.<sup>21</sup>

In a similar study conducted by Elton and Gruber, an attempt was made to empirically determine if a corporation's dividend policy is affected by the marginal tax bracket of its shareholders. The authors developed their hypothesis based on a theory, referred to as the "clientele effect,"

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<sup>21</sup>J. Lintner, "Distribution of Income of Corporations Among Dividends, Retained Earnings and Taxes," American Economic Review Papers and Proceedings 46 (May 1956):1114; (emphasis added).

advanced by Miller and Modigliani. In essence, Miller and Modigliani suggested that whatever dividend policy the corporation adopts, it will attract a "clientele" of investors who desire that dividend policy. Thus, Elton and Gruber hypothesized that "investors who hold stocks which have high dividend yields should be in low tax brackets relative to shareholders who hold stocks with low dividend yields."<sup>22</sup> They examined the behavior of all stock listed on the New York Stock Exchange that paid a dividend during the period of April 1, 1966 to March 31, 1967.

Elton and Gruber reported the results of their study as follows:

The close relationship between both measures of a firms dividend policy and the implied stockholder tax bracket suggest the Miller and Modigliani were right in hypothesizing a "clientele effect." As our results show, firms not only seem to attract a clientele but they attract a rational clientele--one which would prefer their dividend policy.<sup>23</sup>

Thus, while management cannot satisfy the needs of all shareholders, management can nevertheless choose a dividend policy based on the dividend preferences of the majority of its shareholders. Accordingly, the results of the studies by Lintner and Elton and Gruber point out that even large publicly-held corporations could satisfy the

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<sup>22</sup>E. Elton and J. Gruber, "Marginal Stockholder Tax Rates and the Clientelle Effect," Review of Economics and Statistics 35 (February 1970):71.

<sup>23</sup>Ibid., p. 74.



subjective test of the accumulated earnings tax, particularly when that test is applied as mandated by the Supreme Court in Donruss.

## CHAPTER III

### HISTORICAL BACKGROUND

#### Introduction

The objective of this chapter is to provide a review and analysis of the historical development, interpretation and evolution of the tax legislation that has resulted in the current application of the provisions of the Internal Revenue Code of 1954, as amended, and the Income Tax Regulations which relate to the accumulated earnings tax.

#### Tariff Act of 1913

Immediately following the adoption of the Sixteenth Amendment to the Constitution, which gave Congress the right and authority to levy income taxes, Congress passed the Tariff Act of 1913 imposing what is today considered the first official income tax in the United States.<sup>1</sup>

The Tariff Act of 1913 imposed a flat 1 percent tax, referred to as the "normal tax," on both individual and corporate taxable income.<sup>2</sup> However, individual taxpayers

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<sup>1</sup>1981 Federal Tax Course, (Chicago: Commerce Clearing House, Inc. 1980), p. 110.

<sup>2</sup>Tariff Act of 1913, Statutes at Large 38, sec. II (A)(1), 166-7(1913).

whose taxable income exceeded \$20,000 were required to pay an "additional tax" of 1 to 6 percent on their excess taxable income. Thus, while the maximum tax rate for corporations was limited to the normal tax of 1 percent, individual taxpayers were subject to a progressive tax rate structure which ranged from 1 to 7 percent.<sup>3</sup>

As a result of the disparity between the individual and corporate income tax rates, Congress feared that individual taxpayers would attempt to avoid paying the higher individual income tax on a portion of their earnings by establishing corporations and accumulating income within those corporations. This concern was explained in the following Congressional discussion:

The Senator will see that unless we provide for this evil in some way men might escape not the normal tax but escape the additional tax by merely forming themselves [a corporation], or using a brother, wife, or somebody, or an office boy. Then while perfectly willing to pay the normal tax as a corporation, they would escape the additional tax by not having their amount distributed by an arrangement so that they could draw upon the corporation, of course, for whatever they needed.<sup>4</sup>

Thus, Congress decided to formulate a provision which would add a penalty tax on income accumulated and retained within the corporation for the purpose of avoiding having

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<sup>3</sup>Tariff Act of 1913, Statutes at Large 38, sec. II (A)(2), 166-7(1913).

<sup>4</sup>U.S., Congress, Senate, Senator Williams, 63rd Cong., 1st sess., 2 October 1913, Congressional Record 50:5318.

the income taxed at the higher individual tax rates.

In analyzing the alternatives available to Congress, Samuel Sherman aptly noted that there existed two methods which Congress could have adopted as stopgap measures to close this apparent tax loophole. The first method would tax the shareholders themselves as though they were partners in a partnership. Under this method the corporate entity is disregarded and instead each shareholder is taxed upon his pro rata share of the corporate income as though the entire income was actually distributed. The measure of the tax is precisely the amount which the stockholder would have had to pay had he personally received the income instead of the corporation.

The second method would attempt to reach, and tax, the corporation itself. Under this method, the corporation rather than the shareholder, is assessed an additional penalty tax upon the portion of its net income not distributed by the corporation. The penalty tax is generally a flat tax rate imposed upon the corporation, which bears no essential relationship to the amount of tax the shareholders would have been required to pay had the corporation distributed its earnings.<sup>5</sup>

In its final draft form as adopted, the Tariff Act of 1913 included the following accumulated earnings tax

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<sup>5</sup>Samuel Sherman, "Taxation of Corporations Used to Avoid Taxes Upon Shareholders, Part I," Taxes 13(January 1935): 20.

provision utilizing the first method:

For the purpose of this additional tax the taxable income of any individual shall embrace the share to which he would be entitled of the gains and profits, if divided or distributed, whether divided or distributed or not, of all corporations, joint-stock companies, or associations however created or organized, formed or fraudulently availed of for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed; and the fact that any such corporation, joint-stock company, or association, is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business shall be prima facie evidence of a fraudulent purpose to escape such tax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the said tax in such case unless the Secretary of the Treasury shall certify that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the Commissioner of Internal Revenue, or any district collector of internal revenue, such corporation, joint-stock company, or association shall forward to him a correct statement of such profits and the names of the individuals who would be entitled to the same if distributed.<sup>6</sup>

A careful reading of this section indicates that the additional penalty tax could essentially be imposed only if the Secretary of the Treasury determined that a corporation satisfied two conditions: (1) The corporation was formed or fraudulently availed of for the purpose of avoiding taxes with respect to its individual shareholders, and (2) the corporation accumulated earnings beyond the reasonable needs of the business. The following Congressional discussion illustrates the process which was required to be followed

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<sup>6</sup>Tariff Act of 1913, Statutes at Large 38, sec. II(A)(2), 166-7(1913).

in applying the accumulated earnings tax:

He [the Secretary of the Treasury] must first proceed to consider the question whether that corporation as such has been fraudulently availed of for the purpose of permitting parties to escape this additional tax, and considering that question and deciding upon it himself he would consider whether this surplus were too large for the reasonable purposes of that business. If he concluded that the accumulations were too large for the reasonable purposes of that business, and that the fraudulent intent existed, he would then certify that, in his opinion, such accumulation was unreasonable for the purposes of the business.<sup>7</sup>

Thus, the mere fact that a corporation accumulated earnings beyond the reasonable needs of the business was insufficient cause for imposing the additional tax; fraudulent purpose and intent must have been present as well.

Furthermore, analysis of the Congressional discussion reveals that Congress intended that the accumulated earnings tax provision be applied primarily to one specific type of corporation: "Its main purpose is to prevent the formation of holding companies."<sup>8</sup>

A holding company is essentially a corporation whose assets generally consist of investment property which yield passive income such as dividends, interest and rents.<sup>9</sup>

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<sup>7</sup>U.S., Congress, Senate, Senator Williams, 63rd Cong., 1st sess., 2 October 1913, Congressional Record 50:5319 (emphasis added).

<sup>8</sup>U.S., Congress, Senate, 63rd Cong., 1st sess., 6 September 1913, Congressional Record 50:4380.

<sup>9</sup>Income Tax Regulations, Reg. 1 533-(1)(c); (hereinafter referred to as the Regulations).

Congress focused on holding companies because it assumed that only this type of corporation would presumably be formed for the purpose of avoiding taxes. Holding companies are generally formed by wealthy individuals as a device to shelter their investment income from being taxed at the higher individual income tax rates. The typical business corporation, however, involved in manufacturing and selling goods and merchandise is generally not formed for the purpose of sheltering income.

Accordingly, this section specifically stated that the mere fact that a corporation is a holding company "shall be prima facie evidence of a fraudulent purpose" to avoid taxes.<sup>10</sup> All other corporations were essentially exempt from the accumulated earnings tax.

It is also important to note that although the accumulated earnings tax as enacted in the Tariff Act of 1913 was typically referred to as a "penalty" tax, in reality, it was not. As was pointed out in the Annual Report of the Secretary of the Treasury, under this provision of the Tariff Act, "a corporation that permitted an unreasonable accumulation of profits was not subject to the ordinary corporation income tax, but the individual stockholders were taxed upon their proportionate share of its net income, whether distributed

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<sup>10</sup>Tariff Act of 1913, Statutes at Large 38, sec II(A)(2), 166-7(1913).

or not."<sup>11</sup> Consequently, taxpayers who formed fraudulent corporations in order to accumulate earnings and avoid taxes assumed little risk. If it was determined that the corporation had unreasonable accumulations, the income of the corporation would be taxed directly to the individual shareholders as if the corporation never existed. Indeed, the result would be even more favorable than if the corporation had actually distributed its income, in which case double taxation would have applied.

Accordingly, under the Tariff Act of 1913, the income of a corporation was taxed either at the corporate level or, alternatively, if it was determined the corporation had unreasonable accumulations, at the shareholder level but not at both levels.

#### Revenue Acts Enacted from 1916-1953

##### Revenue Act of 1916

The accumulated earnings tax provision incorporated in the Revenue Act of 1916 was essentially the same as that enacted in the Tariff Act of 1913.<sup>12</sup>

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<sup>11</sup>U.S., Secretary of the Treasury, Annual Report for the Fiscal Year 1940, (Washington, D.C.: Government Office, 1941), p. 468 (footnote 16).

<sup>12</sup>Revenue Act of 1916, Statutes at Large 39, sec. 3, 758(1916).



## Revenue Act of 1917

As previously noted, Congress assumed that holding companies, in contrast to other corporations, were the types of entities most likely to be formed in order to accumulate earnings and avoid income taxes. However, this assumption proved to be incorrect. In testimony before Congressional committees it was pointed out that as a result of the disparity between the individual and corporate income tax rates all the corporations of the country have accumulated large and undivided surpluses. Accordingly, Congress attempted to devise a method for "coercing distribution of these earnings when not retained for the necessary requirements of the business" which would apply equally to all corporations.<sup>13</sup>

A careful analysis of the Congressional records of that era reveal that Congress' desire to adopt legislation which would impose the penalty tax on all corporations was primarily influenced by the political and economic circumstances then prevailing. In 1917 the United States was involved in World War I and had committed a significant amount of its resources to supporting the war effort. Pressured to raise additional revenues to finance the war, Congress began to seek new sources of revenue.

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<sup>13</sup>U.S., Congress, Senate, Senator Simmons, 65th Cong., 1st sess., 2 October 1917, Congressional Record 55:7615.

Having been made aware that individual taxpayers were using the corporate veil to avoid taxes, Congress was convinced that earnings accumulated within corporations was one of the best and most readily available sources of potential taxable income.<sup>14</sup>

Thus, Congress adopted a provision in the Revenue Act of 1917, referred to as the War and Excess Profits Tax, which essentially imposed a penalty tax of 10-15 percent on income accumulated within the corporation beyond the reasonable needs of the business.<sup>15</sup> This provision did not replace the original accumulated earnings tax provision, but was rather designed to complement and augment the original provision; both provisions were now matters of law. The basic difference between the War and Excess Profits Tax and the original accumulated earnings tax provision, was that the former could be applied to any corporation regardless of the corporation's purpose and intent for accumulating earnings, while the latter could only be applied if there was fraudulent intent to avoid taxes.<sup>16</sup>

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<sup>14</sup>U.S., Congress, Senate, Report of the Senate Finance Committee, S. Rept. 103, 65th Cong., 1st Sess., 1917, pp. 21-22.

<sup>15</sup>Revenue Act of 1917, Statutes at Large 40, sec. 1206 (2)(b), 334(1917).

<sup>16</sup>Another important distinction between the two provisions was that the War and Excess Profits Tax was levied on the corporation while, as noted, the accumulated earnings tax was levied on the shareholders. Thus, George Lent pointed out that "the 1917 Act imposed the first specific tax on undistributed profits which was levied on the corporation and not on the shareholder." George Lent, The Impact of the Undistributed Profits Tax 1936-1937 (New York: Columbia University Press, 1948), p. 13.

Accordingly, under the Revenue Act of 1917, any corporation that accumulated earnings beyond the reasonable needs of the business for the purpose of avoiding income taxes was subject to a "double-barrelled" tax; a corporation subject to the original accumulated earnings tax was automatically liable for the War and Excess Profits tax.

It should be emphasized that the War and Excess Profits Tax was never intended as a replacement or substitute for the accumulated earnings tax. Congress recognized that it could not permanently tax the entire amount of earnings accumulated within corporations without adversely affecting the growth of the individual corporations and the national economy as a whole.<sup>17</sup> The primary function of this tax was to temporarily raise revenues to support the war effort, and in fact, the War and Excess Profits Tax was essentially repealed in the following year.<sup>18</sup>

It must also be pointed out that although Congress was cognizant that the accumulated earnings tax provision was inadequate and was not being adequately enforced, it did not attempt to change or strengthen the accumulated earnings

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<sup>17</sup>For example, see U.S., Congress, Senate, the statements of Senators Simmons and Jones, 65th Cong., 1st sess., 20 August 1917, Congressional Record 55:6172-6175.

<sup>18</sup>Revenue Act of 1918, Statutes at Large 40, sec's. 301 and 1400, 1088 and 1149 (1918).

tax provision in 1917 because it presumably was satisfied that all earnings accumulated beyond the reasonable needs of the business would be taxed under the War and Excess Profits Tax.

#### Revenue Act of 1918

The first substantial change in the accumulated earnings tax provision, as originally enacted, was made in the Revenue Act of 1918. Congress' intent was to substantively change the manner in which this tax was implemented by deleting merely one word from the original statute--"fraudulently."<sup>19</sup>

Congress recognized that in the five years the accumulated earnings tax had been in effect, "The law had been ineffectual because of [the] difficulty in securing evidence to establish fraud."<sup>20</sup> The Senate Finance Committee accentuated this point in its report:

The section of the present law . . . providing that undistributed profits of a corporation may in certain cases be treated as part of the income of its stockholders subject to surtax, has proved to be of little value because it was necessary to its application that intended fraud on the revenue be established in every case. The committee has done away with this requirement and has provided that in the case of every corporation formed or availed of for the purpose of permitting gains or profits to accumulate instead of

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<sup>19</sup>Revenue Act of 1918, Statutes at Large 40, sec. 220, 1072 (1918).

<sup>20</sup>U.S., Congress, Senate, Senator Simmons, 65th Cong., 2nd sess., 16 December 1918, Congressional Record 57:529.

being divided the income shall be taxed to the stockholders in the same way that partnership earnings are taxed to partners.<sup>21</sup>

Thus, Congress determined to delete the word "fraudulently" from the statute and thereby believed that the provision would be implemented effectively.

However, it was not long before Congress discovered that the problem with the accumulated earnings tax provision went beyond the single issue of proving fraud. The provision was ineffective because of other deficiencies inherent in the statute. For example, the government was unable to establish a guideline for determining whether earnings accumulated by a corporation were beyond "the reasonable needs of the business." Corporations were successful in defending themselves against the imposition of the tax by claiming that the earnings accumulated were needed for some valid business purpose and the government found it virtually impossible to refute such contentions. Since it could not conclusively prove that the earnings accumulated by a corporation were unreasonable, the government decided not to enforce the accumulated earnings tax provision. By so doing, the accumulated earnings tax became effectively inoperative.<sup>22</sup>

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<sup>21</sup>U.S., Congress, Senate, Report of the Senate Finance Committee, S. Rept. 617, 65th Cong., 3d sess., 1918, p. 5.

<sup>22</sup>Seymour Graubard, "Accumulation of Surplus to Avoid Taxes (Part II)," Taxes 10 (December 1932):468.

## Revenue Act of 1921

On March 8, 1920 the Supreme Court of the United States issued its landmark decision in the case of Eisner v. Macomber<sup>23</sup> which ultimately had a profound effect on the character of the accumulated earnings tax. In essence, the Court concluded that when a corporation issues dividends to its shareholders in the form of stock, the stock dividend is not considered income to the shareholders. The Court stated in its majority opinion:

Having regard to the very truth of the matter, to substance and not to form, he has received nothing that answers the definition of income within the Sixteenth Amendment . . . Thus, from every point of view we are brought irresistibly to the conclusion that neither under the Sixteenth Amendment nor otherwise has Congress power to tax without apportionment a true stock dividend made lawfully and in good faith, or the accumulated profits behind it, as income of the stockholder.<sup>24</sup>

Although the decision did not specifically refer to the accumulated earnings tax per se, Congress feared that based on the Eisner v. Macomber dictum, the accumulated earnings tax could be declared unconstitutional. This position was supported by the court's consistent emphasis of the fact that "what is called the stockholder's share in the accumulated

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<sup>23</sup>252 U.S. 189 (S. Ct. 1921).

<sup>24</sup>Ibid., p. 211 and p. 219 (emphasis added).

profits of the company is capital, not income."<sup>25</sup> Since under the accumulated earnings tax provision shareholders were taxed on the corporation's undistributed taxable income, it was contended that the shareholders "have received nothing that answers the definition of income within the Sixteenth Amendment"<sup>26</sup> and presumably could not therefore legally be subject to the accumulated earnings tax.

As a result, Congress adopted the second method for taxing accumulated earnings in the Revenue Act of 1921.<sup>27</sup> Under this method, the entire burden of the penalty tax was placed on the corporation and not on the individual shareholders. Specifically, the accumulated earnings tax provision incorporated in the Revenue Act of 1921 provided that corporations which accumulated earnings beyond the reasonable needs of the business in order to avoid income taxes on behalf of their shareholders would be subject to a penalty tax equal to 25 percent of the corporations' taxable income, in addition to the regular corporate income tax. The individual shareholders, however, would not be directly subject to any additional tax.

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<sup>25</sup>Ibid., p. 219.

<sup>26</sup>Ibid., p. 211.

<sup>27</sup>Revenue Act of 1921, Statutes at Large 42, sec. 220, 247-8 (1921).

The House Ways and Means Committee summarized the reason for changing the accumulated earnings tax provision as follows:

By reason of the recent decision of the Supreme Court in the stock dividend case (Eisner v. Macomber), considerable doubt exists as to the constitutionality of the existing law . . . The bill therefore proposes to amend the existing law so as to impose upon corporations . . . [unreasonably accumulating earnings] a flat additional income tax of twenty-five percent of the net income . . .<sup>28</sup>

It should be noted that Congress' fear that the accumulated earnings tax could be ruled unconstitutional as a result of the Eisner v. Macomber decision appears to have been unwarranted. In 1938 the Supreme Court in Helvering v. National Grocery Company<sup>29</sup> upheld the constitutionality of the accumulated earnings tax under the new method. However, Justice Brandeis, in writing the majority opinion also pointed out that Congress could, if it so legislates, levy the tax on the individual shareholders of the corporation:<sup>30</sup>

. . . [A taxpayer] could not by conducting business as a corporation, prevent Congress, if it chose to do

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<sup>28</sup>U.S., Congress, House, Report of the House Ways and Means Committee, H. Rept. 350, 67th Cong., 1st sess., 1921, pp. 12-13.

<sup>29</sup>304 U.S. 282 (S. Ct. 1938).

<sup>30</sup>It is interesting to note that Justice Brandeis was one of the four dissenting jurists in the Eisner decision. Thus, it should be no surprise that he, in essence, reversed what was implied in the Eisner decision--that the accumulated earnings tax could not be imposed upon the individual shareholders of the corporation.



so, from laying on him individually the tax on the year's accumulated profits.<sup>31</sup>

Thus, not only did the Supreme Court allay Congress' fear regarding the constitutionality of the accumulated earnings tax; moreover, it gave Congress the authority to levy and implement the tax on either the corporation or its shareholders.

With the adoption of the new method, for the first time since its inception, the accumulated earnings tax was justifiably characterized as a "penalty" tax since any corporation subject to this tax was required to pay an "additional" tax above and beyond the normal corporate income tax.

The purpose for amending the accumulated earnings tax provision was to effectively shift the tax from the individual shareholder to the corporation. However, the new statute contained an "escape clause" that appeared to undermine this objective.<sup>32</sup> In essence, the statute provided that if all the shareholders agreed to include in their taxable income their entire pro rata share of the corporation's accumulated income, whether distributed or not, the corporation would be treated as a partnership and neither the regular corporate

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<sup>31</sup>Helvering v. National Grocery Company, 304 U.S. 282 (S. Ct. 1938).

<sup>32</sup>Revenue Act of 1921, sec. 220.

income tax or the penalty tax would be imposed.<sup>33</sup> With the inclusion of this "escape clause," most, if not all, of the sting was removed from the "penalty" tax.

#### Revenue Act of 1924

In its deliberations with respect to the Revenue Act of 1924, the Senate Finance Committee reviewed the effectiveness of the accumulated earnings tax provision. The report concluded that:

It is true a penalty against the organization of a corporation for the sole purpose of evading taxation is included in the present law. In actual result, however, such a penalty provision has been and will be for all practical purposes a nullity. The penalty of the present law has only been applied in one or two cases.<sup>34</sup>

In order to remedy the apparent weaknesses and deficiencies, Congress adopted four major changes that were intended to strengthen the accumulated earnings tax provision.

First, Congress provided that, if a corporation operated as an investment company or a holding company, that fact would be "prima facie evidence of purpose to escape the surtax."<sup>35</sup> An investment company is a corporation whose

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<sup>33</sup>For a more detailed analysis of the escape clause, see the discussion of the Revenue Act of 1926 on page 68 of this Chapter, wherein the escape clause enacted in that Act is compared with this escape clause.

<sup>34</sup>U.S., Congress, Senate, Report of the Senate Finance Committee, S. Rept. 398, 68th Cong., 1st sess., 1921, p. 8.

<sup>35</sup>Revenue Act of 1924, Statutes at Large 43, sec. 220 (b), 277 (1924).

activities "consist substantially of buying and selling stocks, securities, real estate, or other investment property . . . so that the income is derived not only from the investment yield (as is the case with holding companies) but also from the profits upon market fluctuations."<sup>36</sup> In testimony before Congressional committees, it was pointed out that individual taxpayers were avoiding the accumulated earnings tax provision by forming investment companies instead of holding companies.<sup>37</sup> Congress therefore decided to treat investment companies the same as holding companies for purposes of the accumulated earnings tax.

The Congressional discussion reveals, however, that there were those who doubted whether this change would actually strengthen the effectiveness of the provision, even with regard to investment companies. Senator Jones of New Mexico, for example, expressed deep skepticism:

I believe this section will be no more effective than the similar section which exists in the present law, because it all goes back to the one question as to whether or not the corporation is organized for the purpose of evading surtaxes. He is a mighty dumb individual who can not overcome the alleged prima facie case which this provision attempts to make out . . . Why can not a man organize a corporation for the express purpose of investing and reinvesting his funds? Why

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<sup>36</sup>Regulations, Reg. 1.533-1(c).

<sup>37</sup>U.S., Congress, House, Report of the House Ways and Means Committee, H. Rept. 179, 68th Cong., 1st sess., 22 (1924); U.S., Congress, Senate, Report of the Senate Finance Committee, S. Rept. 398, 68th Cong., 1st sess., 26 (1924).

should any individual having property of various kinds organize a corporation for the purpose of easy distribution in the event of his death? They are lawful purposes . . .<sup>38</sup>

The second major change adopted was to eliminate an existing a loophole in that tax law. In computing its taxable income, a corporation was allowed to exclude both dividends received from other corporations and interest derived from certain U.S. government bonds. Thus, holding companies whose net income consisted entirely of dividends from corporations and/or interest from U.S. government bonds could not be subject to the accumulated earnings tax since, as defined by law, it had no taxable income.<sup>39</sup>

In an effort at closing this apparent loophole, the Revenue Act of 1924 specifically provided that in computing the amount of income subject to the penalty tax, the corporation must include any dividends received from another corporation as well as interest received from U.S. government bonds which otherwise would be excluded from the corporation's taxable income.<sup>40</sup>

Third, Congress repealed the "escape-clause" which allowed the shareholders to circumvent the penalty tax by

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<sup>38</sup>U.S., Congress, Senate, 68th Cong., 1st sess., 28 April 1924, Congressional Record 65:7360.

<sup>39</sup>U.S., Congress, House, Report of the House Ways and Means Committee, H. Rept. 179, 68th Cong., 1st sess., 22 (1924).

<sup>40</sup>Revenue Act of 1924, Statutes at Large 43, sec. 220(d), 277 (1924).

electing to be taxed as a partnership.<sup>41</sup>

Fourth, the new provision increased the penalty tax from 25 percent to 50 percent.<sup>42</sup>

Despite these seemingly sweeping changes which were intended to correct deficiencies in the statute, Congress was in fact unable to sufficiently broaden the scope of the penalty tax. Congress did apparently recognize that even the typical business corporation was being used by shareholders as a device for sheltering income from the higher individual income tax rates. Nevertheless, because it could not properly define what was considered "the reasonable needs of a business," Congress was unable to formulate a provision that would make the penalty tax applicable to all tainted corporations. The following Congressional discussion illustrates this problem:

I would like to ask the Senator from Nebraska what proof would be required to determine what are "the reasonable needs of business?" Many wise business men insist upon an enormous surplus. Others insist upon a reduced surplus, and there is a very wide ground there for a divergence of opinion as to what would be a reasonable surplus. There are no guides prescribed in the statute to determine, and there is the discretion which is allowed the executive officers.<sup>43</sup>

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<sup>41</sup>U.S., Congress, Joint Committee, Report of the Conference Committee, H. Rept. 6715, 65th Cong., 1st sess., sec. 220(a) (1924).

<sup>42</sup>Revenue Act of 1924, Statutes at Large 43, sec. 220(a), 277 (1924).

<sup>43</sup>U.S., Congress, Senate, Senator King, 68th Cong., 1st sess., 28 April 1924, Congressional Record 65:7359.

Since it feared that any one definition could ultimately result in penalizing corporations which were legitimately accumulating earnings, Congress chose to defer, rather than solve, one of the major problems and deficiencies inherent with the accumulated earnings tax provision.

#### Revenue Act of 1926

Congress continued to show its inability to deal with the problem of tax avoidance by shareholders who accumulated earnings beyond the reasonable needs of the business when it failed to draft an effective accumulated earnings tax provision for inclusion in the Revenue Act of 1926. That act merely incorporated the same provision enacted in the Revenue Act of 1924, with one substantive change. Congress agreed to reinstate the "escape-clause," which allowed shareholders of a corporation to avoid the penalty tax by electing to be taxed as a partnership and have each shareholder include in his or her individual taxable income a pro rata share of the corporation's taxable income.<sup>44</sup> There were, however, major distinctions between this escape-clause and its predecessor.

Under prior law, the escape clause could be elected only if the following two conditions were satisfied:

- (1) There was unanimous consent of the shareholders to be so taxed and
- (2) the Commissioner approved the election.

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<sup>44</sup>Revenue Act of 1926, Statutes at Large 44, sec. 220(e), 34-5 (1926).

Since the Commissioner's approval was required, the shareholders were allowed to make the election even after the corporate tax returns were filed by filing amended returns. The new law deleted the requirement for commissioner approval and instead required that shareholders make their election "at the time of filing their returns."<sup>45</sup> Thus, while the new law did not require the Commissioner's approval, the shareholders were required to make the election immediately upon filing their tax returns.

There was yet another important difference between the two laws. Under prior law, when shareholders elected the partnership method the corporation was treated exactly as a partnership and was thereby not even subject to the regular corporate income tax. Indeed, this opportunity to shift from corporate to partnership tax status without penalty, was the primary reason Congress repealed the escape clause. Under the new law, however, the corporation retained its identity as a separate taxable entity and remained liable for the ordinary corporate income tax, with the shareholders being treated as having received an additional dividend distribution.

The Conference Committee explained that it had agreed to re-enact this amended form of the escape clause into law because "if the surtax is thus paid, failure to distribute

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<sup>45</sup>Ibid.

the earnings has not resulted in any avoidance of tax, and the reason for the imposition of the 50 percent tax on the corporation no longer exists."<sup>46</sup> Thus, while under the original escape clause enacted in the Revenue Act of 1921 shareholders of the corporation were able to "escape" from not only the penalty tax but also the regular corporate income tax when the corporation elected to be taxed as a partnership, this was not possible under current law.

#### Revenue Act of 1928

The Congressional records reveal that although Congress was well aware that the accumulated earnings tax was ineffective, it was still unable to draft an acceptable alternative provision for inclusion in the Revenue Act of 1928.<sup>47</sup>

Congress' frustration is reflected in the following discussion held in the House of Representatives:

It is not a fact that this paragraph was one of the most difficult things that the committee had to deal with; and if, when this bill goes to the other branch [the Senate], the gentleman can offer some suggestion that will improve the law and make it more effective in its administration, the committee will be only too glad if he will make the suggestion.<sup>48</sup>

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<sup>46</sup>U.S., Congress, Senate, Report of the Senate Finance Committee, S. Rept. 52, 69th Cong., 1st sess., 22 (1926).

<sup>47</sup>Revenue Act of 1928, Statutes at Large 45, sec. 104, 814-5 (1928).

<sup>48</sup>U.S., Congress, House, Representative Treadway, 70th Cong., 1st sess., 12 December 1927, Congressional Record 69:521.



The discussion in the Senate similarly reveals the frustration of being unable to formulate a provision "which would not be to the disadvantage of some and to the advantage of the other corporations."<sup>49</sup> The major stumbling block encountered by both houses of Congress was their inability to define the "reasonable needs of a business":

. . . How much shall be allowed as a surplus before the penalty shall be applied? I do not know. Should we attempt to circumscribe those engaged in business and limit the amount of reserves and accumulations before the penalty of 50 percent is applied, or should the entire matter be committed to the discretion of those administering the law? . . . I am not satisfied with this section, and yet I am not in position to offer an amendment to supersede it. The Finance Committee considered the House amendment, which was intended to clarify the situation; and I think that after due consideration the committee reached the conclusion that instead of clarification it would add to the uncertainty and dubiety if attempts were made to prescribe the limitation upon the amount allowed as reserves and the circumstances under which such reserves should be set up.<sup>50</sup>

Although Congress was obviously aware that the accumulated earnings tax was ineffective, it appears Congress may not have realized the extent of the provision's ineffectiveness. George Lent, in analyzing the accumulated earnings tax, reveals that as of "1928 the penalty provision produced practically no revenue."<sup>51</sup> Thus, not only had typical business

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<sup>49</sup>U.S., Congress, Senate, Senator Simmons, 70th Cong., 1st sess., 7 May 1928, Congressional Record 69:7977.

<sup>50</sup>U.S., Congress, Senate, Senator King, 70th Cong., 1st sess., 7 May 1928, Congressional Record 69:7976.

<sup>51</sup>George Lent, The Impact of the Undistributed Profits Tax, p. 12.

corporations escaped the penalty tax, but even investment and holding companies had successfully circumvented the application of this tax.

#### Revenue Act of 1932

No substantive changes relating to the accumulated earnings tax were incorporated into the Revenue Act of 1932<sup>52</sup> because Congress was informed by the legislative drafting bureau that "they think it is the best they can do."<sup>53</sup> Furthermore, it appears that Congress was convinced that the accumulated earnings tax was ineffective because, in part, of the failure of the Treasury Department to properly administer the law. Congressman La Guardia stated that "the only difficulty with the [accumulated earnings tax provision] . . . is that it has been on the books but has not been administered."<sup>54</sup>

The Treasury Department, however, claimed that it was being unjustly criticized. It argued that the failure to properly implement the accumulated earnings tax was not indicative of an administrative problem but rather of a weak and

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<sup>52</sup>Revenue Act of 1932, Statutes at Large 47, sec. 104, 195 (1932).

<sup>53</sup>U.S., Congress, House, Representative Crisp, 72nd Cong., 1st sess., 18 March 1932, Congressional Record 75:6486.

<sup>54</sup>U.S., Congress, House, 72nd Cong., 1st sess., 18 March 1932, Congressional Record 75:6484.

deficient statute. The Treasury Department insisted it was handicapped by the statute's failure to (1) specifically define what is considered "beyond the reasonable needs of a business" and (2) provide detailed guidelines listing the type of evidence that must be presented in substantiating a claim against a corporation.

Congress, however, rejected the Treasury Department's contentions:

. . . no law goes into all details and specifies the proof, and so forth. That is something that would have to be passed on by the Treasury Department . . . We cannot specify in the bill the kind of affidavits that will be required on the evidence that the Treasury Department must have. Some human agency must be charged with the responsibility of administering the law . . . [and] it is hard sometimes to get proof to make out a case. It is up to the Treasury Department to decide."<sup>55</sup>

Thus, Congress apparently believed that if the Treasury Department adopted a more aggressive approach in administering the law, the accumulated earnings tax could be effectively implemented in its present form.

Although Congress did not directly enact a revenue act in 1933, the National Industrial Recovery Act, enacted in 1933, amended certain sections of the Revenue Act of 1932.<sup>56</sup> These amendments resulted in a few minor technical changes to the accumulated earnings tax provision.

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<sup>55</sup>U.S., Congress, House, Representative Crisp 72nd Cong., 1st sess., 18 March 1932, Congressional Record 75:6486.

<sup>56</sup>National Industrial Recovery Act, Statutes at Large 48, sec. 214, 195 (1933).

## Revenue Act of 1934

Flagrant tax avoidance by corporations accumulating earnings was acknowledged by the House Ways and Means Committee. Particularly disturbing was the fact that holding companies were able to avoid being subject to the penalty tax:

Perhaps the most prevalent form of tax avoidance practiced by individuals with large income is the scheme of the "incorporated pocketbook," that is, an individual forms a corporation and exchanges for its stock his personal holdings in stocks, bonds or other income producing property. By this means the income from the property pays corporation tax, but no surtax is paid by the individual if the income is not distributed.<sup>57</sup>

Although the statute specifically provided that holding companies were "prima facie evidence of a purpose" to avoid taxes, such holding companies were able to avoid the penalty tax because "by making partial distributions of profits and by showing some need for the accumulation of the remaining profits, the taxpayer made it difficult to prove a purpose to avoid taxes."<sup>58</sup>

Thus, in the Revenue Act of 1934, Congress decided to exclude holding companies from the accumulated earnings tax provision and to instead enact a separate provision, Section 351, pertaining solely to holding companies.<sup>59</sup> In essence,

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<sup>57</sup>U.S., Congress, House, Report of the House Ways and Means Committee, H. Rept. 704, 73rd Cong., 2nd sess., 1934, p. 11.

<sup>58</sup>Ibid.

<sup>59</sup>Revenue Act of 1934, Statutes at Large 48, sec. 351, 751 (1934).

Section 351 provided that any corporation satisfying the definition of a holding company was automatically subject to a penalty tax of 35 percent of its taxable income "without any necessity for proving a purpose to avoid taxes."<sup>60</sup>

Thus, with holding companies excluded from the accumulated earnings tax provision, the major focus and emphasis of the provision shifted to the remaining corporations, i.e., the typical business corporation such as manufacturing. However, because of the serious deficiencies inherent in the accumulated earnings tax provision, there was little reason to believe that this tax provision could be effectively applied to these corporations.

Sherman revealed in his study in 1933, that although the accumulated earnings tax provision had been in effect for twenty years, not a single case was reported where the tax was applied to a manufacturing corporation. "The impotency is caused," he claimed, "by the virtual inability of those charged with the law to define . . . what is an unreasonable accumulation."<sup>61</sup> Sherman's analysis merely confirmed the testimony given before various Congressional Committees in prior years.

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<sup>60</sup>U.S., Congress, Senate, Report of the Senate Finance Committee, S. Rept. 558, 73rd Cong., 2nd sess., 1934, p. 15.

<sup>61</sup>Samuel Sherman, "Taxation of Corporations Used to Avoid Taxes Upon Stockholders, Part II," Taxes 13 (February 1935):120.

In addition to excluding holding companies, the Revenue Act of 1934 incorporated two other important changes in the accumulated earnings tax provision. First, it replaced the flat 50 percent penalty tax rate with a two tier graduated tax rate. The first \$100,000 of income would be subject to a 25 percent tax rate and all income in excess of \$100,000 would be subject to a 35 percent tax rate.<sup>62</sup>

Second, the amount of income subject to the penalty tax would be limited. Under prior law, if a corporation was subject to the accumulated earnings tax, the penalty was applied against the corporation's entire taxable income even though a portion of the income had been distributed as a dividend. The new provision provided that any income distributed to shareholders could not be subject to the penalty tax. A corporation would only have to pay the penalty tax on income accumulated in the corporation and not on income distributed as dividends.<sup>63</sup>

#### Revenue Act of 1936

In a special tax message sent to Congress on March 3, 1936, President Roosevelt stated that:

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<sup>62</sup>Revenue Act of 1934, Statutes at Large 48, sec. 102(a), 702 (1934).

<sup>63</sup>Revenue Act of 1934, Statutes at Large 48, sec. 102(c), 703 (1934).

The accumulation of surplus in corporations controlled by taxpayers with large income is encouraged by the present freedom of undistributed corporate income from surtaxes. Since stockholders are the beneficial owners of both distributed and undistributed corporate income, the aim, as a matter of fundamental equity should be to seek equity of tax burden on all corporate income whether distributed or withheld from the beneficial owners. As the law now stands our corporate taxes dip too deeply into the shares of corporate earnings going to stockholders who need the disbursement of dividends, while the shares of stockholders who can afford to leave earnings undistributed escape current surtaxes altogether.<sup>64</sup>

Avoidance of the higher individual income tax rates by shareholders of corporations accumulating income had reached disturbing proportions. As a result, and acting on the President's recommendation, Congress enacted a new "undistributed profits tax" to be applied against all corporations (except those specifically exempt by law) as part of the Revenue Act of 1936.<sup>65</sup> This new tax was to be imposed regardless of whether the corporation had a reasonable need for accumulating the income or not.

Since the accumulated earnings tax provision was also retained in the Revenue Act of 1936, a corporation that accumulated earnings beyond the reasonable needs of the business was subject to both the undistributed profits tax and the penalty tax. Thus, the tax was reminiscent of the

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<sup>64</sup>U.S. Treasury Department, Internal Revenue Bulletin 1939-1 C.B. 644.

<sup>65</sup>Revenue Act of 1936, Statutes at Large 49, sec. 14, 1649 (1936).

earlier War and Excess Profits Tax, adopted in 1917. However, the penalty rates for corporations subject to both taxes was reduced from the two-tiers of 25 percent and 35 percent to 15 percent and 25 percent.<sup>66</sup>

Enactment of the undistributed profits tax was, of course, further evidence of the ineffectiveness of the accumulated earnings tax provision.<sup>67</sup>

#### Revenue Act of 1937

With the exception of a few technical amendments, the Revenue Act of 1937 incorporated the same accumulated earnings tax provisions included in the Revenue Act of 1936.<sup>68</sup> The only significant amendment regarding the accumulated earnings tax concerned foreign holding companies, which are essentially holding companies located in a foreign country.

In testimony given before the Joint Committee on Tax Evasion and Avoidance, witnesses pointed out that taxpayers were successfully using foreign holding companies as a device for avoiding taxes by accumulating earnings with those corporations:

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<sup>66</sup>Revenue Act of 1936, Statutes at Large 49, sec. 102, 1676 (1936).

<sup>67</sup>U.S., Congress, House, Report of the House Ways and Means Committee, H. Rept. 2475, 74th Cong., 2nd sess., 1936, p. 3.

<sup>68</sup>Revenue Act of 1937, Statutes at Large 50, sec. 102, 830-1 (1937).



The testimony taken by the committee has shown that foreign personal holding companies are being utilized by citizens and residents of the United States as a device for tax-avoidance purposes. Income which otherwise would be subjected to the Federal income taxes is being diverted to, and accumulated by, such companies in order that the American shareholder may escape being taxed thereon. Because of the jurisdictional difficulties and collection of taxes involved in reaching these foreign entities, they present a distinct problem. While the provisions . . . of the present law, which imposes surtaxes on the undistributed profits of corporations, by their terms apply to foreign as well as domestic corporations, it appears necessary for the protection of the revenue that a separate method of taxation be provided for with respect to certain types of foreign personal holding companies.<sup>69</sup>

Accordingly, Congress enacted a separate provision which required shareholders of a foreign holding company to include in their income a pro rata share of the corporation's taxable income whether distributed or not. These corporations were, however, exempt from the accumulated earnings tax provision since the shareholders were being taxed on both the corporation's undistributed income as well as distributed income.<sup>70</sup>

#### Revenue Act of 1938

The undistributed profits tax enacted in the Revenue Act of 1936 was described by George Lent as "one of the most

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<sup>69</sup>U.S., Congress, Joint Committee on Tax Evasion and Avoidance, Report on Tax Evasion and Avoidance, H. Doc. 337, 75th Cong., 1st sess., 1937, pp. 16-17.

<sup>70</sup>Revenue Act of 1937, Statutes at Large 50, sec. 102(f)(3), 831 (1937).

controversial tax measures ever enacted in the American Legislature."<sup>71</sup> Business corporations reacted strongly to the imposition of the tax and claimed that the tax was having a detrimental effect on both individual corporations and the national economy as a whole. Thus, by 1938, business corporations actively lobbied for repeal of the tax.

While Congress recognized that the principle of a penalty tax on accumulated and undistributed earnings was both equitable and sound, it also was convinced that the undistributed profits tax was, in many instances, inequitable and often thwarted legitimate business objectives. Thus, Congress acquiesced to the pressure brought to bear upon it by the corporate community and, in the Revenue Act of 1938, essentially repealed the undistributed profits tax.<sup>72</sup>

Having repealed the undistributed profits tax, Congress instructed the House Ways and Means Subcommittee to conduct a study of the accumulated earnings tax provision in order to present recommendations for strengthening the provision. The study revealed that the separate personal holding company provision adopted in the Revenue Act of 1934 "worked well

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<sup>71</sup>George Lent, The Impact of the Undistributed Profits Tax, p. 175.

<sup>72</sup>Ibid., pp. 24-26; The Revenue Act of 1938 included a provision that the tax should expire in its entirety on December 31, 1939.

and efficiently."<sup>73</sup> However, the Subcommittee reported that although the accumulated earnings tax provision had been a part of the tax law for more than twenty-five years, it had conspicuously failed to achieve its objective and had "proved very troublesome to enforce."<sup>74</sup>

The Treasury Department supported the Subcommittee's findings and asserted that the Department's failure to more rigorously apply the accumulated earnings tax provision was due to the inherent weakness of the statute. The Treasury Department cited as evidence two cases which had been recently decided by two Circuit Courts of Appeal in favor of the taxpayer.

In the case of National Grocery Company vs. Helvering,<sup>75</sup> the president of the corporation was its sole shareholder. As of January 31, 1931 it had accumulated earnings in excess of \$8,000,000 and, in addition, had taxable income for the current year of \$780,000. The corporation's total liabilities were less than \$1,000,000 and its accounts payable were never more than \$400,000. Since its inception, the corporation had declared and distributed only two dividends, each of

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<sup>73</sup>U.S., Congress, House, Report of a Subcommittee of the Committee on the House Ways and Means, H. Rept. Jan. 14, 1938, 75th Cong., 3rd sess., 1938, p. 21.

<sup>74</sup>Ibid., p. 28.

<sup>75</sup>92 F.2d 931 (3rd Cir., 1937).

\$25,000, in 1917 and 1918.

The government imposed the accumulated earnings tax on the corporation, and supported its claim that the corporation had accumulated earnings beyond the reasonable needs of the business by pointing out that the corporation had used its accumulated earnings to acquire approximately \$3,000,000 of stocks and bonds instead of using it for regular business operations. Furthermore, whenever the president (and sole shareholder) of the corporation needed funds, he would regularly obtain an interest free loan from the corporation. Accordingly, the government concluded that the only reason the corporation accumulated earnings was to avoid taxes.

The president of the corporation, however, rebutted the government's conclusion and testified that he had not accumulated earnings "in order to avoid the payment of any government tax. I have never done that."<sup>76</sup> Furthermore, he claimed he invested the corporation's excess cash in securities "so that when we would need it we would have it. All corporations do that more or less."<sup>77</sup> Bankers and other expert witnesses, who were friendly with the President, supported the President's testimony and stated that "it was good, sound business practice for the company in that year

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<sup>76</sup>Ibid., p. 932.

<sup>77</sup>Ibid.

not to declare any dividends, because in view of the times, it was important to conserve all cash sources."<sup>78</sup>

In rendering its decision, the court stated that the government "had no proof, substantial or otherwise, to support its imposition of this penalty tax."<sup>79</sup>

The facts and circumstances in the case of Commissioner of Internal Revenue v. Cecil B. DeMille Productions, Inc.,<sup>80</sup> were very similar. The corporation was engaged in the business of producing motion picture films. It had four principal shareholders and by 1929 had accumulated over \$5,000,000 of earnings which were not invested directly for the corporation's regular business operations. As pointed out in the House Subcommittee report, the court rejected the right of the government to impose the accumulated earnings tax on the corporation because it was satisfied with the corporation's contention that it had accumulated the earnings "for the purpose of enabling it to engage in the production of motion pictures at some indefinite time in the future."<sup>81</sup>

The Treasury Department was particularly set back by these two decisions because it believed it had presented

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<sup>78</sup>Ibid., p. 934.

<sup>79</sup>Ibid., p. 935.

<sup>80</sup>90 F.2d 12 (9th Cir., 1937).

<sup>81</sup>U.S., Congress, House, Report of a Subcommittee of the Committee on Ways and Means, H. Rept. Jan. 14, 1938, 75th Cong., 3rd sess., 1938, p. 21.

strong arguments supporting the imposition of the penalty tax. The Treasury Department reasoned that if the courts refused to uphold the application of the penalty tax in these situations, its ability to impose the tax on any corporation in the future appeared doubtful. Analysis of these cases reveals that the courts were willing to allow corporations to accumulate earnings for any possible future contingency or investment, regardless of how speculative or incredulous the future investment might be. Since it was incumbent upon the government to prove that the corporation had accumulated earnings in order to avoid taxes, the courts adopted the position that unless the government proved its case beyond any reasonable doubt, it would refuse to allow the imposition of the penalty tax.<sup>82</sup>

In response to the foregoing, Congress enacted a new subsection into the accumulated earnings tax provision designed to remedy this situation. Under the new law, if it was determined that a corporation had accumulated earnings beyond the reasonable needs of the business for the purpose of avoiding income taxes on behalf of its shareholders, the penalty tax would automatically be levied "unless the corporation by the clear preponderance of the evidence shall prove

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<sup>82</sup>U.S., Congress, House, Representative Harlan, 75th Cong., 3rd sess., 7 March 1938, Congressional Record 83:2940.

to the contrary."<sup>83</sup> The purpose of this provision was to shift the burden of proof from the government to the taxpayer. By merely shifting the burden of proof to the taxpayer, and thereby requiring the taxpayer to prove there was "no purpose to avoid taxes,"<sup>84</sup> Congress believed that it had strengthened the accumulated earnings tax provision, even though the more difficult problem of defining "the reasonable needs of the business" remained unresolved. In fact, the addition of this subsection proved to be one of the most important changes made to the accumulated earnings tax provision.<sup>85</sup>

In addition to some other technical changes, Congress for the final time eliminated the escape clause, which permitted corporations to avoid the penalty tax by electing to be taxed as a partnership.<sup>86</sup>

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<sup>83</sup>Revenue Act of 1938, Statutes at Large 52, sec. 102(c), 483 (1938).

<sup>84</sup>U.S., Congress, Senate, Report of the Senate Finance Committee, S. Rept. 1567, 75th Cong., 3rd sess., pp. 4-5.

<sup>85</sup>Stanley Wagman, "Taxation of Accumulated Earnings and Profits," Taxes 37 (July 1959):575.

<sup>86</sup>U.S., Congress, House, Report of the House Ways and Means Committee, H. Rept. 1860, 75th Cong., 3rd sess., 1938, p. 31.

Revenue Acts of 1939, 1940, 1941,  
1942, 1945, and 1951

Until 1939, each Revenue Act enacted by Congress was a separate and complete statute in its own right. That is, each new Revenue Act contained all the tax laws in effect at that time and repealed all previously enacted laws. Congress, however, recognized that it would be more practical to codify all the tax laws into one unit, and to have any future changes in the tax law made by adding, deleting, or amending the existing code. Thus, in February, 1939, Congress adopted into law the "Internal Revenue Code of 1939" (referred to as the "1939 Code"), which for the first time, codified all existing tax laws.<sup>87</sup> The 1939 Code contained the same accumulated earnings tax provision enacted in Revenue Act of 1938.<sup>88</sup>

Subsequent Revenue Acts enacted between 1939 and 1954 did not substantially change the accumulated earnings tax as originally enacted into the Code, although certain technical amendments were adopted. The accumulated earnings tax provisions was not substantially revised between 1939 and 1954 because Congress perceived the law as being effective and accomplishing its objectives.

Corporate Criticism of the Accumulated Earnings Tax

With the burden of proof shifted to the taxpayer, the Bureau of Internal Revenue was increasingly successful in

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<sup>87</sup>1981 Federal Tax Course, p. 118.

<sup>88</sup>Internal Revenue Code of 1939, Section 102.



assessing the penalty tax on corporations and had adopted an aggressive posture in seeking out corporations to which the accumulated earnings tax could be applied.<sup>89</sup> The ineffectiveness of the penalty tax no longer was an overriding concern. Quite to the contrary, corporations were complaining that the accumulated earnings tax was unreasonably harsh and punitive.

In 1946, for example, the Bureau attempted to more readily identify corporations that could be subject to the accumulated earnings tax, by requiring all corporations failing to distribute 70 percent of their earnings as dividends to its shareholders to file a statement with their corporate income tax returns justifying the need for the retentions. Any corporation filing such a statement was seemingly an obvious target for a tax audit. In order to avoid filing this statement, the boards of directors of many corporations voted to distribute at least 70 percent of the corporations' earnings even when sound business judgement might have dictated otherwise.<sup>90</sup> The Bureau was sharply criticized for this action and ultimately, agreed to rescind this requirement in 1948.

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<sup>89</sup>William Cary, "Accumulations Beyond the Reasonable Needs of the Business: The Dilemma of Section 102(c), Harvard Law Review 60 (1947) pp. 1282-3.

<sup>90</sup>U.S., Treasury Department, Internal Revenue Bulletin, Treasury Decision 4914, 1939-2, C.B. 108.

The Bureau's successful efforts to apply the accumulated earnings tax raised the ire of many corporations. Corporations complained they were being intimidated by the penalty tax and that this tax law was far more harsh than anyone had realized or expected.

#### Special Tax Study Committee

The complaints of the corporate community were substantiated by a Special Tax Study Committee, referred to as the Magill Committee, appointed in 1947. The Committee found evidence of abuse of authority by the Bureau of Internal Revenue in its application of the accumulated earnings tax. It also noted in the report that "So long as the general threat of the (accumulated earnings tax) . . . hangs over directors' heads, they are likely to seek to avoid trouble by distributing more earnings than they honestly believe to be desirable."<sup>91</sup>

The Committee explained the problem as follows:

Many situations arise, which require the retention of earnings, for perfectly legitimate corporate purposes . . . If the corporation is to grow and advance, it must be permitted to reinvest substantial amounts of its own earnings in its own business. Small American businesses have grown great in just this fashion. The corporate directors are the best judges of the company needs. A revenue agent in the field cannot be the best judge, for he does not have the intimate familiarity with the <sup>92</sup> corporation's business that its own directors have.

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<sup>91</sup>U.S., Congress, House, Special Tax Study to the Committee of House Ways and Means, November 1947, quoted by Lucius Buck and Francis Shackelford, "Retention of Earnings by Corporations Under the Income Tax Laws," Virginia Law Review 36 (May 1950):462.

<sup>92</sup>Ibid.

The Committee therefore recommended, among other recommendations, that the accumulated earnings tax provision be weakened by shifting the burden of proof back to the government. Congress, however, refused to adopt the Committee's recommendations fearing that it would render the accumulated earnings tax impotent.<sup>93</sup>

In addition to the dividend distribution problem noted in the Magill Committee's report, corporations criticized the accumulated earnings tax provision on other grounds. Of particular concern were two specific matters: (1) The application of the "immediacy test," and (2) the manner in which the penalty tax was computed.

(1) The "immediacy test." In determining whether the reasonable needs of the business justified the retention of earnings, the Bureau of Internal Revenue applied an "immediacy test." This test required the corporation to prove that it had a specific, definite and immediate plan for using the accumulated earnings. Plans which could not be immediately implemented or which were subject to contingencies, were generally considered to be too vague to justify retentions.<sup>94</sup>

The harshness of the immediacy test is exemplified by the court's decision in World Publishing Company v. United

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<sup>93</sup>Ibid., p. 463.

<sup>94</sup>James Hall, "Revision of the Internal Revenue Code and Section 102," National Tax Journal 8 (September 1955):280.

States.<sup>95</sup> Having decided to construct additional facilities to meet expanding business needs, the World Publishing Company established a reserve of cash in 1942 and 1943 at the expense of the customary dividend policy. The company, however, was unable to construct the new facilities because of a shortage of supplies and materials and other restrictions placed on construction during World War II.

The Court agreed with the Bureau's imposition of the accumulated earnings tax on the company since it was impossible to determine, at that point in time, the number of years the war would continue. Thus, the Court reasoned, that although World Publishing Company had a definite expansion plan, it could not implement the plan immediately and therefore could not justify the retention of earnings.

(2) Computation of penalty tax. The provision in the 1939 Code for the computation of the penalty tax was essentially the same as that adopted in the Revenue Act of 1934: the penalty rates were applied against a corporation's entire undistributed taxable income. Thus, for example, if a corporation's taxable income was \$90,000 and it distributed \$30,000 in dividends, even if it was determined that only \$10,000 of the undistributed \$60,000 was accumulated beyond the reasonable needs of the business, the entire \$60,000 was subject to the penalty tax. The corporate community contended that this method was totally unreasonable and excessively

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<sup>95</sup>169 F.2d 186 (10th Cir., 1948).

punitive. A more equitable method would have been to apply the penalty rates to only that portion of a corporation's undistributed income which is deemed to have been accumulated beyond the reasonable needs of the business.<sup>96</sup>

A review of the events from 1938-1951, makes clear that with the enactment of the Revenue Act of 1938, which required the taxpayer to prove by a "clear preponderance of the evidence" that the corporation was not availed of for the prohibited purpose, the entire complexion of the accumulated earnings tax changed. Criticism of the accumulated earnings tax provision by corporations surfaced and, in fact, swelled because of the Bureau's success in implementing the penalty tax against various corporations. In stark contrast, there were virtually no corporate complaints prior to 1938 because few corporations were found liable for the penalty tax.

Congress had in fact been forewarned and was cognizant of the many potential problems and criticisms that ultimately emerged. As was pointed out in the Congressional discussion and reports relating to the revenue acts prior to 1938, Congress' failure to adopt a new accumulated earnings tax provision in those earlier years was due to the fear that a strong provision would result in abuse by the Bureau of Internal Revenue in its implementation of the tax and that a strong

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<sup>96</sup>Ralph Heninger, "Federal Taxation of Corporate Surpluses," Iowa Law Review 28 (1943):641.

provision would stunt the growth of corporations legitimately accumulating earnings for expansion.

After enactment of the 1939 Code, however, Congress refused to be swayed by the resulting criticism. After nearly three decades in which the accumulated earnings tax had been essentially inoperative, Congress appeared delighted to have enacted a provision that was producing results and was unwilling to permit this tax provision to revert to its prior state of ineffectiveness.

The legitimacy of the corporate community's criticisms was, however, recognized. As reported in a study conducted in 1950 by the Committee on Federal Taxation of the American Institute of Accountants, it was found that:

Many corporations with a temporary highly abnormal liquidity find themselves under powerful silent pressure from the accumulated earnings tax to pay dividends when considerations of normal business prudence would require conservation of these funds for additions to and replacement of facilities, expansion, protection against possible business decline, or other valid purposes. With the return of competitive business conditions, the need for greater working capital is more evident (with prices far above prewar levels, inventories and receivables reflect dollar amounts far larger than prewar amounts, even for the same physical volume). The increasing tendency reflected in some court decisions to restrict justification for earnings to business requirements which are imminent and definite, as well as the fact that the burden of justification of retaining earnings is on the taxpayer, exerts pressure toward unsound dividend policy. Directors, acting in good faith and using their best judgement, may find their judgement held to be erroneous by the Commissioner or by the courts (who have the benefit of hindsight) and thus be exposed to minority stockholders' actions. This pressure and the uncertainty which it creates in

the formulation of sound business policy is the most unfortunate feature of the present situation.<sup>97</sup>

Nevertheless, it was not until 1954, when the Internal Revenue Code of 1954 was enacted, that Congress agreed to adopt substantive amendments to the accumulated earnings tax provision in order to redress the foregoing wrongs.

#### The Internal Revenue Code of 1954

In 1953 Congress decided to once again revamp, revise and recodify the Federal tax laws. After an intensive and comprehensive review of all the federal tax laws and rules, Congress repealed the 1939 Code and in its stead enacted the "Internal Revenue Code of 1954" (the "1954 Code").<sup>98</sup>

In considering a new accumulated earnings tax provision for inclusion in the 1954 Code, Congress recognized that it was necessary to retain the penalty tax as a safeguard against tax avoidance. However, Congress was also prepared to attempt to remedy the many deficiencies inherent in the old statute.

In its report on the Internal Revenue Code of 1954 the House Ways and Means Committee succinctly explained the need for revising the accumulated earnings tax provision as follows:

Your committee has received numerous complaints that the provision is prejudicial to small business, that it has been applied in an arbitrary manner in many

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<sup>97</sup>American Institute of Accountants, Committee on Federal Taxation, Recommendations for Amendment of Federal Tax Laws, (New York: American Institute of Accountants, 1950):19.

<sup>98</sup>1981 Federal Tax Course, p. 119.

cases, and that it is a constant threat to expanding business enterprises. Fear of the penalty is said to result frequently in distribution of funds needed by the corporation for expansion or other valid purposes.<sup>99</sup>

Thus, Congress attempted to draft a provision which while protecting the federal income tax structure would not unreasonably restrict legitimate business activities or adversely affect the national economy.

#### 1954 Code Provision Corrects Deficiencies in Old Statute

As enacted in the 1954 Code, Congress retained the basic two conditions a corporation must satisfy before being subject to the accumulated earnings tax which have been retained to this day: (1) that the corporation be availed of for the purpose of avoiding taxes with respect to its shareholders and (2) that the corporation accumulate earnings beyond the reasonable needs of the business. However, Congress adopted numerous substantive and technical changes which were designed, in part, to remedy three specific problems which were particularly disturbing and bothersome to the corporate community.

#### The Amount of Taxable Income to which the Penalty Rates May Be Applied

As previously noted, corporations complained that it was unreasonable to apply the penalty tax against the entire

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<sup>99</sup>U.S., Congress, House, Report of the House Ways and Means Committee, H. Rept. 1337, 83rd Cong., 2nd sess., 1954, p. 52.



undistributed taxable income of a corporation when it was determined that only a portion of the retained income was accumulated beyond the reasonable needs of the business. Congress sought to correct this inequity by providing that the penalty tax could only be applied against a corporation's "accumulated taxable income" - a new term created by and defined in the 1954 Code.<sup>100</sup>

Accumulated taxable income was defined as an amount equal to the taxable income of the corporation, reduced by the sum of the amount of dividends distributed to the shareholders and the "accumulated earnings credit."

The accumulated earnings credit was in essence a two pronged credit. First, corporations were allowed to accumulate \$60,000 over the life of the corporation without being required to prove any reasonable business need for such an accumulation. Second, if the corporation's accumulated earnings exceeded \$60,000, the amount of the credit would be equal to the amount of taxable income the corporation could prove was necessary for the reasonable needs of the business. In no event was the credit to be less than \$60,000.

Thus, the applicability of the penalty tax was limited to the portion of earnings accumulated by a corporation beyond its reasonable business needs. Earnings accumulated

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<sup>100</sup>Internal Revenue Code of 1954, Section 535;  
(hereinafter referred to as the "Code").

for reasonable business needs could never be subject to the penalty tax.

The Immediacy Test and the Reasonable Needs of the Business

The second substantive change was to expand the definition of the term "reasonable needs of the business." As previously discussed, the Bureau applied an "immediacy test" to determine whether the corporation had a legitimate purpose for accumulating earnings. In order for a corporation to justify an accumulation of earnings, the corporation was required to prove that it had a specific and definite plan which would be immediately implemented.

In order to mitigate the harshness of the application of this test (as exemplified in the case of World Publishing Company v. Commissioner discussed above), Congress specifically provided in the 1954 Code that:

For purposes of this part, the term "reasonable needs of the business" includes the reasonably anticipated needs of the business.<sup>101</sup>

The Senate Finance Committee explained the Statute's intent as follows:

It is intended that this provision will make clear that there is no requirement that the accumulated earnings and profits be invested immediately in the business so long as there is an indication that future needs of the business require such accumulation. In any case where there exists a definite plan for the investment of earnings and profits, such corporations need not necessarily consummate these plans in a relatively short period after the close of the taxable year. However,

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<sup>101</sup>Code, Section 537.

where the future needs of the business are uncertain or vague, or the plans for the future use of the accumulations are inadequate, the amendment does not prevent application of the accumulated earnings tax.<sup>102</sup>

Thus, by expanding the definition of the term "reasonable needs of the business," Congress eliminated the rigidity of the immediacy test, and provided a flexible yardstick for determining whether a corporation's plans could be implemented.

#### The Burden of Proof - On Whom?

As previously noted, the effectiveness of the accumulated earnings tax was markedly enhanced by the enactment of the Revenue Act of 1938 which shifted the burden of proof from the government to the taxpayer. However, taxpayers complained that revenue agents were coercing taxpayers to settle other tax issues by threatening to invoke the accumulated earnings tax, which carried a burden of proof that was difficult to satisfy. It was believed that many small businesses, for example, had agreed to pay proposed deficiency assessments because of the costly and difficult prospect of having to defend a threatened imposition of the accumulated earnings tax.

Moreover, as Otto aptly pointed out, there also was a moral and possibly constitutional question involved - "At present the corporation is guilty until it proves itself

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<sup>102</sup>U.S., Congress, Senate, Report of the Senate Finance Committee, S. Rept. 1622, 83rd Cong., 2nd sess., 1954, p. 318.

innocent - a state of affairs repugnant to the accepted standards of justice in the United States."<sup>103</sup>

The House Ways and Means Committee explained the need for a remedy as follows:

The Committee believes that this imposition of burden of proof on the taxpayer has had several undesirable consequences. The poor record of the government in the litigation cases in this area indicates that deficiencies have been asserted in many cases which were not adequately screened or analyzed. At the same time, taxpayers were put to substantial expense and effort in providing that the accumulation was for the reasonable needs of the business.<sup>104</sup>

Fearful of rendering the penalty tax impotent if the entire burden were shifted to the government, yet realizing the need for some remedial action, Congress adopted a compromise position. The government was required to send the corporate taxpayer a statement of the accumulated earnings tax deficiency assessed. The corporation could then shift the burden of proof to the government by filing a statement with the Internal Revenue Service<sup>105</sup> setting forth the reasons for the retention of earnings. Obviously, unless the statement were well documented the courts would not deem the

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<sup>103</sup>Ingolf Otto, "Section 102: The Tax on a Corporation's Psyche," Taxes 31 (June 1953):438.

<sup>104</sup>U.S., Congress, House, Report of the House Ways and Means Committee, H. Rept. 1337, 83rd Cong., 2nd sess., 1954, p. 52.

<sup>105</sup>As noted in the section on Definitions, the Bureau of Internal Revenue was reorganized and renamed the Internal Revenue Service effective July 9, 1953.

taxpayer's filing of a statement as having satisfied its own initial burden of proof.<sup>106</sup>

#### Other Amendments and Code Section Numbers

Congress also adopted numerous other amendments to the accumulated earnings tax provision. For example, the two-tier penalty tax rate concept previously in effect was retained, but the rates themselves were modified. The new penalty tax rates applied to a corporation subject to the accumulated earnings tax were as follows:

(1) 27 1/2% on "accumulated taxable income" of \$100,000 or less and

(2) 38 1/2% on "accumulated taxable income" in excess of \$100,000.<sup>107</sup>

Other amendments to the accumulated earnings tax provision were primarily technical in nature and did not substantively change the character of the penalty tax.

Satisfied that it had remedied the inequities in the previous laws, Congress numbered the accumulated earnings tax provisions as Sections 531 through 537 and it has remained incorporated as such in the 1954 Code until today. The accumulated earnings tax is, therefore, often referred to as the "Section 531 tax."

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<sup>106</sup>Code, Section 534.

<sup>107</sup>Code, Section 531.

Publicly-Held Corporations  
and the 1954 Code

Equally significant to the substantive changes that were enacted by Congress in the 1954 Code is what Congress did not enact. The House of Representatives had originally proposed a provision which would have specifically exempted any corporation having more than 1,500 shareholders, if no more than 10 percent of the stock was held by an individual, from being subject to the accumulated earnings tax.<sup>108</sup>

The intent of this provision was to generally exclude publicly-held corporations from being subject to the accumulated earnings tax. However, this provision was deleted from the final bill. The Senate Finance Committee explained the reason for deleting the provision as follows:

Under present law the . . . tax is theoretically applicable to publicly-held as well as closely-held companies. As a practical matter, the provision has been applied only in cases where 50 percent or more of the stock of a corporation is held by a limited group . . . Testimony before your committee has indicated that it would be very difficult for many corporations which are generally recognized to be publicly-held to establish from its records that not more than 10 percent of its stock is held by an individual and members of his family. Yet if publicly-held corporations are to be exempted from this tax it is recognized that a requirement of this type is needed. In view of this and the fact that this tax is not now in practice applied to publicly-held corporations, your committee believed it was desirable to remove the exemption provided for such corporations by the House bill.<sup>109</sup>

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<sup>108</sup>U.S., Congress, House, Report of the House Ways and Means Committee, H. Rept. 1337, 83rd Cong., 2nd sess., 1954, p. 54.

<sup>109</sup>U.S., Congress, Senate, Report of the Senate Finance Committee, S. Rept. 1622, 83rd Cong., 2nd sess., 1954, p. 69.

The practical significance of the foregoing is not clear. Robert Holzman asserted that "the very fact that this provision was stricken from the final version of the Code shows that Congress did not intend to confine the accumulated earnings tax to closely-held corporations."<sup>110</sup> James Hall, on the other hand, contended that Congress intended to exclude publicly-held corporations from the accumulated earnings tax but could not formulate a provision which would adequately reflect Congressional intent.<sup>111</sup>

As a matter of policy, however, Hall agrees that consideration should be given to "expanding the corporate area to which the accumulated earnings tax section applies" by imposing the tax on publicly-held corporations as well as on closely-held corporations. This was pointed out in Hall's study on the effectiveness of the accumulated earnings tax, which he conducted for Congress in 1950 and which is analyzed in the Review of Related Literature.<sup>112</sup>

Judicial decisions have merely complicated, rather than clarified, this issue. To date there have been only

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<sup>110</sup>Robert Holzman, "Accumulated Earnings Tax," Taxes 32 (October 1954):847.

<sup>111</sup>James Hall, "Revision of the Internal Revenue Code and Section 102," National Tax Journal 8 (September 1955) pp. 282-284.

<sup>112</sup>U.S., Congress, Joint Committee on the Economic Report, The Taxation of Corporate Surplus Accumulations by James Hall, Joint Committee Print, (Washington, D.C. Government Printing Office, 1952), pp. iv-v.

two reported cases in which the IRS has attempted to impose the accumulated earnings tax on a publicly-held corporation. In Trico Products Corporation vs. Commissioner,<sup>113</sup> decided in 1942, the tax was successfully imposed upon Trico Products Corporation. However, since the major shareholders owned 87 percent of the corporation's outstanding stock so as to make it effectively a closely-held corporation in every aspect but name, this decision cannot be clearly read to have held that publicly-held corporations may be subject to the accumulated earnings tax.

In Golconda Mining Corporation,<sup>114</sup> decided in 1972, the IRS attempted once again to impose the accumulated earnings tax on a publicly-held corporation. Golconda contended that it could not be subject to the accumulated earnings tax since it was a publicly-held corporation, and cited the Senate Finance Committee report in support of its position. The Tax Court, however, responded:

. . . this same Senate report clearly indicates that this action [eliminating the House provision restricting the applicability of the tax to publicly-held corporations] was taken by the Senate with full knowledge that the accumulated earnings tax was theoretically applicable to publicly held, as well as closely held, companies without the specific exemption proposed by the House. Accordingly, we conclude as a matter of law that the accumulated

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<sup>113</sup>46 BTA 346 (1942).

<sup>114</sup>58 TC 139 (1972).



earnings tax can apply to publicly held corporations.<sup>115</sup>

The Court of Appeals, however, overturned the Tax Court's decision, claiming, among other factors, that when Congress enacted the accumulated earnings tax into the Code "it did not intend to change the longstanding practice and application of the tax to closely-held corporations and those corporations alone."<sup>116</sup>

The Court of Claims recently commented on this issue in Alphatype Corporation v. United States.<sup>117</sup> Alphatype, a closely-held corporation, contended that "it was denied due process of law and equal protection of the law because the application of the accumulated earnings tax was limited to nonpublicly owned corporations."<sup>118</sup> Accordingly, it claimed the accumulated earnings tax was unconstitutional. The court, however, held that although the IRS may have only found closely-held corporations to be liable for the tax,

. . . it is the court's opinion that the accumulated earnings tax can apply to publicly-held corporations. They are included within the statute; Congress had an opportunity to exempt them and did not.<sup>119</sup>

The Internal Revenue Service has adopted the position that this penalty tax could be applied to publicly-held

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<sup>115</sup>Ibid., p. 158.

<sup>116</sup>507 F.2d 594 (9th Cir. 1974), p. 597.

<sup>117</sup>76-2 USTC 9730 (Ct. Cl. 1976).

<sup>118</sup>Ibid.

<sup>119</sup>Ibid.

corporations. In fact, in response to the Court of Appeals opinion in Golconda, the IRS issued a Revenue Ruling stating:

The position of the Service is that there is no legal impediment in applying, in an appropriate case, the accumulated earnings tax to a publicly-held corporation.<sup>120</sup>

Thus, whether the accumulated earnings tax can legally be applied to publicly-held corporations is still an open issue, largely unresolved.

#### The Accumulated Earnings Tax Since 1954

Although Congress has amended certain provisions of the accumulated earnings tax since their original enactment in 1954, those amendments have largely been technical in nature. For example, the accumulated earnings credit was increased from \$60,000 to \$100,000 in 1958 and then again increased in 1975 to \$150,000.<sup>121</sup> Certain administrative actions and judicial decisions, however, have significantly affected the accumulated earnings tax.

#### Administrative Actions

In 1959 the Treasury Department issued Regulations relating to the accumulated earnings tax which explained, amplified and interpreted the various tax provisions contained in Sections 531-537 of the 1954 Code. The Regulations

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<sup>120</sup>U.S., Treasury Department, Internal Revenue Bulletin, Revenue Ruling 75-305, 1975-2 C.B. 228.

<sup>121</sup>Code, Section 535(c)(2).

included a representative list of items which "if supported by sufficient facts, may indicate that the earnings and profits of a corporation are being accumulated for the reasonable needs of the business."<sup>122</sup> The Regulations also contained a list of items for which an accumulation of earnings would not be justified. These two lists have not been changed or amended since their original promulgation and are currently in effect.

The following are the items enumerated in the Regulations which indicate that earnings are being accumulated for the reasonable needs of the business:

1. To provide for bona fide expansion of business or replacement of plant;
2. To acquire a business enterprise through purchasing stock or assets;
3. To provide for the retirement of bona fide indebtedness created in connection with the trade or business, such as the establishment of a sinking fund for the purpose of retiring bonds issued by the corporation in accordance with contract obligations incurred on issue;
4. To provide necessary working capital for the business, such as, for the procurement of inventories; or
5. To provide for investments or loans to suppliers or customers if necessary in order to maintain the business of the corporation.<sup>123</sup>

The following are the items enumerated in the Regulations which indicate that the corporation has accumulated earnings for "unreasonable" business needs.

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<sup>122</sup>Regulations, Reg. 1.537-3(b).

<sup>123</sup>Ibid.

1. Loans to shareholders, or the expenditure of funds of the corporation for the personal benefit of the shareholders;
2. Loans having no reasonable relation to the conduct of the business made to relatives or friends of shareholders or to other persons;
3. Loans to another corporation, the business of which is not that of the taxpayer corporation, if the capital stock of such other corporation is owned, directly or indirectly, by the shareholder or shareholders of the taxpayer corporation and such shareholder or shareholders are in control of both corporations;
4. Investments in properties, or securities which are unrelated to the activities of the business of the taxpayer corporation; or
5. Retention of earnings and profits to provide against unrealistic hazards.<sup>124</sup>

The Regulations, however, do not present a detailed analysis of each item nor do they explain how each item is to be interpreted. For example, further clarification is needed as to what may be considered "necessary working capital of the business" or when an investment in properties or securities may be considered "unrelated to the activities of the business."

A more detailed analysis, however, can be found in the Tax Audit Guidelines (referred to as the Guidelines) which were made available to the public in 1975. As noted in Chapter I, the Guidelines were treated as confidential material by the IRS until the courts, pursuant to a Freedom of Information Act request, required their public dissemination.<sup>125</sup> The

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<sup>124</sup>Regulations, Reg. 1.537-3(c).

<sup>125</sup>See page 26 of this dissertation.

Guidelines reflect how the IRS interprets and applies various Code provisions, including the accumulated earnings tax, and specifically sets forth criteria that must be satisfied before the IRS will impose the accumulated earnings tax on a corporation.

For example, the Guidelines contain a list of 25 items which should be referred to when determining whether the penalty tax can be applied to a corporation under audit. The list contains all the items listed in the Regulations plus additional items which, based on its own experience and analysis, the IRS deems significant in determining the applicability of the tax to a specific corporation. A more complete discussion of the items listed in the Regulations is presented in Chapter IV, which contains a detailed analysis of the Tax Audit Guidelines.

#### Judicial Decisions

The most significant impact upon the accumulated earnings tax was effected by various court decisions. In Bardahl Manufacturing Corporation<sup>126</sup> decided in 1965, the Tax Court developed a mathematical formula, referred to as the "Bardahl formula," for determining the amount of working capital a corporation needs to operate during one business cycle. As noted in the Review of Related Literature, the Bardahl formula is used as the first step for determining if a corporation

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<sup>126</sup>24 TCM 1030 (1965).

has accumulated earnings beyond the reasonable needs. Courts have consistently relied on this formula and have in most instances adjusted the formula to the particular circumstances of the individual corporation under analysis.

The development of the Bardahl formula was of particular significance and importance because it represented, for the first time, a general uniform standard and guideline against which to measure an accumulation beyond the reasonable needs of the business. Prior to the development of the Bardahl formula, the so-called objective condition which a corporation must satisfy before being subject to the accumulated earnings tax (i.e., determining if a corporation had accumulated earnings beyond the reasonable needs of the business), was, in reality, a largely subjective test. No reliable yardstick was available by which corporations could measure whether what they considered the reasonable needs of the business was consistent with what the Internal Revenue Service and the courts considered the reasonable needs of the business. Although the Bardahl formula by no means represented a fixed and absolute standard, and in virtually every case the formula has been modified to the specific circumstances surrounding the case at hand, corporations were provided with a general and reliable guideline by which they could

determine whether the IRS and the courts would consider an accumulation reasonable or not.<sup>127</sup>

In 1969, the United States Supreme Court issued its landmark decision in Donruss Corporation v. United States.<sup>128</sup>

The court held in Donruss that in determining whether a corporation was availed of for the purpose of avoiding taxes with respect to its shareholders, tax avoidance need not be the dominant or controlling motive, but need only be one of the motives for accumulating earnings beyond the reasonable needs of the business. As pointed out in the Review of Related Literature, this decision in effect mitigated the need for the IRS to prove that a corporation was availed of for the purpose of avoiding taxes for its shareholders since virtually all corporations consider the tax implication of dividend distributions on its shareholders in determining dividend policy.<sup>129</sup>

The case involving Golconda Mining Corporation was yet a third significant court decision. As previously discussed, in Golconda the Tax Court<sup>130</sup> upheld the IRS's imposition of

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<sup>127</sup>Kathleen Hyland, "Working Capital Needs and the Taxation of Accumulated Earnings--Adjustments to the Bardahl Formula," Marquette Law Review 60 (1977) pp. 251-3

<sup>128</sup>393 U.S. 297 (S. Ct. 1969).

<sup>129</sup>See Chapter 2 page 42 of this dissertation.

<sup>130</sup>58 TC 139 (1972).

the accumulated earnings tax on a publicly-held corporation, but the Court of Appeals<sup>131</sup> overturned the decision by holding that the accumulated earnings tax could not be applied to publicly-held corporations. To date, the issue of whether publicly-held corporations could be subject to the accumulated earnings tax is yet unresolved.

#### Summary

In summarizing the legislative history of the accumulated earnings tax, the following significant facts and events are particularly relevant:

1. The accumulated earnings tax has its ancestral roots in the Tariff Act of 1913, the first official income tax law enacted in the United States.

Since 1913, when the original provision was enacted, to date, two conditions were required to be satisfied before a corporation could be found subject to the accumulated earnings tax: (1) the corporation must have satisfied the objective condition of having accumulated earnings beyond the reasonable needs of the business, and (2) the corporation must have satisfied the subjective condition of having accumulated earnings for the purpose of avoiding income tax with respect to its shareholders.

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131507 F.2d 594 (9th Cir. 1974).



2. From 1913 to 1921 the accumulated earnings tax was levied solely on individual shareholders and not upon the corporation.

3. As a result of the United States Supreme Court decision in Eisner v. Macomber, the Revenue Act of 1921 amended the accumulated earnings tax by providing that the penalty tax be levied on the corporation instead of on individual shareholders.

4. The Revenue Act of 1934 excluded personal holding companies from the accumulated earnings tax, and instead provided a separate penalty tax for personal holding companies.

5. In order to strengthen the accumulated earnings tax provision which was essentially unenforceable and ineffective, the Revenue Act of 1938 provided that if the Bureau of Internal Revenue determines that a corporation is subject to the accumulated earnings tax, the taxpayer is automatically liable for the penalty tax unless the taxpayer can prove to the contrary by a "clear preponderance of the evidence." By so doing, the burden of proof, which heretofore rested on the shoulders of the government, was shifted to the taxpayer.

As a result of this amendment, the Bureau of Internal Revenue was able to effectively administer the accumulated earnings tax and was successful in imposing the penalty tax on various corporations. The imposition of the penalty tax

was, however, soundly criticized by the corporate community as adversely affecting their businesses.

6. In Trico Products Corporation v. Commissioner, decided in 1942, the Tax Court upheld the imposition of the accumulated earnings tax on a publicly-held corporation which was controlled by a small number of shareholders.

7. A Special Tax Study Committee (the Magill Committee) issued a report documenting, and verifying the legitimacy of the many complaints raised against the accumulated earnings tax. Although the report recognized a need for the accumulated earnings tax, it found the penalty tax, in many instances, unduly harsh and having particularly adverse effects on small business corporations.

8. In 1950, Congress commissioned James Hall to conduct a study devoted solely to the effectiveness of the accumulated earnings tax. In addition to presenting recommendations for amending the accumulated earnings tax provision, he suggested that the Bureau of Internal Revenue consider expanding the corporate area to which the accumulated earnings tax section applies, "by imposing the tax on publicly-held corporations as well as closely-held corporations."

9. In 1954, Congress enacted the Internal Revenue Code of 1954. The accumulated earnings tax provisions incorporated in the 1954 Code attempted to remedy the deficiencies inherent

in the prior provisions. Specifically, the following three particular problems were remedied: (a) Under prior law, the penalty tax was applied against a corporation's entire undistributed taxable income even when only a portion of the income was accumulated beyond the reasonable needs of the business. The 1954 Code provided that the penalty tax can only be applied against a corporation's "accumulated taxable income," which essentially included only corporate income accumulated beyond the reasonable needs of the business;

(b) Under prior law, the Bureau of Internal Revenue applied the "immediacy test" to determine if a corporation could justify its retention of earnings. The 1954 Code expanded the definition of the term "reasonable needs of the business" to include the "reasonably anticipated needs of the business" and thereby provided for a more flexible yardstick for determining whether a corporation's retentions were justified;

(c) Under prior law, if the Bureau of Internal Revenue imposed the accumulated earnings tax on a corporation, a corporation was held liable for the accumulated earnings tax imposed by the Bureau of Internal Revenue unless the corporation could prove by "a clear preponderance of evidence" to the contrary. The 1954 Code provided that, if certain requirements were satisfied by the corporation, the burden of proof was automatically shifted to the government.

10. In 1959, the Treasury Department issued Regulations relating to Sections 531-537 of the 1954 Code. While these Regulations have been modified somewhat over the years, they have remained essentially unchanged and are currently in effect.

11. In 1965, the Tax Court in Bardahl Manufacturing Corporation developed a general formula, referred to as the Bardahl formula, for determining the working capital needs of a corporation. The Internal Revenue Service and the courts have since consistently relied on this formula as a first step in determining whether a corporation satisfied the objective condition of the accumulated earnings tax.

12. In 1969, the United States Supreme Court issued the landmark Donruss decision, which held that in determining if a corporation satisfied the subjective test of corporate intent to avoid taxes on behalf of its shareholders, tax avoidance need not be the "dominant" motive but merely "one" of the motives.

13. In 1972, the Court of Appeals overturned the Tax Court's decision in Golconda Mining Corporation and thereby denied the IRS the right to impose the accumulated earnings tax on a publicly-held corporation. The IRS responded by setting forth its view in a Revenue Ruling that "there is no legal impediment in applying, in an appropriate case, the accumulated earnings tax to a publicly-held corporation."

14. In 1975, the Internal Revenue Service publicly disseminated its Tax Audit Guidelines. The Guidelines present a detailed description and analysis of the manner in which the Internal Revenue Service implements the accumulated earnings tax.

## CHAPTER IV

### CRITERIA USED BY THE INTERNAL REVENUE SERVICE FOR DETERMINING IF A CORPORATION COULD BE SUBJECT TO THE ACCUMULATED EARNINGS TAX

#### Introduction

This chapter contains an analysis of the twenty-five factors listed in the Tax Audit Guidelines regarding the accumulated earnings tax. The objectives of this analysis are:

1. to determine the validity of each of the twenty-five factors, and
2. to identify the criteria upon which the Internal Revenue Service relies when determining if a corporation could be subject to the accumulated earnings tax.

As noted in Chapter III, under current tax law, in order for a corporation to be subject to the accumulated earnings tax it must satisfy both the objective condition of having accumulated earnings beyond the reasonable needs of the business and the subjective condition of having accumulated earnings for the purpose of avoiding personal income

taxes with respect to its shareholders. Each factor listed in the Guidelines relates to one of these two conditions. Accordingly, sections a through f of this chapter contain an analysis of those factors which are categorized as relating to the objective condition and sections g through k contain an analysis of those factors which are categorized as relating to the subjective condition.<sup>1</sup> Since the analysis for some of the factors is detailed and involved, a summary of the major points discussed is provided at the end of each section.

Category I: Objective Condition

- a. Reasonably Anticipated Needs of the Business:  
Specific, Definite and Feasible

Unfavorable factor:

6. Documentation of the needs of the business:  
 (a) In the corporate minutes.  
 (b) Performing actual work in fulfilling the needs.

Favorable factor:

1. The business need for the accumulation are vague and indefinite.<sup>2</sup>

The Regulations state that an accumulation of earnings is considered beyond the reasonable needs of the business "if it exceeds the amount a prudent businessman would consider

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<sup>1</sup>As noted in the Methodology section in Chapter I, page 30, similar and related factors were grouped together. Thus, all of the factors included in each group are discussed together in one section.

<sup>2</sup>Gramatically, this sentence is incorrect because the first half of the sentence is written in the singular ("need") while the second half is written in the plural ("are"). Accordingly, hereinafter, this factor will be stated in the plural, i.e., the business needs for the accumulation are vague and indefinite.

appropriate for the present business needs and for the reasonably anticipated future needs of the business."<sup>3</sup> Conversely, an accumulation of earnings is deemed to be for the reasonable needs of the business if a prudent businessman would consider the amount appropriate for the present business needs and for the reasonably anticipated future needs of the business.

Thus, based on this Regulation, a corporation may accumulate earnings if it satisfies one of two conditions: (1) the earnings are needed for current and "present business needs," or (2) the earnings are needed "for the reasonably anticipated future needs of the business."

#### Present Business Needs

The first condition, which allows a corporation to accumulate earnings for "present business needs" essentially refers to the amount of working capital required by a corporation to meet its current operating expenses. This amount is generally determined by the "Bardahl formula" which is more fully discussed and explained in section b of this Chapter.<sup>4</sup>

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<sup>3</sup>Regulations, Reg. 1.537-1(a).

<sup>4</sup>William Tankersley and Margaret Johnson, "Accumulated Earnings Tax: An Appeal for Flexibility," North Carolina Law Review 52 (1974):1182.



Reasonably Anticipated Future Needs of the Business

The second condition, which allows a corporation to accumulate earnings "for the reasonably anticipated future needs of the business," essentially refers to the amount of funds needed by the corporation to provide for capital growth and future business contingencies. Examples include the corporation's need to provide for new machinery, expansion of plant facilities and the need to set up a reserve for possible future losses arising from potential lawsuits.<sup>5</sup>

While the Regulations clearly allow a corporation to accumulate earnings for future business needs, they are equally explicit in noting that the law does not accept as the reasonable needs of the business visionary hopes and aspirations which have no substance or fundamental basis:

Where the future needs of the business are uncertain or vague, where the plans for the future use of an accumulation are not specific, definite, and feasible, or where the execution of such a plan is postponed indefinitely, an accumulation cannot be justified on the grounds of reasonably anticipated needs of the business.<sup>6</sup>

The key phrase in this Regulation which sets down the criteria for distinguishing between a valid and vague plan is "specific, definite, and feasible." In fact, the courts have consistently relied on, and referred to, this phrase

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<sup>5</sup>Ibid.

<sup>6</sup>Regulations, Reg. 1.537-1(b).

when analyzing whether an accumulation of earnings to provide for future business needs is justified.<sup>7</sup>

Indeed, determining whether a plan is specific, definite and feasible may be highly subjective and relative to the particular set of facts and circumstances relating to the corporation being analyzed. Prominent factors in one case may become minor in another. The court, in Fischer Lime and Cement Company v. United States,<sup>8</sup> detailed some general factors which indicate whether a proposed project is specific, definite and feasible:

To make the accumulation reasonable, their plans for improving plant facilities, machinery, and equipment, and for expansion must have substance as an existing reality at the time the decision to retain earnings was made. The mere recognition of a future need is not sufficient under the law to justify an accumulation . . . The intention must have been manifested by some course of conduct at the time of the accumulation.<sup>9</sup>

Substantiation of a corporation's intention to effectuate a proposed plan can often be verified by examining the minutes of the meetings of the corporation's board of directors and other relevant documents relating to the proposed plan.<sup>10</sup> As stated in the Guidelines:

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<sup>7</sup>Robert Holzman, Accountants and Treasurer's Complete Guide to Accumulated Earnings Tax, (New Jersey: Prentice-Hall, Inc. 1974) pp. 64-67.

<sup>8</sup>12 AFTR2d 5540 (W.D. Tenn. 1963).

<sup>9</sup>Ibid., p. 5543.

<sup>10</sup>Robert Monyek, "The Growing Problem of Accumulated Earnings: Section 531 Today," Taxes 47 (December 1969):772.

The minute books and correspondence files should be carefully examined to determine if plans for the use of earnings and profits are definite and realistic. Unrealistic statements to puff up the minutes should be noted.<sup>11</sup>

While a proposed plan must have a certain degree of specificity and concreteness, it need not be absolute and without risk. That is, the known existence of a contingency factor which may eventually compel the corporation to abandon its proposed plan will not, per se, invalidate the accumulation of earnings. For example, in Faber Cement Block Company Inc.,<sup>12</sup> the court stated:

Yet, the mere fact that expansion plans are contingent upon the outcome of certain political action will not result in a blanket bar of accumulations made pursuant to such plans . . . Taking note of the fact that local zoning matters typically abound with political nuances, we do not think it our province to second-guess the optimism of the [corporate directors] . . .<sup>13</sup>

Moreover, the Regulations point out that a plan will be considered specific, definite and feasible even if the plan cannot be immediately implemented. As noted in Chapter III,<sup>14</sup> when Congress enacted the Internal Revenue Code of 1954, it purposely expanded the definition of the term "reasonable needs of the business" to include the "reasonably anticipated

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<sup>11</sup>Internal Revenue Manual, para. 782(e).

<sup>12</sup>50 TC 317 (1968).

<sup>13</sup>Ibid., p. 332.

<sup>14</sup>See page 96 of this dissertation.

needs of the business," Congress' intent was to eliminate the "immediacy test" and provide corporations with an extended time period for implementing proposed plans. Accordingly, the Regulations state that "an accumulation need not be used immediately, nor must the plans for its use be consummated within a short period after the close of the taxable year."<sup>15</sup>

The courts have, therefore, adopted a liberal and lenient policy regarding the amount of time a corporation may avail itself before it consummates a proposed future business project and plan. For example, in Magic Mart Inc.,<sup>16</sup> the corporation accumulated earnings to provide for an expansion project which was not culminated until ten years later. The project was constantly delayed by unexpected events and inefficient management. Nevertheless, the court stated that "under the circumstances established by [the corporation] . . . we do not think the time element is controlling."<sup>17</sup> Therefore, the court held that the corporation had satisfied the requirement that the expansion plan be specific, definite, and feasible.

While the Magic Mart case is obviously an extreme example,<sup>18</sup> the courts have allowed corporations to delay

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<sup>15</sup>Regulations, Reg. 1.537-1(b).

<sup>16</sup>51 TC 775 (1969).

<sup>17</sup>Ibid., p. 797.

<sup>18</sup>In Alabama Coca-Cola Bottling Company, et. al., (28 TCM 635 (1969)), the court also allowed the corporation over ten years to consummate its plans.

implementation of their plans for such reasons as the need to obtain approval of a state regulatory agency;<sup>19</sup> to settle labor strikes;<sup>20</sup> and to await the recovery from illness of the manager in charge of the project.<sup>21</sup>

### Business Contingencies

The concept that a business need must be "specific, definite, and feasible" applies primarily to those accumulations of earnings which provide funds for the "reasonably anticipated future needs of the business." In reviewing the Guidelines' list of unfavorable and favorable factors, the following examples of such future business needs are included in the list: expansion of plant and equipment; investments; diversification; retirement of bond indebtedness; and stock redemptions. Each of these items is discussed in detail in the Guidelines and, therefore, is analyzed separately in succeeding sections of this Chapter.

However, one example of a future business need which is not included in the Guidelines' discussion and is specifically mentioned in the Regulations is the provision for future business contingencies and hazards.

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<sup>19</sup>California Motor Transport Co., Ltd., et. al.  
11 TCM 974 (1943).

<sup>20</sup>Knoxville Iron Company, 18 TCM 251 (1959).

<sup>21</sup>Sterling Distributors, Inc. v. United States,  
313 F.2d 803 (5th Cir. 1963).

The Regulations provide that "retention of earnings and profits to provide against unrealistic hazards"<sup>22</sup> is not considered a reasonable business need. The Guidelines, however, point out that the courts have allowed corporations to accumulate earnings "to guard against the harmful effects of a foreseeable contingency."<sup>23</sup> A contingency will be considered a reasonable realistic need of the business if, rather than being a remote possibility, a prudent businessman might expect such a contingency would arise. The Guidelines cite, as examples, the following six business contingencies:

- (a) An actual or potential lawsuit.
- (b) A possible liability arising out of some contractual obligation.
- (c) A possible business reversal resulting from the loss of a customer.
- (d) Accumulations to guard against competition has been justified in some cases.
- (e) An accumulation to provide funds to finance a self-insurance plan. This includes key men as well as the more common types of risk insurance.
- (f) Accumulations to provide a retirement plan for employees.<sup>24</sup>

Unfortunately, the Guidelines' discussion of this area ends at this point. It does not amplify or explain how, when, and in what context the courts have considered these items as reasonable business needs to justify an accumulation of earnings. Accordingly, each of the six items listed above

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<sup>22</sup>Regulations, Reg. 1.537-2(c)(5).

<sup>23</sup>Internal Revenue Manual, para. 774.3(1).

<sup>24</sup>Ibid.

will be analyzed separately and its validity substantiated by specific court cases.

(a) An actual or potential lawsuit. A corporation may accumulate earnings if a lawsuit is currently pending against the corporation or if possible legal action is real and evident. For example, in Fotocrafters Incorporated<sup>25</sup> the court agreed that a potential lawsuit was real where a competitor corporation had been using a device in their business similar to one on which Fotocrafters had a patent application pending. A qualified patent attorney testified that litigation was being considered and that there was a strong possibility of protracted litigation.

However, the court disallowed an accumulation of earnings in Gibbs and Cox, Inc. v. Commissioner<sup>26</sup> for the purpose of meeting possible damage suits arising from the corporation's liability in case of employee negligence. The court noted that there had never been any such claim against the corporation and there was no proof that the corporation had reason to believe that such a claim would occur in the foreseeable future.<sup>27</sup>

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<sup>25</sup>19 TCM 1401 (1960).

<sup>26</sup>147 F.2d 60 (2nd Cir. 1945).

<sup>27</sup>For additional cases see Casey v. Commissioner, 267 F.2d 26 (2nd Cir. 1959); Steelmasters, Inc., 35 TCM 460 (1976); Estate of Kreisel, 37 TCM 264 (1977).

(b) A possible liability arising out of some contractual obligation. This example is obviously similar to the preceding item except that this example focuses in on one specific type of lawsuit--a lawsuit arising out of a contractual obligation. In Bardahl International Corporation<sup>28</sup> the corporation was allowed to accumulate earnings to cover the estimated cost of defending a breach of contract lawsuit where the aggrieved party had already brought a similar suit against other corporations and there was no reason to believe that Bardahl would be spared.

Additionally, in Adolph Coors Co., et al<sup>29</sup> the court required the IRS to take into consideration a \$14,000,000 civil suit for breach of contract pending against the corporation when determining whether it had accumulated earnings beyond the reasonable needs of the business.

(c) A possible business reversal resulting from the loss of a customer. A corporation is allowed to appropriate a portion of its retained earnings to a special reserve account, where a significant percentage of its income is derived from one, or a mere few, principal customers. For example, in Ted Bates and Company, Inc.<sup>30</sup> the corporation derived 70% of its income from four large corporations. The

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<sup>28</sup>25 TCM 935 (1966).

<sup>29</sup>27 TCM 1351 (1968).

<sup>30</sup>24 TCM 1346 (1965).



court determined that Ted Bates and Company was in an extremely precarious position because the retention of these four corporations as future customers was unassured and, therefore, the corporation acted properly in accumulating earnings in order to preserve its financial viability in case it would lose one or all of its customers.

However, the court in Reynard Corporation<sup>31</sup> disallowed an accumulation of earnings to cover the potential loss of an important customer where the customer had signed a contract with Reynard and the contract would not expire for another two years. The court noted that there was no indication that the customer intended to breach the contract or even that there would be a cessation of the relationship after the contract expired.

(d) Accumulation to guard against competition has been justified in some cases. Robert Holzman points out that "of all the risks which a business must face, competition is probably the most common."<sup>32</sup> Thus, an accumulation of earnings can be justified for the purpose of neutralizing the effect of a competitive threat. In Motor Fuel Carriers, Inc. v. United States<sup>33</sup> the court noted that "most businesses must

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<sup>31</sup>37 BTA 552 (1938).

<sup>32</sup>Robert Holzman, Accountant's and Treasurer's Complete Guide to the Accumulated Earnings Tax (New Jersey: Prentice-Hall, Inc., 1974):109.

<sup>33</sup>202 F. Supp. 497 (N.D. Florida, 1962).

meet competition with like types of business but fear of competition alone, particularly where its record of earnings in the past does not justify such fear, does not warrant accumulation of surplus in excess of that which is reasonable."<sup>34</sup> Thus, as with all contingencies, there must be a real and apparent threat before an accumulation can be justified.

For example, in John P. Scripps Newspapers v. Commissioner,<sup>35</sup> the corporation realized that a competitor newspaper was beginning to affect its own circulation. John P. Scripps Newspapers therefore decided to set aside a portion of its earnings for the purpose of devising a plan to offset the competitors threat. The court recognized that in this situation, "setting aside a portion of earnings to meet competition is a reasonable need."<sup>36</sup>

(e) An accumulation to provide funds to finance a self-insurance plan. This includes key men as well as the more common types of risk insurance. A corporation may accumulate earnings for self-insurance even if commercial insurance is available. This applies to insurance for fire, theft or other casualty as well as life insurance for

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<sup>34</sup>Ibid., p. 500.

<sup>35</sup>44 TC 453 (1965).

<sup>36</sup>Ibid., p. 470.

employees. For example, in Wilcox Manufacturing Company Inc.,<sup>37</sup> the court agreed that the corporation had a right to accumulate earnings for self-insurance against fire in its manufacturing facilities. This was true even though the corporation had never had a significant fire in its facilities and had not established a specific reserve for this purpose. The court reasoned that "the record clearly establishes that the risk of a serious fire was substantial . . . [and though] the absence of a reserve on its books indicates that Wilcox had no plan of self-insurance . . . we think a plan on the part of Wilcox can be inferred from its cancelling the bulk of its commercial insurance."<sup>38</sup>

However, self-insurance was not regarded as a valid reason for accumulating earnings in Electric Regulator Corporation<sup>39</sup> because the court determined that a real intention of providing for the insurance was not evident, and nothing of a preventive nature was done by the corporation which would have otherwise been required by an insurance company.

Thus, if a corporation can prove that it has accumulated earnings for self-insurance purposes the courts will generally not question or challenge the need for the

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<sup>37</sup>38 TCM 1979-92.

<sup>38</sup>Ibid., p. 395.

<sup>39</sup>40 TC 757 (1963).

insurance. However, corporations have experienced difficulty in proving the amount needed for self-insurance. In the aforementioned Wilcox Manufacturing case the court reduced the amount allowed as adequate protection in case of fire to \$500,000 from the corporation's contended need of \$800,000. In Coastal Casting Service, Inc. v. Phinney the court claimed that a reserve of \$100,000 for fire insurance was excessive.<sup>40</sup>

In addition to allowing corporations to accumulate funds to finance self-insurance for casualties, the court in Bradford-Robinson Printing Company v. United States<sup>41</sup> recognized as a valid retention of earnings a reserve for life and disability insurance for their key personnel. The court held that the corporation was allowed to set up a fund to provide insurance in the event of the death of a key executive or should an executive become disabled and unable to carry on with the business of the corporation.

(f) Accumulation to provide a retirement plan for employees. A corporation may accumulate earnings in order to fund employee retirement plans. For example, in Bremerton Sun Publishing Company<sup>42</sup> retention of earnings was deemed to be justified where the corporation had an obligation to fund

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<sup>40</sup>26 AFTR2d 70-5862 (Texas 1970).

<sup>41</sup>1 AFTR2d 1278 (Colorado 1957).

<sup>42</sup>44 TC 566 (1965).

a profit-sharing and retirement plan for its employees. However, in Oklahoma Press Publishing Company v. United States<sup>43</sup> the court denied the corporation an allowance for setting aside additional funds for a retirement fund. The court noted that while setting up a reserve for a retirement fund is a justifiable reason for accumulating earnings, in this instance, the corporation had adequate reserves from past years' accumulations and, in fact, had purchased other insurance policies. Therefore, the court ruled, "the taxpayer had the burden of explaining why further additions to the retirement fund were necessary."<sup>44</sup>

#### Other Business Contingencies

In addition to the six examples cited in the Guidelines, other business contingencies are also considered valid reasons for accumulating earnings. In fact, in the Revenue Act of 1978 Congress enacted a new provision in the Code, Section 537(b)(4), which specifically mentioned another contingency not included in the Guidelines. In essence, the new Section states that corporations may accumulate earnings and set up a reserve "for the payment of reasonably anticipated product liability losses." The Conference Committee Report on this Act noted that the inclusion of this new provision into the Code did not change the existing law, but

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<sup>43</sup>437 F.2d. 1275 (10th Cir. 1971).

<sup>44</sup>Ibid., p. 1280.

rather "this amendment is consistent with, and merely clarifies, present law."<sup>45</sup> For example, in Wilcox Manufacturing Company, Inc. the court held that the corporation was justified in accumulating earnings for self-insurance against product liability for the corporation's tax years of 1969-1971--years prior to the passage of the Revenue Act of 1978.<sup>46</sup>

Examples of other valid business contingencies and hazards include potential labor disputes; potential adverse legislation; additional assessment of taxes including a potential deficiency for the accumulated earnings tax; effects of adverse business conditions such as a general economic recession.<sup>47</sup>

### Summary

The reasonable needs of a business can essentially be divided into two categories: (1) current business needs and (2) future business needs. Current business needs, which is more fully discussed in section b of this Chapter, essentially refers to the amount of working capital a corporation needs

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<sup>45</sup>U.S., Congress, Joint Committee, Revenue Act of 1978: Conference Report, No. 95-1800, 95th Cong., 2nd sess., 1978, p. 287.

<sup>46</sup>38 TCM 1979-92, p. 397.

<sup>47</sup>Noel Cunningham, "More than You Ever Wanted to Know About the Accumulated Earnings Tax," Journal of Corporate Taxation 6 (Autumn 1979):213-214.

to meet current operating expenses.

Future business needs refers to the "reasonably anticipated future needs of the business." Specific examples of valid future business needs are listed in the Guidelines and more fully discussed in succeeding sections of this Chapter. The only significant example of a future business need not specifically listed in the Guidelines is that of future business contingencies. Accordingly, this section included a detailed analysis of future business contingencies.

Regardless of the particular business need, in order for an accumulation of earnings to be justified, it must be "specific, definite, and feasible" as opposed to vague, indefinite and impractical. However, while a proposed plan for any business need must possess a degree of specificity and concreteness, it need not necessarily be implemented immediately. Thus, the Guidelines' listing of "the business needs for the accumulation are vague and indefinite" as a favorable factor when determining whether the accumulated earnings tax may be imposed upon a corporation is clearly valid.

A corporation may avoid being subject to the accumulated earnings tax if, as listed in the Guidelines, it has "documentation of the needs of the business" which shows that it truly intended to bring its future plans to fruition. Substantiation of a corporation's intention can generally be made by examining the corporate minutes and by reviewing

relevant documents which may reveal actions taken by the corporation toward eventually carrying out the plan.

#### b. Working Capital Requirements

Unfavorable factors:

7. Low current asset - current liability ratio.
8. Low current asset - current working capital ratio.<sup>48</sup>

Favorable factors:

2. The need for working capital can be met from current operations.
13. High current asset - current liability ratio.
14. High current asset - working capital ratio.

Of the first issues which must be resolved in determining whether a corporation is subject to the accumulated earnings tax is that of verifying whether the corporation has adequate funds to satisfy its current operating needs.<sup>49</sup> The Regulations clearly state that if a corporation does not have adequate funds to satisfy its current operating needs then the corporation cannot be subject to the accumulated earnings tax.<sup>50</sup>

The standard measure which has traditionally been used to determine whether a corporation has adequate funds to

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<sup>48</sup>The term "current working capital" is not found in the professional or academic literature because, by definition, the concept of working capital refers to current items. Moreover, favorable factor 14 which is the reciprocal of this factor, does not include the word "current" with the term working capital. Accordingly, for clarity and consistency, when referring to this factor the word "current" was deleted.

<sup>49</sup>Charles Gibson, "IRS Audit Techniques--Accumulated Earnings Tax," CPA Journal 45 (April 1975):24.

<sup>50</sup>Regulations, Reg. 1.537-2(b)(4).



satisfy its current operating needs is the corporation's "working capital." The American Institute of Certified Public Accountants defines and explains the concept of working capital as follows:

[It is] the excess of current assets over current liabilities and identifies the relatively liquid portion of total enterprise capital which constitutes a margin or buffer for meeting obligations within the ordinary operating cycle of the business.<sup>51</sup>

#### The Bardahl Formula

The problem, however, that remains unresolved is what amount is considered adequate working capital? Until 1965 the courts had used various rules of thumb for determining what amount of working capital would be adequate for a particular corporation. The courts, however, generally relied on two methods. One was the so called "one year" rule which assumed that the corporation would have no income for one year and therefore allowed the corporation to have sufficient working capital to meet operating expenses for one entire year. The other method was the "2.5:1 current ratio" rule which allowed a corporation to have working capital equivalent to \$2.50 of current assets for each \$1 of current liability. These rules of thumb, however, were considered inadequate and deficient because of their arbitrariness and

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<sup>51</sup>American Institute of Certified Public Accountants, Professional Standards, volume 3, (Chicago: Commerce Clearing House, Inc., 1977) para. 2031.03; (This refers to Accounting Research Bulletin 43, Chapter 3A).

their failure to distinguish between the different and varying needs of each individual corporation.<sup>52</sup>

Accordingly in 1965, the Tax Court in Bardahl Manufacturing Corporation<sup>53</sup> developed a mathematical formula, referred to as the "Bardahl formula," for determining the amount of working capital a corporation needs to operate during one business cycle. The court defined one operating cycle as being equal to "the period of time required to convert cash into raw materials, raw materials into an inventory of marketable . . . products, the inventory into sales and accounts receivable, and the period of time required to collect its outstanding accounts."<sup>54</sup>

Thus, the operating cycle is determined by computing the length of time a corporation has its inventory in stock prior to sale, referred to as the "inventory turnover cycle,"

$\left( \frac{\text{average inventory}}{\text{cost of goods sold}} \times 365 \right)$ , and the length of time it takes to collect its accounts receivable, referred to as the "accounts receivable turnover cycle,"

$\left( \frac{\text{average accounts receivable}}{\text{sales}} \times 365 \right)$ . The sum of the

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<sup>52</sup>Kathleen Hyland, "Working Capital Needs and the Taxation of Accumulated Earnings--Adjustments to the Bardahl Formula," Marquette Law Review 60 (1977):55.

<sup>53</sup>24 TCM 1030 (1965).

<sup>54</sup>Ibid., p. 1141.

inventory turnover cycle expressed in number of days and the accounts receivable turnover cycle expressed in number of days is equal to one operating cycle of a corporation. The operating cycle is then expressed as a percentage of a year by dividing the number of days in the operating cycle of 365 days.

To illustrate, assume the inventory turnover cycle of a corporation is 30 days and the accounts receivable turnover cycle is 60 days then the corporation's operating cycle is 90 days or approximately  $.2466 \left( \frac{90 \text{ days}}{365 \text{ days}} \right)$  of a year.

This percentage is then used to calculate the amount of working capital required by a corporation by multiplying the operating expenses of the corporation for the entire year by the operating cycle percentage.

The operating expenses of the corporation includes cost of goods sold and other expenses incurred by the corporation for its regular business operations. Depreciation and amortization expenses are excluded from the operating expenses since they reflect the usage and wasting away of assets and are not expenses which require an outlay of actual working capital funds. In addition, some courts have held that income taxes should also be excluded from operating expenses. These courts reasoned that since income taxes may not have to be paid until the following year it should be

treated as an independent item of debt.<sup>55</sup> However, other courts have held that corporations which pay income taxes currently and are required to make estimated tax payments throughout the year should be allowed to include their income tax liability in current operating expenses.<sup>56</sup> The Guidelines exclude income taxes in determining the amount of operating expenses to be used when computing the Bardahl formula.<sup>57</sup>

Thus, continuing with our previous illustration, if the corporation's operating expenses for one year is \$100,000, an adequate amount of working capital for this corporation would be approximately \$24,660 ( $.2466 \times \$100,000$ ).

The amount of working capital computed by using the Bardahl formula is then compared with the corporation's actual working capital as reflected on its balance sheet. If the corporation's working capital is equal to, or less than, the working capital computed under the Bardahl formula then the accumulated earnings tax can generally not be applied. If, however, the working capital of the corporation exceeds the working capital derived by the Bardahl formula then the accumulated earnings tax can be applied unless the

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<sup>55</sup>Magic Mart, Inc., 51 TC 775 (1969); Bardahl International Corp., 25 TCM 935 (1966).

<sup>56</sup>Empire Steel Castings, Inc., 33 TCM 155 (1974).

<sup>57</sup>Internal Revenue Manual, para. 777.4(2)(a).

corporation can prove it needs the excess funds for other reasonable needs of the business.

#### Computation of Bardahl Formula Summarized

Specifically, the computation of the Bardahl formula involves the following six steps:

- (1) Determine inventory turnover cycle. =  $\frac{\text{average inventory}}{\text{cost of goods sold}} \times 365$
- (2) Determine accounts receivable turnover cycle. =  $\frac{\text{average accounts receivable}}{\text{sales}} \times 365$
- (3) Determine the number of days in one operating cycle. = Add results of steps (1) and (2).
- (4) Express the operating cycle as a percentage of an entire year. =  $\frac{\text{step}(3)}{365}$
- (5) Determine the operating expenses of the corporation for the year less expenses not requiring cash outlays and federal income taxes. = Operating expenses less depreciation, amortization and income taxes.
- (6) Determine the amount of working capital allowed. = Step(4) multiplied by Step(5).

#### Illustrative Problem Using the Bardahl Formula

For any corporation, the pertinent information necessary to compute the Bardahl formula can generally be derived from the three basic financial statements: balance sheet, income statement and statement of changes in financial position. In fact, every publicly-held corporation must publish these

three statements in its annual report to its shareholders as well as file the statements with the Security and Exchange Commission.

In order to illustrate the manner in which the Bardahl formula is computed, the balance sheet, income statement and statement of changes in financial position for International Business Machines Corporation for the calendar year ended December 31, 1976 filed with the Security and Exchange Commission are presented in Figures 2, 3 and 4 respectively.<sup>58</sup>

Following the six steps previously outlined, the Bardahl formula for IBM Corporation is computed by extracting the relevant data from these statements:

$$(1) \text{ Inventory turnover cycle}^{59} = \frac{\$ 755,188}{\$5,825,444} \times 365 = 47 \text{ days}$$

$$(2) \text{ Accounts receivable turnover cycle}^{60} = \frac{\$ 2,463,060}{\$16,304,333} \times 365 = 55 \text{ days}$$

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<sup>58</sup>Internal Business Machines Corporation, Form 10-K, Annual Report, (December 1976) pp. F-1 through F-4.

<sup>59</sup>Inventory turnover cycle is equal to  $\left( \frac{\text{average inventory}}{\text{cost of goods sold}} \times 365 \right)$ . The numerator is computed by averaging the "inventories" for 1975 and 1976 as stated in the assets section of the balance sheet [(\$740,699 + 769,676) ÷ 2]. The denominator is the sum of "cost of sales" and "cost of rentals and services" for 1976 as stated in the statement of earnings and retained earnings (\$1,959,631 + 3,865,813).

<sup>60</sup>Accounts receivable turnover cycle is equal to  $\left( \frac{\text{average accounts receivable}}{\text{sales}} \times 365 \right)$ . The numerator is computed by averaging the "notes and accounts receivable" and "other accounts receivable" for 1975 and 1976 as stated in

**INTERNATIONAL BUSINESS MACHINES CORPORATION  
AND SUBSIDIARY COMPANIES**

**CONSOLIDATED BALANCE SHEET  
at December 31:**

**ASSETS**

	<u>1976</u>	<u>1975</u>
	(Thousands of Dollars)	
<b>Current Assets:</b>		
Cash .....	\$ 208,607	\$ 183,870
Marketable securities — at lower of cost or market (market value: 1976 \$6,006,352; 1975 \$4,623,041) — Note 3 (Schedule I) .....	5,947,654	4,584,445
Notes and accounts receivable — trade, less reserve: 1976 \$142,827; 1975 \$120,599 — Note 4 (Schedule XII) .....	2,343,968	2,080,907
Other accounts receivable .....	282,017	219,227
Inventories — at lower of average cost or market — Note 5 .....	769,676	740,699
Prepaid expenses .....	368,398	305,595
	<u>9,920,320</u>	<u>8,114,743</u>
Other Investments and Sundry Assets .....	<u>462,132</u>	<u>374,049</u>
Plant, Rental Machines and Other Property — at cost — Notes 1d and 6 (Schedule V) .....	16,054,481	15,037,331
Less — Accumulated depreciation (Schedule VI) .....	8,713,607	7,995,647
	<u>7,340,874</u>	<u>7,041,684</u>
	<u>\$17,723,326</u>	<u>\$15,530,476</u>

Fig. 2. Balance sheet

## LIABILITIES AND STOCKHOLDERS' EQUITY

	<u>1976</u>	<u>1975</u>
	(Thousands of Dollars)	
<b>Current Liabilities:</b>		
U.S. Federal and non-U.S. income taxes .....	\$ 1,383,696	\$ 1,084,716
Accounts payable .....	336,355	229,583
Short-term borrowings .....	84,634	159,956
Current portion of long-term debt .....	31,244	54,310
Salaries, commissions, etc. ....	727,848	578,192
Amounts withheld from employees for taxes, stock purchase plan, etc. ....	107,194	80,906
Taxes, other than U.S. Federal and non-U.S. income taxes .....	559,762	485,051
Deferred income under service contracts .....	194,757	141,971
Other accrued expenses and liabilities .....	656,705	548,229
	<u>4,082,195</u>	<u>3,362,914</u>
Deferred Investment Tax Credits .....	<u>63,237</u>	<u>44,829</u>
Reserves for Employees' Indemnities and Retirement Plans (Schedule XII) .....	<u>553,480</u>	<u>411,847</u>
Long-Term Debt — Note 7 (Schedule IX) .....	<u>275,127</u>	<u>295,115</u>
<b>Stockholders' Equity:</b>		
Capital stock — par value \$5.00 per share — Notes 8 and 17 .....	4,031,652	3,852,525
Shares authorized — 162,500,000		
Shares issued: 1976 — 150,766,927		
1975 — 149,844,582		
Retained earnings .....	<u>8,737,348</u>	<u>7,563,246</u>
	<u>12,769,000</u>	<u>11,415,771</u>
Less: Treasury stock, at cost .....	19,713	—
Shares: 1976 — 72,379		
1975 — none		
	<u>12,749,287</u>	<u>11,415,771</u>
	<u>\$17,723,326</u>	<u>\$15,530,476</u>

Fig. 2. Balance sheet (continued)



**INTERNATIONAL BUSINESS MACHINES CORPORATION  
AND SUBSIDIARY COMPANIES**

**CONSOLIDATED STATEMENT OF EARNINGS AND RETAINED EARNINGS**

For the year ended December 31:

	1976	1975
	(Thousands of Dollars)	
Gross Income from Sales, Rentals and Services:		
Sales .....	\$ 5,959,475	\$ 4,545,359
Rentals and services .....	10,344,858	9,891,182
	16,304,333	14,436,541
Cost of sales .....	\$1,959,631	\$1,630,978
Cost of rentals and services .....	3,865,813	3,717,709
Selling, development and engineering, and general and administrative expenses ..	6,409,315	5,664,897
Interest on debt .....	44,950	62,607
	12,279,709	11,076,191
	4,024,624	3,360,350
Other income, principally interest .....	494,469	360,527
Earnings before income taxes .....	4,519,093	3,720,877
Provision for U.S. Federal and non-U.S. income taxes — Notes 1g and 10 .....	2,121,000	1,731,000
Net Earnings for the year .....	2,398,093	1,989,877
Per share .....	\$15.94	\$13.35
Average number of shares outstanding:		
1976 — 150,425,442		
1975 — 149,044,427		
Retained Earnings, January 1 .....	7,563,246	6,542,358
	9,961,339	8,532,235
Cash dividends .....	1,203,791	968,989
Cost in excess of proceeds of treasury stock sold under employees stock purchase plan .....	20,200	—
	1,223,991	968,989
Retained Earnings, December 31 .....	\$ 8,737,348	\$ 7,563,246

Fig. 3. Income and retained earnings statement

**INTERNATIONAL BUSINESS MACHINES CORPORATION  
AND SUBSIDIARY COMPANIES**

**CONSOLIDATED STATEMENT OF EARNINGS AND RETAINED EARNINGS**

**For the year ended December 31:**

	1976	1975
	(Thousands of Dollars)	
Gross Income from Sales, Rentals and Services:		
Sales .....	\$ 5,959,475	\$ 4,545,359
Rentals and services .....	10,344,858	9,891,182
	16,304,333	14,436,541
Cost of sales .....	\$1,959,631	\$1,630,978
Cost of rentals and services .....	3,865,813	3,717,709
Selling, development and engineering, and general and administrative expenses ..	6,409,315	5,664,897
Interest on debt .....	44,950	62,607
	12,279,709	11,076,191
	4,024,624	3,360,350
Other income, principally interest .....	494,469	360,527
Earnings before income taxes .....	4,519,093	3,720,877
Provision for U.S. Federal and non-U.S. income taxes — Notes 1g and 10 .....	2,121,000	1,731,000
Net Earnings for the year .....	2,398,093	1,989,877
Per share .....	\$15.94	\$13.35
Average number of shares outstanding:		
1976 — 150,425,442		
1975 — 149,044,427		
Retained Earnings, January 1 .....	7,563,246	6,542,358
	9,961,339	8,532,235
Cash dividends .....	1,203,791	968,989
Cost in excess of proceeds of treasury stock sold under employees stock purchase plan .....	20,200	—
	1,223,991	968,989
Retained Earnings, December 31 .....	\$ 8,737,348	\$ 7,563,246

Fig. 4. Statement of changes in financial position.

- (3) Number of days in one operating cycle =  $47 + 55 = 102$  days
- (4) Operating cycle as a percentage of a year =  $\frac{102}{365} = .2795$
- (5) Operating expenses less depreciation and federal income taxes =  $\$12,279,709^{61} - 2,237,970^{62} = \$10,041,739$
- (6) Working capital allowed =  $\$10,041,739 \times .2795 = \$2,806,666$

The amount of working capital allowed under the Bardahl formula (\$2,806,666) is then compared with IBM Corporation's actual working capital at the end of 1976 (\$5,838,125).<sup>63</sup> Since IBM Corporation's actual working capital is greater than the amount allowed under the Bardahl formula, theoretically, the accumulated earnings tax could be imposed upon IBM for 1976 unless it can show that it needed to use the funds for other reasonable business purposes.

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the assets section of the balance sheet [ $(\$2,080,907 + 219,277) + (\$2,343,968 + 282,017) \div 2$ ]. The denominator is the sum of "sales" and "rentals and services" for 1976 as stated in the statement of earnings and retained earnings. ( $\$5,959,475 + 10,344,858$ ).

<sup>61</sup>This figure is the sum of all expenses, except taxes, as stated in the statement of earnings and retained earnings.

<sup>62</sup>This figure is stated on the statement of changes in financial position.

<sup>63</sup>Ibid.

### Validity of the Bardahl Formula

The validity and general acceptance of the Bardahl formula in determining the working capital needs of a corporation is substantiated by the fact that the courts have consistently relied on the formula.<sup>64</sup> Moreover, the Guidelines include a specific directive to IRS agents to use the formula:

Inasmuch as the need for working capital has been recognized as the main reason for accumulating earnings and profits, at this point the examiner should, for most taxpayers, compute the Bardahl formula.<sup>65</sup>

In order to facilitate the agents' task the Guidelines include a "Bardahl Formula Worksheet" which outlines the various steps in computing the Bardahl formula.<sup>66</sup>

### Applicability of the Bardahl Formula

Three important factors regarding the applicability and usage of the Bardahl formula must be emphasized. First, the Bardahl formula computation merely represents the minimum amount of working capital necessary for the corporation. Thus, it is generally not difficult for corporations to prove that they require additional working capital

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<sup>64</sup>For a partial listing of the most significant and recent court cases which utilize the Bardahl formula see, Noel Cunningham, "More Than You Ever Wanted To Know About the Accumulated Earnings Tax," Journal of Corporate Taxation 6 (Autumn 1979):211-212.

<sup>65</sup>Internal Revenue Manual, para. 784(1).

<sup>66</sup>*Ibid.*, Exhibit 700-2.

to meet current operating needs in excess of this minimum amount. Furthermore, as will be discussed in succeeding sections of this Chapter, a corporation may have valid reasons for retaining excess working capital other than the need to meet current operating expenses. For example, a corporation may accumulate funds in order to purchase new machinery and equipment or for expansion purposes.

Second, although the Bardahl formula has been universally accepted, the courts have consistently modified the formula based on the specific circumstances surrounding each particular corporation being reviewed. In fact, virtually every court has modified the Bardahl formula to some degree. For example, as previously noted, determining whether income taxes are included in operating expenses for the year depends on the manner in which the corporation pays its income taxes.<sup>67</sup>

Another example of an item in the formula which the courts consistently modified involves the computation of the inventory turnover of a corporation. Courts have allowed the corporation to use their "peak inventory" figure, i.e., the largest amount of inventory in stock during the year, rather than the average inventory figure in computing the

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<sup>67</sup>In fact, the Guidelines specifically cite other cases which modified the Bardahl formula. For example it mentions the cases of Apollo Industries, Inc. v. Commissioner, 358 F.2d 867 (1st Cir. 1966) and Electric Regulator Corp. v. Commissioner, 336 F.2d 339 (2nd Cir. 1964).

inventory turnover.<sup>68</sup> This allows the corporation to have working capital in excess of what would have been allowed if the average inventory figure was used.

Furthermore, the courts have made their most severe modifications to the Bardahl formula when applying the formula to businesses involved in the "service" industry. The major problem with regard to service businesses is that they generally do not have inventory. For example, in C. E. Hooper, Inc. v. United States,<sup>69</sup> the court applied a modified form of the Bardahl formula. The corporation was engaged in the business of compiling market surveys and reports for radio and television shows. Although the corporation obviously had no inventories in the conventional sense, the court treated the survey reports as inventory equivalents for purposes of the formula.

In some instances the difficulty encountered by the courts in applying the Bardahl formula was deemed to be so great that the courts disregarded the formula entirely. For example, in the case of Simons-Eastern Company v. United States<sup>70</sup> the taxpayer was an engineering service corporation

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<sup>68</sup>For example, see Kingsbury Investments, Inc., 28 TCM 1082 (1969); Magic Mart, Inc., 51 TC 775 (1969); Dielectric Materials Co., 57 TC 587 (1972).

<sup>69</sup>539 F.2d 1276 (Ct. Cl. 1976).

<sup>70</sup>354 F.Supp. 1003 (N.D. Ga. 1972).

whose basic asset consisted of the talents and abilities of its employees. The court stated that "the plaintiff is strictly a service organization and this makes a manufacturing formula inappropriate."<sup>71</sup> After discussing the general working capital requirements of the corporation, the court concluded that the corporation was justified in retaining working capital sufficient to cover the professional and technical payroll only for an additional period of two months, or 60 days.<sup>72</sup>

Accordingly, the Guidelines clearly point out that the Bardahl formula is merely a "tool" which must be bent and shaped to conform to the situation at hand:

It is important to stress that the Bardahl formula is not the ultimate in solving IRC 531 cases and should be considered as a tool to be used in determining the applicability of the tax. It should not be applied in every case. If the taxpayer's business is highly seasonal, the average length of time for acquiring and selling materials and collecting the receivable may make the formula inappropriate. In the case of a service type business, it may be well to consider the average length of time required to perform on a contract rather than to use the operating inventory concept.<sup>73</sup>

The third point to be emphasized regarding the applicability of the Bardahl formula is that use of the formula does not preclude the need for calculating working capital ratios and other financial ratios. For example, in

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<sup>71</sup>Ibid., p. 1007.

<sup>72</sup>Ibid., p. 1008.

<sup>73</sup>Internal Revenue Manual, para. 777.4(7).

Cadillac Textiles Inc.<sup>74</sup> the court noted that the Bardahl formula "is only one of several rules of thumb this court may employ to determine whether the accumulation of earnings by a taxpayer is reasonable."<sup>75</sup> Thus, the court concluded that the corporation's unjustifiably high working capital ratio of 6.9 to 1 and "quick ratio"<sup>76</sup> of 3.6 to 1 was sufficient evidence to assert that the corporation's accumulation of earnings was unreasonable.<sup>77</sup>

Accordingly, the concept of working capital is listed separately in the Guidelines from the concept of working capital ratios. However, it is somewhat surprising, and not clearly understandable, why the Guidelines felt it incumbent to list the concept of working capital and working capital ratios in five individual and separate factors. It is even more curious in light of the fact that the Guidelines' list of factors does not specifically mention the Bardahl formula--

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<sup>74</sup>34 TCM 295 (1975).

<sup>75</sup>Ibid., p. 307.

<sup>76</sup>The quick ratio is generally defined as current monetary assets divided by current liabilities. The quick ratio is more meaningful in determining net liquid capital available than is the working capital ratio because it excludes from current assets non-monetary assets such as inventory which cannot be as easily converted to cash.

<sup>77</sup>In Cheyenne Newspapers Inc., 494 F.2d 429 (10th Cir. 1974), a working capital ratio of 5:1 was considered excessive and, therefore, the court imposed the penalty tax on the corporation.



an item discussed extensively in the Guidelines' chapter. Presumably, the Bardahl formula is implicitly implied in the five factors which refer to working capital.

Two Working Capital Factors Not Discussed in the Guidelines

It must be noted that the Guidelines do not specifically define or explain the concept of "current asset - working capital ratio" listed in unfavorable factor 8 and favorable factor 14. However, literally defined, the ratio involves comparing the corporation's current assets to its working capital. The following example illustrates how this ratio is computed:

<u>Corporation A</u>	
Current assets	\$10,000
Current liabilities	<u>1,000</u>
Working Capital	<u>\$ 9,000</u>
 Current asset- working capital ratio	 10:9

The Guidelines' silence in discussing this concept is aggravated by the fact that it does not explain what is meant by a "low" or "high" current asset working capital ratio. Omission of the explanation is especially disturbing in light of the fact that if the two terms "low" and "high" are used in their conventional sense, unfavorable factor 8 is not unfavorable and favorable factor 14 is not favorable.

To illustrate, assume the current asset working capital ratio for Corporation B is as follows:

Corporation B

Current assets	\$10,000
Current liabilities	<u>7,000</u>
Working capital	<u>\$ 3,000</u>
Current asset- working capital ratio	10:3

If Corporation B's ratio is compared with the ratio computed for Corporation A in the previous example, relative to each other, Corporation A has a "low" ratio and Corporation B has a "high" ratio. Accordingly, in determining which of these two corporations would more likely be subject to the accumulated earnings tax it appears that Corporation B, whose ratio is higher than that of Corporation A, would be a more "favorable" candidate since the Guidelines list a high current asset-working capital ratio as a favorable factor for applying the accumulated earnings tax. However, this result is obviously incorrect. Corporation A's working capital is three times greater than that of Corporation B and, all other things being equal, corporations with larger amounts of working capital are more susceptible to the accumulated earnings tax than are corporations with smaller amounts of working capital. Thus, a corporation with a "low" current asset-working capital ratio is more likely to be subject to the accumulated earnings tax than a corporation with a "high" ratio.

This apparent error in the Guidelines' list could be corrected by merely interchanging the two factors such that

unfavorable factor 8 becomes "high current asset-working capital ratio" and favorable factor 14 becomes "low current asset-working capital ratio." That this error has gone undetected to date is probably a reflection of the fact that this concept has not been used in any court case and was not found mentioned in any accounting, tax or other business text.

### Summary

The concept of working capital (i.e., the excess of current assets over current liabilities) and the related ratios (i.e., current ratio and quick ratio) have been used by both the IRS and the courts for determining whether a corporation has adequate funds to satisfy its current operating needs. Small amounts of working capital and low ratios are indicative that the corporation has not accumulated earnings beyond the reasonable needs of the business while large amounts of working capital and high ratios are indicative of unjustified accumulations. Accordingly, the Guidelines' listing of a low working capital ratio as an unfavorable factor and a high working capital ratio as a favorable factor are valid.

Furthermore, the Guidelines' listing of "the need for working capital can be met from current operations" as a favorable factor is also valid and is generally determined by computing the Bardahl formula. In fact, the courts have

consistently relied on the results obtained in computing the Bardahl formula and have generally used the concept of working capital ratios only as ancillary evidence to substantiate the Bardahl results.

The concept of "current asset-working capital ratio," however, which is listed as unfavorable factor 8 and favorable factor 14 has not been used in any court case and is not discussed in the Guidelines or in any legislative or administrative pronouncement or publication. Thus, this ratio has no significance when determining if a corporation is subject to the accumulated earnings tax. Moreover, the Guidelines' listing of a "low" ratio as an unfavorable factor and a "high" ratio as a favorable factor is apparently incorrect and should be listed in exactly the opposite manner (i.e., the low ratio as a favorable factor and the high ratio as an unfavorable factor).

c. Expansion and Replacement of Plant and Equipment

Unfavorable factor:

9. The need for expansion of plant and equipment.

Expansion

The Regulations specifically state that an accumulation of earnings "to provide for a bona fide expansion of business" is justified and not considered beyond the reasonable needs

of the business.<sup>78</sup> Accordingly, the only question which must be resolved when a corporation contends that it accumulated earnings for the purpose of expansion is whether the corporation had a "specific, definite, and feasible" plan.<sup>79</sup> The IRS will attempt to impose the penalty tax on a corporation which it believes did not have any real expansion plan in the year it accumulated the earnings and merely used this argument as an afterthought in order to rebut the assertion that it accumulated earnings beyond the reasonable needs of the business.<sup>80</sup>

Thus, in its discussion, the Guidelines do not explain what is considered a valid business expansion, but rather emphasize that the IRS agent should be careful to verify that the corporation had actually adopted measures to implement its plan for expansion:

In order to determine whether an accumulation for the expansion of the business was based upon specific, definite, and feasible plans, the examiner will have to review the minute books and correspondence files of the corporation. Furthermore, in the case of

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<sup>78</sup>Regulations, Reg. 1.537-2(b)(1).

<sup>79</sup>Regulations, Reg. 1.537-1(b).

<sup>80</sup>For cases involving corporations which failed to prove that it had adequate plans see Motor Fuel Carriers, Inc., 34 TCM 1290 (1975); Cheyenne Newspapers, Inc., 32 TCM 234 (1973); Barrow Manufacturing Co. v. Commissioner, 294 F.2d 79 (5th Cir. 1961); Smoot Sand and Gravel Co. v. Commissioner, 274 F.2d 495 (4th Cir. 1960); I. A. Dress Co. V. Commissioner, 273 F.2d 543 (2nd Cir. 1960).

a closely held corporation, which is normally involved in IRC 531 cases, there may not be detailed minutes. Accordingly, the examining officer should discuss the corporation's expansion plan with its officers, directors, etc., with a view toward determining whether or not the corporation's expansion plans were a real consideration during the year or years in question rather than merely being an afterthought in an attempt to justify the accumulation. The test should be, "Was expansion a real consideration of the taxpayer?"<sup>81</sup>

### Replacement

The Guidelines point out in its introductory comments regarding the concept of expansion that corporations may also legitimately accumulate earnings to replace its outdated, obsolete and old property, plant and equipment: "Expansion of the corporation's business and the replacement of assets both indicate a justification for the corporation to accumulate earnings."<sup>82</sup>

Although it may appear that the IRS has adopted a liberal attitude toward allowing corporations to accumulate earnings in order to replace assets, a careful reading of the Guidelines and the relevant IRS Revenue Rulings indicates otherwise. The Guidelines state:

Plans to replace specific assets are an acceptable reason for an accumulation of earnings. However, since depreciation deductions are current charges against earnings, an additional reserve for the purpose of replacing plant or equipment will be have to be justified by proof of the inadequacy of the taxpayer's

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<sup>81</sup>Internal Revenue Manual, para 776.3(3).

<sup>82</sup>Ibid., para. 776.3(1); emphasis added.

depreciation reserves; otherwise, there would be, in effect, a double accumulation for replacing the same equipment or plant.<sup>83</sup>

Thus, the Guidelines clearly indicate that the corporation can generally only accumulate earnings for the purpose of replacing its assets in an amount equal to the depreciation deduction. However, since corporations are allowed to deduct depreciation as an expense from gross income in arriving at net income, funds from this year's revenues are automatically accumulated in the corporation by virtue of the depreciation deduction. The net result is that the corporation cannot set aside any of its accumulated earnings to provide for future replacement of assets.

Moreover, the IRS issued a Revenue Ruling which specifically states that the corporation cannot accumulate additional funds in excess of its depreciation deduction in order to allow for inflation:

The corporation contends that, in justifying the reasonable needs of its business, it should be permitted to include a fund equal to its depreciation reserves escalated for the economic factors of increased costs of replacement regardless of whether it has any specific or definite plans to use the funds in its business . . . (However, we rule that) a corporation may not include a fund equal to its depreciation reserves escalated for the economic factors of increased replacement costs in justifying the reasonable needs of its business pursuant to Section 537 of the Code.<sup>84</sup>

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<sup>83</sup>Ibid., para. 776.4

<sup>84</sup>U.S., Treasury Department, Internal Revenue Bulletin, Revenue Ruling 67-64, 1967-1 C.B. 150.

Accordingly, the mere fact that a corporation recognizes that it must eventually replace old assets is insufficient cause to justify an accumulation of earnings in excess of the depreciation deduction. Only if the corporation can prove that it actually is ready to replace its assets with new and more expensive property, will it be able to justify an additional accumulation of earnings.

For example, in North Valley Metabolic Laboratories,<sup>85</sup> the corporation accumulated earnings in excess of its depreciation deduction in order to enable it to purchase a new and more sophisticated auto-analyzer machine. The cost of the new machine was almost seven times greater than the original cost of the machine currently used. Yet, the only reason that the court held that the corporation was justified in setting aside funds in excess of the depreciation deduction allowed on the old machine was because the corporation proved that in the year it began accumulating funds for the purchase of the new machine it was aware that the "acquisition of this more advanced equipment required an additional expenditure of funds greatly in excess of the cost of earlier models."<sup>86</sup>

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<sup>85</sup>34 TCM 400 (1975).

<sup>86</sup>Ibid., p. 405; For additional cases see, for example, Battlestein Investment Co. v. U.S., 442 F.2d 87 (5th Cir. 1971); Dahlem Foundation, Inc. v. U.S., 405 F.2d 993 (6th Cir. 1969); Smoot Sand and Gravel Corp. v. Commissioner, 274 F.2d 495 (4th Cir. 1960).



### Summary

A corporation may accumulate earnings to provide for the expansion and replacement of plant and equipment. Thus, while the Guidelines only list "the need for expansion of plant and equipment" as an unfavorable factor, in reality, both expansion and replacement of assets justify an accumulation of earnings. However, in order to justify an accumulation of earnings the corporation must be able to prove that it has a specific, definite and feasible plan.

With respect to accumulations for the purpose of replacing old assets, the IRS has held that a corporation may not accumulate earnings in excess of allowable depreciation deductions unless it can show that it actually intends to buy a new and more expensive asset to replace the old one. A corporation cannot accumulate earnings in excess of depreciation merely because it knows that when it will be ready to replace its assets in the future the replacement cost will be higher. Furthermore, the IRS refuses to allow the corporation to accumulate additional funds in order to compensate for an inflation factor.

#### d. Investments and Diversification

Unfavorable factors:

5. The need for the corporation to diversify as a result of:
  - a. One customer business

- b. Business obsolescence<sup>87</sup> factor high
10. There is an actual entry into an unrelated business.

Favorable factors:

3. Investments of a passive nature which are in nonliquid form.
4. Diversification into an unrelated business is only contemplated.
10. Investments in subsidiaries that are not controlled.

#### Active Business Investments v. Passive Investments

The Regulations specifically state that in analyzing whether a corporation's particular investment is considered for the reasonable needs of the business, the government must recognize that the

business of a corporation is not merely that which it has previously carried on but includes, in general, any line of business which it may undertake.<sup>88</sup>

Thus, the tax law allows the corporation to invest its accumulated earnings in order to expand, grow and diversify, whether horizontally or vertically, in any manner it deems will be most beneficial to its own interests.

The Regulations, however, also provide that an unreasonable accumulation of earnings is indicated where the corporation has

investments in properties, or securities which are unrelated to the activities of the business of the taxpayer corporation.<sup>89</sup>

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<sup>87</sup>Note that the word "obsolescence" is spelled correctly in this dissertation. However, in the Guidelines it is misspelled as "obsolescence."

<sup>88</sup>Regulations, Reg. 1.537-3(a).

<sup>89</sup>Ibid., Reg. 1.537-2(c)(4).

This seeming contradiction between these two Regulations is easily resolved by distinguishing between investing earnings in an active business and merely acquiring an interest in a passive investment.

The key element in determining whether an investment constitutes an active business or a passive investment, and thereby whether the accumulation of earnings is justified, is the degree of involvement in the operation and management of the acquired business investment. Where the officers of the acquiring corporation actively participate in the management of the acquired business, an accumulation of earnings is justified. On the other hand, if the corporation merely acquires the stock of another corporation, the earnings accumulated for this purpose are considered beyond the reasonable needs of the business.<sup>90</sup>

In many instances, however, this distinction may not be crystal clear. For example, in Sandy Estate Company v. Commissioner,<sup>91</sup> the corporation owned and managed various apartment buildings. A portion of its accumulated earnings were used to operate a separate and essentially unrelated business dealing with mortgage loans. The IRS attempted to

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<sup>90</sup>Gloria Case, "Accumulated Earnings Tax Aspects of Business Expansion and Investments, " Tax Law Review 32 (1976):60.

<sup>91</sup>43 TC 361 (1964).

impose the accumulated earnings tax on the corporation by asserting that "in respect of these activities . . . they did not constitute a business at all but represented merely liquid investments of surplus funds."<sup>92</sup> The court, however, disagreed with this analysis and stated:

Taking into account the number of such loans, the extensive and continuous activities in relation to them, and the manner in which such activities were carried on, we have no doubt that [the corporation] was engaged in a mortgage loan business . . .<sup>93</sup>

On the other hand, where little management activity is required, the acquisition takes on the appearance of a passive investment. For example, in Automotive Rebuilding Company Inc.,<sup>94</sup> the corporation was engaged in the business of rebuilding automobile and truck engines and other related automotive activities. It used its accumulated earnings to provide a loan for a company involved in the production of films and movies and therefore contended that it used its funds for a new and separate business. The court rebuffed the corporation's claim and asserted that "the mere loaning or investment of money with no participation in management or losses beyond its invested principal cannot be considered a business."<sup>95</sup>

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<sup>92</sup>Ibid., p. 375.

<sup>93</sup>Ibid., p. 376.

<sup>94</sup>17 TCM 968 (1958).

<sup>95</sup>Ibid., p. 975.

In Atlantic Commerce and Shipping Company, Inc.,<sup>96</sup>

the corporation was engaged in the business of furnishing brokerage and management services to shippers. The corporation decided to invest its accumulated earnings in real estate and eventually purchased a factory building. The corporation claimed that this was merely its first step in becoming involved in the business of real estate. The Second Circuit Court, however, found the corporation's argument unconvincing since there was "no indication in the record that Atlantic would have been capable of actively managing any of these properties as a new line of business."<sup>97</sup>

The Guidelines' Discussion of Investments  
and Diversification in Unrelated Businesses

It seems quite clear from the Regulations and related court decisions previously discussed that corporations may invest their earnings in a new business enterprise unrelated to its present operations as long as it actively participates in the managerial functions of the new business. This is consistent with the legislative history of the accumulated earnings tax wherein Congress constantly reiterated the point that the penalty tax was never intended to limit or

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<sup>96</sup>32 TCM 473 (1973) aff'd 500 F.2d 937 (2nd Cir. 1974).

<sup>97</sup>Ibid., p. 940.

restrict the ability of corporations to grow.<sup>98</sup>

The discussion contained in the Guidelines, however, does not correspond with this analysis. Specifically the Guidelines state:

1. The regulations indicate that the business of a corporation is any business which it wishes to enter. Although this would indicate that a corporation is free to diversify into any business, some court cases tend to limit diversification by corporations into products or businesses similar or related to their principal field or product.
2. One of the better arguments in favor of diversification is the decline of the principal business of the corporation which is usually brought about by technological advances. It is not necessary, however, that the corporation be faced with an immediate permanent decline or total extinction of its principal business to justify an accumulation. In one such case, the accumulation was justified as a result of the corporation being in an industry where there was rapid technological change which could make its product obsolete almost overnight.<sup>99</sup>

Clearly, the Guidelines are correct when they assert (in the second paragraph) that where a corporation is involved in a business experiencing technological change an accumulation of earnings is justified. For example in Fotocrafters Inc.,<sup>100</sup> the corporation was engaged in the

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<sup>98</sup>See for example, the statement contained in U.S., Congress, House, Special Tax Study to the Committee of House Ways and Means, November 1947 which is quoted in Chapter III page 88 of this dissertation; also see statement by Congressman Green which is quoted in Chapter I page 18 of this dissertation.

<sup>99</sup>Internal Revenue Manual, para. 776.2.(1); (2).

<sup>100</sup>19 TCM 1401 (1960).

business of printing and developing film. The corporation, which heretofore only processed black and white film, accumulated earnings in order to expand into the color film market. The court stated that obviously the corporation "was in a growth industry experiencing rapid technological change . . . the pure need for survival compelled the [corporation] to enter the color field. Intelligent management could not have done otherwise."<sup>101</sup>

The same logic dictates that if a corporation is involved in a business which is facing possible extinction, an accumulation of earnings is justified.

However, the Guidelines have misconstrued the meaning of the Regulations which allow corporations to enter into "any line of business" and have apparently misinterpreted the thrust of the judicial decisions, when it states that "some court cases tend to limit diversification by corporations into products or businesses similar or related to their principal field or product."

Gloria Case in her study of the court cases relating to this area aptly points out:

"In apparently no case does a court limit expansion, change in business or diversification per se to similar or related products or businesses. In contradistinction, the government victories generally are based on passive investment grounds, the vagueness of the taxpayers' expansion or diversification plans and the taxpayers'

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<sup>101</sup>Ibid., p. 1408.

failure as to the burden of proof therefore, or on a combination of all these grounds. Indeed, the very fact that government victories are based on these grounds evidences an aversion on the part of the courts to put an outright limit on diversification."<sup>102</sup>

Accordingly, the Guidelines' requirement that there be a nexus between the corporations' current business and any additional investments is unsubstantiated. Only accumulations of earnings for the purpose of investing funds in passive investments are considered beyond the reasonable needs of the business. Moreover, it is interesting to note that the Guidelines specifically list as unfavorable factor 10 that "an actual entry into an unrelated business" generally indicates that the corporation has not accumulated earnings beyond the reasonable needs of the business.

#### Investment and Diversification Plan Must Exist

While it is clear that a corporation may enter into a new business enterprise or diversify, nevertheless, as was pointed out in section a of this Chapter, in order to justify an accumulation for such purposes the corporation must have a "specific, definite, and feasible" plan for implementing any project. The court noted in Battelstein

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<sup>102</sup>Gloria Case, "Accumulated Earnings Tax Aspects of Business Expansion and Investments," Tax Law Review 32 (1976):12; the Guidelines' statement is similarly criticized by William Lewis, Accumulated Earnings Tax, ed. Leonard L. Silverstein, (Washington, D.C.: Tax Management Inc., 1979), p. A-24.



Investment Company v. United States<sup>103</sup> that "in the proper circumstances, no doubt, a business may accumulate its earnings with impunity over a period of years in order to finance contemplated future expansion . . . [But the plans] must be manifested by a contemporaneous course of conduct."<sup>104</sup>

However, in KOMA Inc. v. Commissioner,<sup>105</sup> even though the corporation contended it accumulated earnings for expansion purposes the court upheld the imposition of the accumulated earnings tax because it found that "the records . . . are silent as to any steps taken by the board of directors looking to such projects."<sup>106</sup> Obviously, where the corporation's plans cannot be carried out for reasons beyond its control, the accumulated earnings tax will not be applied.<sup>107</sup>

#### Accumulations for Subsidiaries

Another form of investment is where a parent corporation uses its funds for its subsidiary corporation. The Regulations specifically state that a parent corporation is justified in accumulating earnings in order to invest its funds in a

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<sup>103</sup>302 F. Supp. 320 (SD Texas 1969)

<sup>104</sup>Ibid., p. 327.

<sup>105</sup>189 F.2d 390 (10th Cir. 1951).

<sup>106</sup>Ibid., p. 395.

<sup>107</sup>See, for example, Thomas S. Lee Enterprises, Inc., 12 TCM 730 (1953).

subsidiary corporation if "such a corporation is a mere instrumentality" of the parent.<sup>108</sup> In general, a corporation is considered a "mere instrumentality" of another if the parent corporation controls the subsidiary by owning "at least 80 percent of the voting stock of the [subsidiary] corporation."<sup>109</sup>

Furthermore, the court in Inland Terminals, Inc. v. United States<sup>110</sup> interpreted the intent and meaning of this Regulation as also allowing a subsidiary to accumulate earnings for the benefit of its parent corporation.

Thus, the Guidelines are correct in noting that "investments in subsidiaries that are not controlled" generally do not justify an accumulation of earnings. However, the Regulations clearly point out that it is possible for a parent corporation to own less than 80 percent of the stock in its subsidiary and yet it may still be justified in accumulating earnings on behalf of the subsidiary. The determination of whether a parent corporation which owns less than 80 percent of its subsidiary's stock may accumulate earnings on its behalf "will depend upon the particular circumstances of the case."<sup>111</sup>

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<sup>108</sup>Regulations, Reg. 1.537-3(b).

<sup>109</sup>Ibid.

<sup>110</sup>477 F.2d 836 (4th Cir. 1973).

<sup>111</sup>Regulations, Reg. 1.537-3(b).

Summary

In order to properly relate the foregoing analysis with all five factors listed in the Guidelines regarding accumulation of earnings for the purpose of investments and diversification, each individual factor will be discussed separately.

Unfavorable factor 5: The need for the corporation to diversify as a result of (a) one customer business; (b) business obsolescence factor high. While there is no doubt that a corporation with a one customer business or engaged in a business where the obsolescence factor is high may diversify, the implication that other corporations may not accumulate earnings for diversification purposes is incorrect. A corporation is not prevented from diversifying and engaging in any business where it assumes operational and management responsibilities.

Unfavorable factor 10: There is an actual entry into an unrelated business. The discussion in the Guidelines points out that some courts have limited diversification by corporations "into products or businesses similar or related to their principal field or products." This statement in the Guidelines is clearly inaccurate and unsubstantiated. To the contrary, as this factor clearly states, "an actual entry into an unrelated business" generally justifies an accumulation of earnings provided that it is not a mere passive investment.

Favorable factor 3: Investments of a passive nature which are in nonliquid form. Investments of a passive nature are obviously unjustified regardless of whether the investment is in a liquid or nonliquid asset. Thus, the Guidelines would be more accurate if it would merely state as a favorable factor, "investments of a passive nature," and not add the words "which are in a nonliquid form" which tends to imply that passive investments in a liquid form may be justified.

Favorable factor 4: Diversification into an unrelated business is only contemplated. This factor is merely a subset of favorable factor 1, which set down the general rule that if "the business needs for the accumulation are vague and indefinite" the accumulation is not justified. Both of these factors are derived from the Regulations' requirement that any proposed business plan must be "specific, definite, and feasible."

Favorable factor 10: Investments in subsidiaries that are not controlled. The Guidelines are correct in stating that investments in subsidiaries that are not controlled generally indicate that the corporation has accumulated earnings beyond the reasonable need of the business. However, this should not be interpreted to mean that an investment in an uncontrolled subsidiary can never be justified. Under the proper circumstances such an investment can also be considered a reasonable need of the business.

## e. Business Indebtedness

Unfavorable factor:

4. The existence of business indebtedness.

Favorable factor:

11. The corporation has [a] no outstanding debt obligations or [b] the debts were incurred for nonbusiness reasons.<sup>112</sup>

Assumption of Debt

A corporation which must raise funds, whether to meet current or future operating expenses or to finance an expansion project, is justified in accumulating earnings. This is true even if prudent business judgment dictates that the corporation should raise the funds by borrowing them from external sources rather than using internally generated funds. The court in National Yarn Corporation<sup>113</sup> stated that "we would be unwilling to say that a business should borrow rather than operate on its own cash resources."<sup>114</sup>

This position is consistent with the court's desire not to restrict or limit a corporation's managerial discretion. For example, in Henry Van Hummel, Inc.,<sup>115</sup> the court asserted:

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<sup>112</sup>This factor was divided into two parts because, unlike all of the other twenty-five factors, it contains two separate and distinct statements. In fact, as is pointed out in this section, part [a] of this factor could not be substantiated while part [b] was found to be valid.

<sup>113</sup>9 TCM 603 (1950).

<sup>114</sup>Ibid., p. 610.

<sup>115</sup>23 TCM 1765 (1964).

The reasonable needs of a corporation for adequate financial strength by accumulation of earnings must first be determined by its officers and directors, and courts should be hesitant to substitute their judgment and attribute an ultimate tax avoidance motive unless the facts and circumstances clearly warrant the conclusion that the accumulations were unreasonable and for the proscribed purpose.<sup>116</sup>

Accordingly, the Guidelines in their discussion clearly state:

It has been held by the courts that a corporation cannot be required to resort to the borrowing of funds under any circumstances; therefore, the current operations of the business or planned expansion may be financed fully by retained earnings.<sup>117</sup>

For example, in A. H. Phillips, Inc.,<sup>118</sup> the court allowed the corporation to accumulate earnings "for the purpose of financing, without borrowing, its program of converting its small [grocery] stores into supermarkets."<sup>119</sup> Thus, the Guidelines' listing (part [a] of favorable factor 11) that "the corporation has no outstanding debt obligations" as a favorable factor is not substantiated. To the contrary, the Guidelines' discussion of this issue indicates that a corporation which has no outstanding debt obligations can justify an accumulation of earnings.

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<sup>116</sup>Ibid., p. 1773.

<sup>117</sup>Internal Revenue Manual, para. 774.4(1).

<sup>118</sup>10 TCM 1007 (1951).

<sup>119</sup>Ibid.

However, as noted in section a of this Chapter, a corporation may accumulate earnings to finance future projects only if the corporation has a "specific, definite, and feasible" plan for implementing the project. For example, in Barrow Manufacturing Company, Inc.,<sup>120</sup> the corporation contended that it intended to erect a new modern plant in the near future and that it accumulated earnings in order to reduce whatever borrowing might be necessary when the plan was put into effect. The court, however, found that "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."<sup>121</sup> Therefore, the court held that the corporation's accumulation of earnings to mitigate the need for borrowing on this project was unjustified.

#### Retirement of Corporate Debt

The Regulations specifically provide that a corporation may accumulate earnings "for the retirement of bona-fide indebtedness created in connection with the trade or business."<sup>122</sup> Accordingly, the Guidelines state:

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<sup>120</sup>19 TCM 203 (1960).

<sup>121</sup>Ibid., p. 205.

<sup>122</sup>Regulations, Reg. 1.537-2(b)(3).

An accumulation to retire a corporate indebtedness has in most cases been determined to be a reasonable need of the business, depending upon the reason the debt was created in the first place. The examining officer should determine if the debt to be retired by the accumulation was bona fide and was incurred in connection with the trade or business. If not, this would be an indication that the surplus accumulation was beyond the reasonable needs of the business.<sup>123</sup>

It is incumbent upon the corporation, however, to prove that it cannot retire its debt obligation using funds generated from future revenues. For example, in Battelstein Investment Company v. United States,<sup>124</sup> the court held that the existence of a long-term installment obligation did not justify an accumulation of earnings since the corporation "could easily pay off its long-term obligations out of current earnings as each installment came due."<sup>125</sup>

Moreover, the courts have looked unfavorably upon accumulations of earnings to retire the debt obligations owed to corporate officers and shareholders, even if it is a bona fide debt. For example, in Smoot Sand and Gravel Corporation v. Commissioner,<sup>126</sup> the court held that the corporation was not justified in accumulating earnings in order to set up

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<sup>123</sup>Internal Revenue Manual, para. 774.4(2).

<sup>124</sup>302 F.Supp. 320 (S.D. Texas 1969).

<sup>125</sup>Ibid., p. 326.

<sup>126</sup>241 F.2d 197 (4th Cir. 1957).



a reserve to retire the bond indebtedness of Mr. Smoot, its sole shareholder. The court stated that since "payments could be postponed indefinitely at Mr. Smoot's discretion . . . it is difficult to perceive any justification for creating a reserve for the bond indebtedness."<sup>127</sup>

### Summary

The Guidelines' listing of "the existence of business indebtedness" as an unfavorable factor is valid since a corporation which incurred bona-fide business debt obligations may accumulate earnings for the purpose of retiring its outstanding debt. If, on the other hand, the "debts were incurred for nonbusiness reasons," (part [b] of favorable factor 11) then an accumulation of earnings to retire such debts is indicative of unjustified accumulations.

However, the Guidelines' listing of "the corporation has no outstanding debt obligation" (part [a] of favorable factor 11) as a favorable factor is somewhat misleading and essentially unsubstantiated. A corporation which has no outstanding debt and must raise funds to finance a business project, can justify an accumulation of its earnings by asserting that it prefers to use internally generated funds rather than become beholden to a bank or other financing companies. The fact that it has no outstanding debt is proof positive that this is corporate policy. Thus, the fact that

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<sup>127</sup>Ibid., p. 204.

a corporation has no outstanding debt will generally be an unfavorable factor in determining whether a corporation could be subject to the accumulated earnings tax.

#### f. Stock Redemptions

Favorable factor:

6. Stock redemptions.

#### Stock Redemption Defined

A stock redemption refers to a corporation's purchase of its own outstanding stock from its shareholders. In general, if a corporation purchases a pro rata share of each shareholder's stock, the purchase will not be treated as a stock redemption for tax purposes, but rather as a dividend distribution since each shareholder's interest in the corporation remains unchanged. However, if the purchase is not pro rata, such as where all the stock of only one shareholder is redeemed, then the transaction will qualify as a valid stock redemption for tax purposes.<sup>128</sup>

A qualified and valid stock redemption is treated as a sale of the stock by the shareholder. Since stock is generally considered a capital asset, a stock redemption affords the shareholder the opportunity to obtain favorable capital gain tax treatment if the stock is redeemed at a price in excess of its adjusted basis. If the stock is redeemed at a price below its adjusted basis, the shareholder

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<sup>128</sup>Code, Section 302(b).

also benefits from the fact that the redemption is treated as a sale since he may recognize a taxable loss, rather than having the transaction treated as a dividend distribution wherein the entire proceeds must be included in gross income.<sup>129</sup>

### Stock Redemptions and the Accumulated Earnings Tax

Regarding the accumulated earnings tax, the question arises whether a corporation may accumulate earnings for a qualified and valid stock redemption. Although the Code and Regulations are silent on this issue, the courts have litigated numerous cases relating to stock redemptions.<sup>130</sup>

Accordingly, the Guidelines attempt to summarize the general rules derived from the various court decisions in the following statements:

1. Although there is no clear rule in regards to the reasonableness of an accumulation for a stock redemption, the decisions of the Court in this area point to whether the redemption was for the benefit of the corporation or whether it was for the benefit of the stockholders.

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<sup>129</sup>Boris Bittker and James Eustice, Fundamentals of Federal Income Taxation of Corporations and Shareholders, (Boston: Warren Gorham and Lamont 1980) para 9.03.

<sup>130</sup>As will be discussed later in this section, Code Section 537(a)(2) states that a specific type of stock redemption, "the Section 303 redemption needs of the business," is considered a reasonable need of the business. However, other than this one example, the general concept of stock redemptions is not specifically mentioned in the Code or Regulations.

2. Generally, it has been held that the redemption of the stock of a majority shareholder indicated an unreasonable accumulation of earnings and profits, whereas, in the redemption of the stock of a minority shareholder, a business purpose has been much easier to establish. A valid business purpose would exist where the stock of minority stockholders, whom it was believed might interfere with the carrying out of the business policies of management, was redeemed.
3. Examining officers should thoroughly investigate the facts and circumstances in the case with a view toward determining whether the redemption was for a corporate purpose or was primarily for the benefit of the stockholders in a redemption of the stock of a minority or a majority stockholder.<sup>131</sup>

Thus, whether an accumulation of earnings to provide for a stock redemption is justified depends upon its real purpose. If the redemption primarily benefits the corporation it is considered to have been made for the reasonable needs of the business. If, on the other hand, the redemption primarily benefits the shareholder it is considered a non-business purpose which will not justify an accumulation.

#### Stock Redemption of Minority and Majority Stockholders

As noted above (in item 2), the Guidelines also emphasize that, in general, the determination of whether the stock redemption has a valid business purpose depends on whose stock is being redeemed. The redemption of the stock of a majority shareholder is indicative of an unreasonable accumulation, while the redemption of the stock of a minority

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<sup>131</sup>Internal Revenue Manual, para. 774.2(1), (2), (3).

shareholder is considered a valid business purpose.<sup>132</sup>

This "majority-minority" distinction, however, is not entirely supported by the relevant court cases. In fact, to date, there have been only two court cases involving the stock redemption of a majority shareholder. In Pelton Steel Company,<sup>133</sup> the corporation accumulated earnings to redeem the shares of two shareholders, one owning 60 percent of the corporation's outstanding stock and the other owning 20 percent. While the court held that the redemption did not serve any corporate purpose, careful analysis of the court's opinion indicates that it arrived at this conclusion independent of the fact that the corporation was redeeming the stock of a majority shareholder.<sup>134</sup> Pelton contended that if it had not accumulated its earnings in order to redeem the two shareholders' stock, the corporation may have been placed "in jeopardy if, as it might have happened, some large out-of-town company had become interested and, by its purchase of said controlling interest, had made [the corporation] a so-called captive foundry."<sup>135</sup> The court rejected this

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<sup>132</sup>Ibid., see also para. 774.1(2)(a).

<sup>133</sup>28 TC 153 (1957).

<sup>134</sup>George E. Rudolph, "Stock Redemptions and the Accumulated Earnings Tax--An Update," Journal of Corporate Taxation 4(1977):111.

<sup>135</sup>Pelton Steel Company, 28 TC 153 (1957), p. 171.

argument and stated:

the harms alleged by [the corporation] . . . were, at best, only conjectural and have not been shown to have had any real basis in fact. Sale [of the corporations stock by the stockholders' whose shares were redeemed] to an outsider was not imminent . . . [and] from the present record, it was hardly even likely.<sup>136</sup>

Furthermore, the court pointed out that the corporation could have just as easily effected the redemption of the shareholders' stock if they had not accumulated the earnings and therefore concluded that the retention of earnings served no valid business purpose.

Thus, the fact that a majority shareholder was involved in the stock redemption did not affect the court's decision. Moreover, the court held that the redemption of both the majority and minority shareholders were unjustified.

In the other case involving the stock redemption of a majority shareholder, Vulcan Steam Forging Company, Inc.,<sup>137</sup> the court specifically stated that in determining whether the corporation accumulated earnings beyond the reasonable needs of the business "we attach[ed] little significance . . . to the purchase of Leo's stock at the time of his retirement from the business . . ." <sup>138</sup> and based its decision that the

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<sup>136</sup>Ibid., p. 176.

<sup>137</sup>35 TCM 110 (1976).

<sup>138</sup>Ibid., p. 116.

corporation was not subject to the accumulated earnings tax entirely on other factors.

Thus, the court has never explicitly ruled that an accumulation of earnings to provide for the stock redemption of a majority shareholder shall be prima-facie evidence of an unreasonable accumulation.

All the other cases involved the redemption of the stock of shareholders owning 50 percent or less of the corporation's outstanding stock.<sup>139</sup> Careful analysis of those cases indicate that, in general, the critical factors affecting the courts' decision was whether the corporation's viability as an entity would have been jeopardized by a discordant stockholder and if the redemption served a corporate need.<sup>140</sup>

For example, in Mountain State Steel Foundries, Inc. v. Commissioner,<sup>141</sup> the corporation's stock was owned equally by two 50 percent shareholders. Upon the death of one shareholder, the widow and daughters of the deceased demanded that

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<sup>139</sup>For other cases involving stock redemptions of shareholders owning 50 percent or less of the corporation's outstanding stock not discussed in this section see, for example, Wilcox Manufacturing Co., TCM 1979-92; Gazette Publishing Co. v. Self, 103 F. Supp. 779 (E. D. Ark. 1952); Dill Manufacturing Co., 39 BTA 1023 (1939).

<sup>140</sup>David Aikenhead, "The Accumulated Earnings Tax and Stock Redemptions Under the Tax Reform Act of 1969," University of Pittsburgh Law Review 71 (1970):78.

<sup>141</sup>284 F.2d. 737 (4th Cir. 1960).

the business be sold or liquidated. The other shareholder refused and instead formulated a stock redemption plan which provided for the corporation to pay a specific amount as a down payment, with the balance of the price payable in installments over a period of forty years. The court held that the stock redemption plan was a reasonable need of the business and stated:

When the situation results in demands that the business be sold or liquidated, as it did here, the impact of the conflict upon the corporation is direct and immediate . . . The resolution of such a conflict, that the need of the corporation may govern managerial decision, is plainly a corporate purpose.<sup>142</sup>

In Farmers and Merchants Investment Company Inc.,<sup>143</sup>

the court also set down the principle that the stock redemption of a discordant shareholder is justified:

The promotion of harmony in the conduct of the business is a proper business purpose. If redeeming the stock of one stockholder . . . is designed to secure it against dissension amongst those who determine business policy, the redemption is justified as a business need.<sup>144</sup>

However, in order for a stock redemption of a discordant shareholder to qualify as a valid business purpose, the disagreement between the shareholders must be real and apparent.

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<sup>142</sup>Ibid., p. 745.

<sup>143</sup>29 TCM 705 (1970).

<sup>144</sup>Ibid., p. 711.



For example, in Cadillac Textiles Inc.,<sup>145</sup> the corporation's stock was owned equally by two 50 percent shareholders, and when one shareholder desired to retire because of ill-health, the corporation agreed to redeem his outstanding stock. The court found that although there was some evidence of a disagreement between the two principal shareholders, the redemption was primarily motivated by the desire of one shareholder to retire from the business. Thus, the court held, that "since the principal reason behind the redemption was a personal desire to withdraw from the business . . . due to his poor health . . . the redemption fails to qualify as a legitimate business need on account of which any accumulation may be justified."<sup>146</sup>

The Guidelines, therefore would have been more accurate if they would have ignored the majority-minority distinction and instead have merely emphasized the second-half of their generalization by stating that an accumulation of earnings is justified if the stock redemption involves a "discordant" (instead of "minority") stockholder whom it was believed might interfere with the carrying out of the business

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<sup>145</sup>34 TCM 295 (1975).

<sup>146</sup>Ibid., p. 309; It is interesting to note that in Vulcan Steam Forging Co., (35 TCM 110 (1976)), the court appears to have implied that a stock redemption prompted primarily by the ill health of a shareholder may be considered a valid business purpose.

policies of management.<sup>147</sup>

### Section 303 Stock Redemptions

As previously noted, when a corporation purchases its own stock from its shareholders, if it does not qualify as a valid stock redemption, the entire proceeds will be treated as a dividend distribution to the shareholders. Thus, Congress incorporated Section 303 into the Code in order to insure that, in every event, when a corporation redeems the stock of a deceased shareholder whose principal asset had been stock in a closely held corporation, the redemption be treated as a stock redemption. The purpose of this section was to insure that estates will have sufficient funds to finance the estate taxes and administration expenses.<sup>148</sup>

In essence, Section 303 provides that the corporation may redeem enough shares of stock of such a deceased shareholder to cover his estate taxes and administration expenses.

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<sup>147</sup>It must be pointed out that in Oman Construction Company (24 TCM 1799 (1965)), the court stated that any "redemption of the stock of a minority shareholder is automatically a valid business purposes" (Ibid., p. 1810). However, this is not supported by any other court decision. In fact, in Firstco Inc. v. United States, (430 F. Supp. 1193 (D. Miss. 1977)), which was decided after Oman, the court set forth a more rigid guideline when it stated that "in the absence of any disharmony or dissenting minority stockholders, stock redemptions are normally for the benefit of stockholders and not a business need of the corporation" (Ibid., p. 1202).

<sup>148</sup>Boris Bittker and James Eustice, Fundamentals of Federal Income Taxation, para. 9.40.

All shares so redeemed will automatically be considered a stock redemption which qualified the shareholder's estate for favorable tax treatment.

Prior to 1969, the courts generally held that a corporation could not accumulate earnings prospectively in order that it may eventually fund Section 303 redemptions for the estates of its shareholders. In Youngs Rubber Company,<sup>149</sup> decided in 1962, the court stated:

We do not consider [accumulating earnings for Section 303 redemptions] an acceptable ground for the accumulation of [corporation's] earnings and profits . . . [Corporation] loses sight of the requirement that the accumulation must be for the reasonable needs of its business, and not to provide the estate of its majority stockholder with sufficient funds to meet the various estate duties and other expenses.<sup>150</sup>

Congress, however wanted to facilitate the administration of estates and was disturbed by the courts' refusal to consider accumulations of earnings for Section 303 redemptions as a reasonable need of the business.<sup>151</sup> Accordingly, in the Tax Reform Act of 1969, Congress amended the Code to include an accumulation of earnings for Section 303 redemptions as a reasonable need of the business.<sup>152</sup>

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<sup>149</sup>21 TCM 1593 (1962).

<sup>150</sup>Ibid., p. 1600; The courts issued similar rulings in Dickman Lumber Co. v. United States (355 F.2d 670 (9th Cir. 1966)); and Kirlin Co. (23 TCM 1580 (1964)).

<sup>151</sup>U.S., Congress, Senate, Report of the Senate Finance Committee, S. Dept. 552, 91st Cong. 2d sess., 1969, p. 280.

<sup>152</sup>Code, Section 537(a)(2).

In other words, a corporation may accumulate earnings in order to redeem stock held by the estate of a deceased shareholder so that the proceeds of such redemption can pay the estate taxes and administration expenses incurred by the estate.

Thus, the Guidelines, in their discussion of this issue state:

4. The Tax Reform Act of 1969 amended IRC 537 to provide that the reasonable needs of the business as defined by that section includes the IRC 303 stock redemption needs of the business. These new provisions apply to tax imposed by IRC 531 for taxable years ending after May 20, 1969.
5. Generally, the prior Court decisions in this area held that the redemptions served no business purpose of the corporation and were made for the benefit of the stockholder. Therefore, an accumulation for this purpose was held not to be for the reasonable business needs of the corporation.<sup>153</sup>

#### Summary

The Guidelines' listing of "stock redemptions" as a favorable factor is valid if the redemption primarily benefits the shareholders. However, if the redemption has a business purpose and benefits the corporation it is considered to have been made for the reasonable needs of the business. In addition, the Code provides that a corporation may accumulate earnings to fund Section 303 stock redemptions.

The Guidelines' discussion relating to stock redemptions, however, is somewhat misleading. The Guidelines state that

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<sup>153</sup>Internal Revenue Manual, paras. 774.2(4); (5).

the redemption of the stock of a majority shareholder is indicative of an unreasonable accumulation, while the redemption of the stock of a minority shareholder is considered a valid business purpose. This "majority-minority" distinction is not supported by the relevant court cases.

Category II: Subjective Condition

g. Motive for Accumulation

Favorable factor:

15. The corporation is aware of the accumulated earnings tax and made a conscious attempt to avoid its application.

Theoretically, the first issue which must be considered when determining if a corporation is subject to the accumulated earnings tax, is that of corporate motivation and intent (i.e., the subjective condition). This is true since, unless the corporation accumulated earnings for the purpose of avoiding income taxes on behalf of its shareholders, the penalty tax cannot be applied even if it is determined that the corporation accumulated earnings beyond the reasonable needs of the business.<sup>154</sup>

Accordingly, the Guidelines present the following statement as an introductory comment to its discussion of

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<sup>154</sup>Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, (Boston: Warren, Gorham and Lamont, 4th ed., 1979) pp. 8-4 and 8-5; Jacob Mertens, The Law of Federal Income Taxation, ed. James Doheny, 15 vols. (Chicago: Callaghan and Company, 1976), vol. 7, sec. 39.29, pp. 52-3.

the subjective condition:

A prerequisite to imposition of the accumulated earnings tax has been that the corporation be formed or availed of the purpose of avoiding the income tax on the shareholders. Inasmuch as purpose involves a state of mind or intent, it is always necessary to look at the surrounding circumstances and the attending facts in each individual case to determine whether the purpose of the failure to distribute was to allow the shareholders to avoid the income tax or for some other purpose.<sup>155</sup>

As a practical matter, however, the issue of corporate intent is generally ignored and not considered when determining if a corporation could be subject to the accumulated earnings tax. This is the result of the interplay between Code section 533(a) and the Supreme Court decision in United States v. Donruss.

#### Code Section 533(a) and the Donruss Decision

Section 533(a) of the Code states:

. . . 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 the shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.<sup>156</sup>

Thus, according to this section of the Code, once the government asserts that the corporation accumulated earnings beyond the reasonable needs of the business, a tax avoidance motive

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<sup>155</sup>Internal Revenue Manual, para. 761.

<sup>156</sup>Code, Section 533(a).

is automatically presumed. In order to rebut and refute this presumption, it is incumbent upon the corporation to prove "by the preponderance of the evidence" that it did not consider the tax consequences of its actions in accumulating its earnings.

The Supreme Court decision in United States v. Donruss<sup>157</sup> sufficiently broadened the subjective condition of corporate intent so that it is now virtually impossible for a corporation to rebut the presumption inherent in Section 533(a). As noted in Chapter III, the court ruled that in order for the government to prove that a corporation satisfied the subjective condition it need not prove that tax avoidance was "the" motive of the corporation, but rather, it suffices if the government can prove that tax avoidance was "a" or "one" of the motives for accumulating earnings. However, since in virtually every dividend distribution the directors and officers consider, with varying degrees of significance, the tax effect of the dividend or its shareholders, tax avoidance is always considered one of the motives for accumulating earnings.<sup>158</sup>

Thus, once it is determined that a corporation accumulated earnings beyond the reasonable needs of the business,

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<sup>157</sup>393 U.S. 297 (1969).

<sup>158</sup>See Chapter II, page 42.

the following two factors come into play: (1) Section 533(a) presumes a tax avoidance motive, and (2) the Donruss ruling severely limits, if not eliminates, the corporation's ability to rebut the Section 533(a) presumption.<sup>159</sup>

Bittker and Eustice succinctly pointed out that as a result of the interplay of Section 533(a) with the Donruss decision, unless a corporation accumulates earnings "out of caprice, spite, miserliness, or stupidity rather than for sound business reasons"<sup>160</sup> it will be unable to rebut the subjective condition of corporate intent.

The validity of this statement is supported by the fact that since Donruss there has been only one court case, Simons-Eastern Company v. United States,<sup>161</sup> in which a corporation was able to avoid the imposition of the accumulated earnings tax based on the fact that it failed to satisfy the subjective condition. In that case, the court found that the corporate directors were so naive and untutored in tax law that the reason for their accumulation of earnings could not be linked to any tax motive. The court stated that although the

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<sup>159</sup>"Corporations Must Show Absence of Tax Avoidance Motive as One Purpose for Unreasonable Accumulation," Vanderbilt Law Review 22 (April 1969):697.

<sup>160</sup>Bittker and Eustice, Federal Income Taxation of Corporations, p. 8-10.

<sup>161</sup>254 F. Supp. 1003 (N.D. Georgia 1972).



shareholders were "well-educated, highly intelligent, competent people,"<sup>162</sup> it was convinced that they did not have "knowledge of the desirability of capital gains over ordinary income."<sup>163</sup> The court also noted that they "had no knowledgeable tax accountants or tax counsel . . . but merely used a bookkeeping firm which prepared the necessary tax forms."<sup>164</sup> Thus, the court concluded that Simons-Eastern Company could not be subject to the accumulated earnings tax even though it accumulated earnings beyond the reasonable needs of the business.<sup>165</sup>

#### Rebutting the Presumption of Corporate Intent

In considering the options available to corporations for rebutting the Section 533(a) presumption, David Oakes aptly pointed out, that under present law, there are in essence only two arguments which a corporation can use:

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<sup>162</sup>Ibid., p. 1010.

<sup>163</sup>Ibid.

<sup>164</sup>Ibid., p. 1011.

<sup>165</sup>The court in Atlantic Properties Inc., (62 TC 644 (1974)), further limited the corporation's ability to rebut the subjective condition. All the shareholders of the corporation voted to declare a dividend except for one shareholder who owned 25% of the corporation's outstanding stock and also had a veto power over any dividend declaration. While absolving the other shareholders from any tax avoidance motive, the court found that the dissenting shareholder's decision to veto the dividend declaration was motivated by personal tax considerations. The court, therefore, held that the corporation was liable for the accumulated earnings tax because "a tax avoidance motive need not be attributed to every shareholder in order to find tax avoidance was one of the purposes for the accumulation " (Ibid., p. 660).

(1) it can assert that it was ignorant of the tax consequences of its actions, and (2) it can assert that knowledge of the tax consequences of the accumulation did not contribute in any way to its decision not to declare a dividend. Clearly, proving the validity of either contention would be extremely difficult for any corporation, except in highly unusual situations.<sup>166</sup>

In fact, in Doug-Long Inc.,<sup>167</sup> the corporation attempted to avoid the imposition of the accumulated earnings tax by contending that it did not satisfy the subjective condition. It used both of the aforementioned arguments to support its contention. The court, however, categorically rejected both arguments:

We cannot accept [the corporation's] assertion that Longway [the sole shareholder] did not know the tax consequences of his actions and merely relied on his accountant. Longway was a very skillful businessman, who managed to increase his sales and profits during an extremely difficult period for his industry. We do not believe that he did not know the tax consequences of retaining earnings and profits in the corporation, and we reject as incredible testimony to the contrary. On this basis, we conclude that [the corporation] has not carried its burden of disproving the presumption which arises from our finding that its earnings and profits accumulated beyond its reasonable needs.<sup>168</sup>

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<sup>166</sup>David Oakes, "Motive of Minority Shareholder in Deadlock--Guaranteed Situation Sufficient to Constitute Section 532 Tax Avoidance Purpose," Tax Lawyer 29 (Winter 1976):382.

<sup>167</sup>72 TC 86 (1979).

<sup>168</sup>*Ibid.*, p. 100.

Thus, since rebutting the Section 533(a) presumption is an extremely formidable and unlikely task, the only factor currently considered when determining if a corporation is subject to the accumulated earnings tax is the objective condition, i.e., determining whether the corporation accumulated earnings beyond the reasonable needs of the business.<sup>169</sup>

However, as will be pointed out in succeeding sections of this chapter, the courts often avoid relying only on the Section 533(a) presumption and attempt to provide additional specific evidence that the corporation's intention for accumulating earnings was to avoid personal income taxes.

#### Summary

The Guidelines' listing as a favorable factor that "the corporation is aware of the accumulated earnings tax and made a conscious attempt to avoid its application" is a valid description of the subjective condition.

However, the subjective condition is generally not seriously considered when determining if a corporation is subject to the accumulated earnings tax since once it is determined that a corporation accumulated earnings beyond the reasonable needs of the business, it is extremely difficult for the corporation to assert that it did not satisfy

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<sup>169</sup>Robert Casey, "Accumulated Earnings Tax--Disproof of the Proscribed Purpose," Tulane Law Review 44 (February 1970):402.

the subjective condition. This is true because (1) the Code presumes that a corporation which accumulated earnings beyond the reasonable needs of the business was motivated by tax avoidance considerations, and (2) the Supreme Court decision in Donruss which held that if tax avoidance was merely one factor in the corporation's decision to accumulate earnings, the corporation is deemed to have satisfied the subjective condition.

#### h. Loans and Salaries to Shareholders

Unfavorable factor:

2. The payment of a substantial salary to the principal stockholder who is an employee of the corporation.

Favorable factor:

7. Loans to shareholders of other businesses of the shareholders.

#### Shareholder Loans

Use of corporate funds to provide loans to its shareholders indicates that these funds are not needed for business purposes. In Herzog Miniature Lampworks, Inc., v. Commissioner,<sup>170</sup> the court pointed out that "such loans . . . are to be viewed with circumspection, since they entirely accord with a desire to get the equivalent of [the stockholder's] dividends under another guise."<sup>171</sup>

Thus, loans to shareholders are obviously indicative of corporate intent to avoid income taxes on behalf of its

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<sup>170</sup>32 AFTR2d 73-5282.

<sup>171</sup>Ibid., p. 5286.

shareholders. Accordingly, the Guidelines state:

- (1) Corporate loans to or expenditures on behalf of shareholders tend to show that the corporation has the capacity to distribute these funds as dividends, particularly if there is a pattern of such transactions.
- (2) The loans or expenditures are substitutes for dividends and show that corporate earnings were unreasonably diverted.<sup>172</sup>

As noted in section g of this Chapter, since corporate intent to avoid taxes is automatically presumed once it is determined that a corporation accumulated earnings beyond the reasonable needs of the business, the existence of corporate loans to shareholders merely lends additional support to the fact that the corporation was availed of for the proscribed purpose. This point was emphasized by the court in Cataphote Corporation of Mississippi v. United States<sup>173</sup> as follows:

In addition to the fact of the accumulation beyond the reasonable needs of the business which both logic and the statute make presumptively determinative of the purpose to avoid the income tax with respect to its shareholder, there is other evidence of such purpose. There is almost complete absence of cash dividends, and coupled with it are substantial loans to the stockholder for his personal and speculative needs.<sup>174</sup>

The existence of shareholder loans, however, are not per se, indicative of a corporate intent to avoid taxes. This is particularly true with regard to short-term loans and loans that are not substantial in amount. For example, in

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<sup>172</sup>Internal Revenue Manual, para. 762.2.

<sup>173</sup>535 F.2d 1225 (Ct. Cl. 1976).

<sup>174</sup>Ibid., p. 1237; (emphasis added).

Vulcan Steam Forging Company, Inc.,<sup>175</sup> the court stated that "With respect to the loans to [the shareholder], they were isolated transactions, small in amount . . .; they were repaid over a period of approximately four years."<sup>176</sup> Therefore, the court asserted that "we attach little significance to the loans"<sup>177</sup> in determining if the corporation is subject to the accumulated earnings tax.

### Shareholder Salaries

The Guidelines do not present any discussion with respect to shareholder salaries. Furthermore, the court cases involving shareholder salaries primarily dealt with the effect of low shareholder salaries. For example, in Battlestein Investment Company v. United States,<sup>178</sup> the court stated that "the payment of low salaries to employees who are also controlling stockholders is another indication of the existence of the purpose to avail the corporation in order to avoid shareholder taxes."<sup>179</sup>

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<sup>175</sup>35 TCM 110 (1976).

<sup>176</sup>Ibid., p. 116.

<sup>177</sup>Ibid.

<sup>178</sup>302 F. Supp. 320 (DC Texas 1969).

<sup>179</sup>Ibid., p. 331; For similar decisions see Young Motor Co. v. Commissioner, 339 F.2d 481 (1st Cir. 1964) and Factories Investment Corp. v. Commissioner, 328 F.2d 781 (2nd Cir. 1964).

The courts, however, have not specifically ruled or set down any general guideline as to the effect high shareholder salaries may have when determining if a corporation has satisfied the subjective condition.

### Summary

The Guidelines listing of "loans to shareholders or other businesses of the shareholders" as a favorable factor is valid since the use of corporate funds to provide loans to shareholders is indicative that these funds are not needed for business purposes. However, the listing of substantial salary payments to shareholder-employees as an unfavorable factor is not entirely substantiated since the courts have not rendered an opinion regarding this specific type of situation.

#### i. Dividends

##### Unfavorable factor:

1. The corporation has a history of paying good dividends.

##### Favorable factor:

8. The dividend history of the corporation is unfavorable such as:

- (a) No cash dividend.
- (b) Cash dividends related to shareholders tax status.

9. Inability to pay dividends.

- (a) Restriction on dividend payments.
- (b) Lack of liquid funds.

### Dividend History of the Corporation

The courts have consistently cited as evidence to support the Section 533(a) presumption (i.e., a corporation which satisfied the objective condition automatically satisfies the subjective condition), where appropriate, the fact that the corporation had an unfavorable history with regard to distributing dividends to its shareholders. For example, in Union Offset<sup>180</sup> the court stated:

Finally we conclude that the [corporation] was formed or availed of for the purpose of avoiding the income tax with respect to its shareholders by permitting its earnings to accumulate instead of being distributed . . . [since the corporation] has never paid a dividend, and the failure to do so has worked an income tax saving for [the corporation's] sole shareholders.<sup>181</sup>

In Atlantic Commerce and Shipping Company, Inc.,<sup>182</sup> the court succinctly summed up the effect an unfavorable dividend history may have on the ability of the IRS to impose the accumulated earnings tax on a corporation as follows: "A poor dividend record is of course a very important indication that the [corporation] was availed of for the purpose of avoiding taxes on its shareholders."<sup>183</sup>

In contrast, where the corporation has a good history of paying dividends the court will allow this fact to be used

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<sup>180</sup>36 TCM 202 (1977).

<sup>181</sup>Ibid., p. 209.

<sup>182</sup>32 TCM 473 (1973).

<sup>183</sup>Ibid., p. 483.



to rebut the subjective condition. For example, in American Trading and Production Corporation v. United States,<sup>184</sup> the court determined that the corporation "had a record of a consistent policy of paying dividends to its stockholders since it even declared dividends in those years in which the corporation incurred losses."<sup>185</sup> Accordingly, the court held, "that there was no tax avoidance purpose."<sup>186</sup>

Indeed, determining what is considered a "good" dividend history may be extremely difficult and somewhat subjective. In Electric Regulator Corporation v. Commissioner,<sup>187</sup> the court held that even though the corporation had not paid any dividends for over a decade, the corporation could not be subject to the accumulated earnings tax because it proved that it needed to use the funds for valid business purposes.

On the other hand, as noted in the Guidelines, even if a corporation has a good dividend history it may still be liable for the penalty tax if it cannot justify the need

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<sup>184</sup>362 F. Supp. 801 (DC Maryland 1972).

<sup>185</sup>Ibid., p. 804.

<sup>186</sup>Ibid.; See also Bremerton Sun Publishing Co., (44 TC 566 (1965)), where the court stated that "there is no doubt that a good history of dividends . . . indicate that the accumulation of earnings and profits was for legitimate business needs" (Ibid., p. 588-9).

<sup>187</sup>336 F.2d 339 (2nd Cir. 1964).

for the accumulation of earnings.

A corporation's dividend history is relevant to the question of whether funds were accumulated for the prohibited purpose. A failure to distribute dividends or minimal payments indicates that earnings may have been accumulated to avoid shareholder taxes. Even if the corporation has a good dividend record and pays liberal officer-stockholder salaries, this does not in itself serve to rebut the tax avoidance factor.<sup>188</sup>

### Stock Dividends

Corporations have attempted to conceal their true dividend history by declaring stock dividends. The effect of such a declaration is twofold: (1) Stock dividends result in capitalizing earnings (i.e., accumulated earnings are merely shifted to the capital stock account without distributing any cash) which makes it more difficult to detect if the corporation may be liable for the accumulated earnings tax; and (2) stock dividends are generally not taxable to the shareholders.

The courts have, therefore, viewed such dividends unfavorably. For example, in the case of Atlantic Commerce previously cited, the court asserted that "the stock dividend which [the corporation] declared . . . was nontaxable and therefore had no effect on earnings and profits other than concealment."<sup>189</sup>

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<sup>188</sup>Internal Revenue Manual, para 762.4.

<sup>189</sup>32 TCM 473, p. 483.

Inability to Pay Dividends

The Guidelines list as favorable factor 9 the corporation's "inability to pay dividends." However, the Guidelines do not contain any specific discussion which clearly explain what is meant by an "inability to pay dividends." Moreover, the two examples included in this factor as illustrations ("restriction on dividend payments" and "lack of liquid funds") are also vague and unclear.

The first example, "restriction on dividend payments," literally interpreted means that there are certain restrictions which prevent the corporation from declaring an appropriate dividend such as a law which disallows corporations to increase dividend payments to their shareholders. However, based on the relevant court cases, this should be cited as an "unfavorable" factor. For example, in William C. Atwater and Company, Inc., v. Commissioner,<sup>190</sup> the court found that the corporation was precluded by law from distributing its earnings as dividends until a pending lawsuit against the corporation was settled. Thus, the court held that the corporation's accumulation of earnings did not indicate a desire to avoid taxes on behalf of its shareholders.

If, however, the factor is more liberally interpreted to include a self-imposed corporate restriction such as where a corporation appropriates earnings for a future

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<sup>190</sup>10 TC 218 (1948).

project, then the purpose for the restriction must be analyzed and evaluated on its own merits in order to determine if it is considered a reasonable business need or not, as more fully discussed in section a of this chapter.

Furthermore, the second example, "lack of liquid funds" is equally unclear. If the lack of liquid funds was caused by the corporation's investing in unrelated investments then this factor is merely a restatement of favorable factor 3--"Investments of a passive nature in non-liquid form." If, on the other hand, the lack of liquid funds was caused by the corporation's legitimate business needs then its listing as a favorable factor is obviously incorrect.

In every event, favorable factor 9 is vague and unclear. Therefore, before any valid critique can be formulated regarding this factor, the IRS must expand on its explanation of this factor.

### Summary

In general, the Guidelines' listing of "the corporation has a history of paying good dividends" as an unfavorable factor and the listing of "the dividend history of the corporation is unfavorable" as a favorable factor are supported by the relevant court cases. However, the meaning of favorable factor 9, "inability to pay dividends," is unclear and therefore cannot be substantiated.

j. Shareholders Tax Brackets

Favorable factor:

12. The shareholders are in a high tax bracket.

The Guidelines do not contain any discussion with respect to the relationship between shareholders' tax brackets and the accumulated earnings tax. However, logic dictates that since shareholders in high tax brackets are more adversely affected, for tax purposes, by distributions of ordinary dividends than shareholders in low tax brackets, the officers and directors of corporations whose shareholders are in high tax brackets will more naturally attempt to avoid making large dividend distributions.<sup>191</sup>

For example, in Battlestein Investment Company v. United States<sup>192</sup> the court found that the shareholders were in the 50 percent tax bracket. By virtue of accumulating earnings within the corporation instead of distributing the earnings as dividends the shareholders had avoided paying a substantial amount of personal income taxes. Thus, the court stated that "the fact that the stockholders have saved large amounts of income taxes as a result of the corporate accumulation is important in determining whether the [accumulated

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<sup>191</sup>Jacob Mertens, The Law of Federal Income Taxation, ed. James Dohery, 15 vols. (Chicago: Callaghan and Company, 1976), vol. 7, sec. 39.49, p. 102.

<sup>192</sup>302 F. Supp. 320 (DC Texas 1969).

earnings tax] should be applied."<sup>193</sup>

It is important to note that although the court looked at the shareholders tax brackets, the critical factor in determining whether the subjective condition was satisfied was that the shareholders "saved large amounts of income taxes as a result." For example, in C. E. Hooper v. United States<sup>194</sup> the corporation's majority shareholders were in the 40 and 50 percent tax brackets. Nevertheless, the court asserted that the personal income taxes the shareholders saved would have been offset by other personal expenses which they would have incurred as a result of unnecessarily accumulating the corporation's earnings, such as "the cost of possible tax litigation, and the possibility of personal liability to the corporation in a suit against them by the minority stockholders for having caused the corporation to incur an unnecessary penalty tax for their personal benefit . . ."<sup>195</sup> Thus, the court concluded that the tax bracket of the shareholders could not be used in that case as an argument for asserting that the corporation satisfied the subjective condition.

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<sup>193</sup>Ibid., p. 331.

<sup>194</sup>539 F.2d 1276 (Ct. Cl. 1976).

<sup>195</sup>Ibid., p. 1291.

Summary

The Guidelines' listing as a favorable factor that "the shareholders are in a high tax bracket" is valid only if the shareholders also saved on paying personal income taxes as a result of accumulating earnings within the corporation. Thus, the fact that the shareholders are in a high tax bracket is not, per se, indicative that the corporation satisfied the subjective condition.

## k. Closely-Held v. Publicly-Held Corporations

Unfavorable factor:

3. The stock of the corporation is publicly held as opposed to being owned by a small group.

Favorable factor:

5. Stock of the corporation is closely held.

The Distinction Between Closely-Held and Publicly-Held Corporations

Historically, the accumulated earnings tax has been applied virtually exclusively to closely-held corporations and not to publicly-held corporations. Bittker and Eustice explained the reason the IRS has not attempted to impose the penalty tax on publicly-held corporations as follows:

The accumulated earnings tax seems limited as a practical matter, to closely held corporations in view of the requirement of Section 532(a) that the corporation be availed of to avoid taxes with respect to its shareholders. Thus, publicly held corporations have little to fear from Section 531 if the management is independent and not under the domination of a few individual large stockholders, and if individual stockholdings are sufficiently diffused so that no single

group can exercise effective control over corporate dividend policy. Moreover, the threat of stockholder pressure, including possible lawsuits, if the corporation improperly accumulated its surplus probably constitutes a greater incentive for such corporate managements to declare dividends than Section 531 itself.<sup>196</sup>

Thus, the primary reason publicly-held corporations have not been subject to the accumulated earnings tax is that even if it were determined that the corporation had accumulated earnings beyond the reasonable needs of the business and thereby satisfied the objective condition, the fact that the corporation is publicly owned tends to negate the existence of a tax avoidance motive. Bittker and Eustice assumed that if a publicly-held corporation's stock is widely-held by thousands of nameless and faceless shareholders, the officers and directors of the corporation could not take into account the tax preferences of the individual shareholders when deciding whether to distribute the earnings as dividends or accumulate the earnings within the corporation. Thus, Bittker and Eustice distinguished between public corporations that are widely-held and closely-held, and asserted that widely-held corporations would not satisfy

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<sup>196</sup>Bittker and Eustice, Federal Income Taxation of Corporation and Shareholders, (Boston: Warren, Gorham and Lamont, 4th ed., 1979): pp. 8-6 to 8-7.



the subjective condition.<sup>197</sup>

However, as pointed out in the Review of the Related Literature, finance theoreticians have provided empirical evidence that the officers and directors of widely-held public corporations do, in fact, consider the individual tax preferences of their shareholders when deciding on dividend policy.<sup>198</sup> While it is obvious that corporate directors cannot consider every shareholder's tax preference in determining dividend policy, it is sufficient if they consider the tax preference of the corporations general class of shareholder. Moreover, the court in Atlantic Properties Inc.<sup>199</sup> held that even if a corporation accumulated earnings for the purpose of avoiding taxes on behalf of only one minority shareholder, the corporation will have satisfied the subjective condition.<sup>200</sup>

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<sup>197</sup>It is important to note that Bittker and Eustice's assumption has been validated by the courts: The Tax Court in Golconda Mining Corporation, (58 TC 139 (1972), p. 158), quoted Bittker and Eustice when it explained why the accumulated earnings tax has not been generally imposed upon publicly-held corporations.

<sup>198</sup>See Chapter II, page 45 , of this dissertation.

<sup>199</sup>62 TC 644 (1975).

<sup>200</sup>See Section g of this Chapter, footnote 165.

### The Legal Issue

Beyond the question of whether publicly-held corporations could possibly satisfy the subjective condition, there is also a question as to whether publicly-held corporations could legally be subject to the accumulated earnings tax. As noted in Chapter III, although the Code specifically states that the accumulated earnings tax could be applied to "every corporation"<sup>201</sup> (except those specifically excluded), the courts, in reviewing the legislative history of this tax, have issued conflicting opinions as to whether Congress intended that publicly-held corporations be exempt from this tax or not. The Court of Appeals in Golconda<sup>202</sup> held that the publicly-held corporations are legally exempt from the penalty tax while all the other courts which discussed this issue disagreed.<sup>203</sup> Furthermore, the IRS issued a Revenue Ruling which specifically states that, in appropriate cases, it could impose the accumulated earnings upon any publicly-held corporation.<sup>204</sup>

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<sup>201</sup>Code, Section 531; (emphasis added).

<sup>202</sup>507 F.2d 594 (9th Cir. 1974).

<sup>203</sup>See for example Golconda Mining Corporation, 58 TC 139 (1972) and Alphatype Corp. v. United States, 76-2 USTC 9730 (Ct. Cl. 1976).

<sup>204</sup>U.S., Treasury Department, Revenue Ruling, 75-305 1975-2, C.B. 228.

Accordingly, the IRS adopted a firm and clear policy position regarding the applicability of the accumulated earnings tax to publicly-held corporations. This policy is emphasized in the Guidelines as follows:

1. Under present law the accumulated tax is theoretically applicable to every corporation, other than a personal holding company or a tax exempt organization, which accumulates earnings and profits for the prohibited purpose of permitting its shareholders to avoid the income tax.
2. No distinction is made in the statute as to whether the corporation is publicly owned with hundreds of small stockholders or is closely held by a small family group. There is a tendency to think of this tax as being applicable only to closely held corporations and it is usually on this type of corporation that the tax is imposed. Where the stock of the taxpayer corporation is closely held, the ability to control and manipulate it for individual benefit is obvious. Therefore the examining officer should naturally concentrate on the closely held corporations for this issue.
3. The accumulated earnings tax can be applied to publicly held corporations. In some cases the corporate taxpayer although publicly owned is in reality privately controlled, usually by one or two families, when a small group of stockholders own enough stock to exercise legal or practical control over dividend policy. Under these circumstances, the corporation would appear to have the main characteristics of a closely held corporation and the intent to avoid tax by the majority shareholders may be present; therefore, examiners should be alert to determine if the other conditions necessary for an IRC 531 case are present in this type of corporation as well as those closely held.<sup>205</sup>

A careful reading of the foregoing paragraphs, however, indicates that the IRS assumes publicly-held corporations

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<sup>205</sup>Internal Revenue Manual, para. 730.

could be subject to the accumulated earnings tax only if they are "in reality privately controlled." The IRS, in formulating its policy probably relied on the argument and assumption espoused by Bittker and Eustice. Based on the empirical studies advanced by the finance theoreticians, however, it appears that even a widely-held public corporation could be subject to the accumulated earnings tax if it is determined that the corporation accumulated earnings beyond the reasonable needs of the business.

#### Summary

The Guidelines' listing as an unfavorable factor that "the stock of the corporation is publicly-held" and as a favorable factor that "the stock of the corporation is closely-held" are supported by the fact that, to date, only two court cases involving publicly-held corporations have been adjudicated. All the other court cases involved closely-held corporations. While there is a question surrounding the issue of whether publicly-held corporations are legally exempt from the accumulated earnings tax, the IRS has adopted the position that under the proper circumstances they could legally be subject to the penalty tax.

Summary of Results

Based on the results of the analysis presented in this chapter, the twenty-five factors listed in the Tax Audit Guidelines were divided into the following three categories:

1. Those factors which were found to be valid, i.e., they were substantiated as being either unfavorable or favorable factors in determining whether a corporation could be subject to the accumulated earnings tax.

2. Those factors which could not be substantiated and therefore were not conclusively found to be either unfavorable or favorable in determining whether a corporation could be subject to the accumulated earnings tax.

3. Those factors which were found to be invalid and contra-indicative, i.e., those factors listed in the Guidelines as favorable which were found to be unfavorable, and those factors listed in the Guidelines as unfavorable which were found to be favorable.

Table 2 lists the twenty-five factors and indicates for each factor whether it was found to be valid (category 1), unsubstantiated (category 2) or invalid (category 3).

Twenty of the twenty-five factors were found to be valid. One factor, favorable factor 11, "The corporation [a] has no outstanding debt obligations or [b] the debts were incurred for nonbusiness reasons," yielded two distinctly differing

TABLE 2

RESULT OBTAINED IN DETERMINING THE VALIDITY  
OF EACH FACTOR LISTED IN THE TAX AUDIT GUIDELINES

Factor	Result
<u>Unfavorable factors:</u>	
1. The corporation has a history of paying good dividends.....	Valid
2. The payment of a substantial salary to the principal stockholder who is an employee of the corporation.....	Unsubstantiated
3. The stock of the corporation is publicly held as opposed to being owned by a small group.....	Valid
4. The existence of business indebtedness.	Valid
5. The need for the corporation to diversify as a result of:.....	Valid
(a) One customer business.	
(b) Business obsolescence factor high.	
6. Documentation of the needs of the business.....	Valid
(a) In the corporate minutes.	
(b) Performing actual work in fulfilling the needs.	
7. Low current asset-current liability ratio.....	Valid
8. Low current asset-current working capital ratio.....	Invalid
9. The need for expansion of plant and equipment.....	Valid
10. There is an actual entry into an unrelated business.....	Valid
<u>Favorable factors:</u>	
1. The business need for the accumulation are vague and indefinite.....	Valid
2. The need for working capital can be met from current operations.....	Valid
3. Investments of a passive nature which are in nonliquid form.....	Valid
4. Diversification into an unrelated business is only contemplated.....	Valid

TABLE 2--Continued

Factor	Result
5. Stock of the corporation is closely held.....	Valid
6. Stock redemptions.....	Valid
7. Loans to shareholders or other businesses of the shareholders.....	Valid
8. The dividend history of the corporation is unfavorable such as:..... (a) No cash dividend. (b) Cash dividends related to shareholders tax status. (c) Declaration of stock dividends.	Valid
9. Inability to pay dividends..... (a) Restriction on dividend payments. (b) Lack of liquid funds.	Unsubstantiated
10. Investments in subsidiaries that are not controlled.....	Valid
11. The corporation has [a] no outstanding debt obligations or [b] the debts were incurred for nonbusiness reasons.....	[a]Unsubstantiated [b]Valid
12. The shareholders are in a high tax bracket.....	Valid
13. High current asset-current liability ratio.....	Valid
14. High current asset-working capital ratio.....	Invalid
15. The corporation is aware of the accumulated earnings tax and made a conscious attempt to avoid its application.....	Valid

results because it, in essence, combines two distinct and separate conditions into one factor. The first part of the factor (part [a]) could not be substantiated while the other part (part [b]) was found to be valid. Of the remaining four factors, two factors could not be substantiated while the other two factors were found to be invalid and contra-indicative.

The results of the analysis pertaining to the twenty valid factors were then applied to identify the criteria used by the Internal Revenue Service in determining if a particular corporation could be subject to the accumulated earnings tax. Consistent with the methodology adopted for this Chapter, first the criteria relating to the objective condition are identified and then the criteria relating to the subjective condition are considered.

#### Criteria Relating to the Objective Condition

As noted in Chapter 1, the factors relating to the objective condition were subdivided into the following six groups of items:



TABLE 3

CATEGORIZATION OF FACTORS RELATING  
TO THE OBJECTIVE CONDITION

Item	Guideline Factor Number	
	Unfavorable	Favorable
1. Reasonably anticipated needs of the business: specific, definite and feasible.....	6	1
2. Working capital requirements..	7;8	2;13;14
3. Expansion and replacement of plant and equipment.....	9	
4. Investments and diversification.....	5;10	3;4;10
5. Business indebtedness.....	4	11
6. Stock redemptions.....		6

Each of the above six items was developed as a separate criterion for determining the existence of the objective condition as it relates to the reasonable needs of a business.<sup>206</sup>

Each criterion may be expressed in question form, as follows:

1. In the year it accumulated its earnings, did the corporation have a specific, definite and feasible plan detailing the purpose for which the earnings would be used?

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<sup>206</sup>Although three of the factors relating to these six items were either found to be unsubstantiated or invalid (Unfavorable factor 8 included in Item 2; favorable factor 11 (part a) included in Item 5; and favorable factor 14 included in Item 2), each of the six items contain at least one valid factor.

A positive response would indicate that the corporation could justify the accumulation of earnings while a negative response would indicate that the corporation accumulated earnings beyond the reasonable needs of the business.

2. Did the corporation have an adequate amount of working capital to satisfy its current operating expenses? A positive response would indicate that the corporation accumulated earnings beyond the reasonable needs of the business while a negative response would indicate that the corporation had accumulated earnings to provide for the legitimate needs of the business.

3. Did the corporation expend a portion of its funds for expansion and replacement of plant and equipment? A positive response would indicate that the corporation accumulated earnings for the reasonable needs of the business. A negative response would not alone provide any definite indication because it merely signifies that the corporation did not expend funds for plant and equipment. The corporation, however, may have used the funds for other legitimate business purposes.

4. Did the corporation expend a portion of its funds for investments, diversification, and acquisition which qualify as legitimate business needs (i.e., investments which it controls and manages)? A positive response indicates that the corporation accumulated earnings for the reasonable

needs of the business. A negative response (i.e., the corporation expended funds for unqualified and unrelated business investments) indicates that the corporation accumulated earnings beyond the reasonable needs of the business.

5. Did the corporation expend a portion of its funds to retire outstanding long-term debt obligations? A positive response indicates that the corporation accumulated earnings for the reasonable needs of the business.

6. Did the corporation expend a portion of its funds for stock redemptions? A positive response indicates that the corporation accumulated earnings beyond the reasonable needs of the business.

Table 4 lists the six criteria and points out whether a positive or negative response to each criterion would indicate that a corporation (1) accumulated earnings beyond the reasonable needs of the business (i.e., for unreasonable needs); (2) accumulated earnings for reasonable business needs; or (3) would not indicate whether the corporation accumulated earnings beyond the reasonable needs of the business or for the reasonable needs of the business.

TABLE 4

EFFECT OF RESPONSE TO CRITERIA RELATING  
TO THE REASONABLE NEEDS OF THE BUSINESS

Criterion	Response Indicates	
	Positive	Negative
1. In the year it accumulated its earnings, did the corporation have a specific, definite and feasible plan?.....	Reasonable	Unreasonable
2. Did the corporation have an adequate amount of working capital?.....	Reasonable	Unreasonable
3. Did the corporation expend funds for expansion and replacement of plant and equipment?.....	Reasonable	Non-indicative
4. Did the corporation expend funds for "qualified" business investments?.....	Reasonable	Unreasonable <sup>1</sup>
5. Did the corporation retire any outstanding long-term debt?.....	Reasonable	Non-indicative
6. Did the corporation expend funds for stock redemptions?.	Unreasonable	Non-indicative

<sup>1</sup>A negative response to this question means that the corporation expended funds for "unqualified" business investments.

Criteria Relating to the Subjective Condition

All of the factors relating to the subjective condition were generally not considered by the Internal Revenue Service in determining whether a corporation could be subject to the accumulated earnings tax. This is true because (1) the Code

automatically presumes that a corporation which accumulated earnings beyond the reasonable needs of the business was motivated by tax avoidance considerations and (2) the Supreme Court decision in Donruss which held that if tax avoidance was merely one factor in the corporation's decision to accumulate earnings, the corporation is deemed to have satisfied the subjective condition.

It must be pointed out, however, that the Internal Revenue Service oftentimes used the factors relating to the subjective condition in order to provide ancillary evidence for supporting the presumption that when the corporation accumulated earnings beyond the reasonable needs of the business it did so with the intent of avoiding personal income taxes on behalf of its shareholders.

Accordingly, no specific criteria were identified for the subjective condition since the factors relating to the subjective condition were not found to be decisive or critical in determining whether a corporation could be subject to the accumulated earnings tax.

## CHAPTER V

### DEVELOPMENT AND APPLICATION OF MODEL FOR DETERMINING WHICH PUBLICLY-HELD CORPORATIONS COULD BE SUBJECT TO THE ACCUMULATED EARNINGS TAX

#### Introduction

The objectives of this chapter are:

1. to detail and explain the specific elements incorporated into the model developed for the purpose of determining whether a corporation could be subject to the accumulated earnings tax; and
2. to analyze the results obtained when the model was applied to all publicly-held corporations included on the COMPUSTAT computer tape.

#### The Model

Based on the analysis presented in Chapter IV, it was found that in determining whether a corporation could be subject to the accumulated earnings tax the Internal Revenue Service generally considers only the objective condition relating to the reasonable needs of the business and not the subjective condition of corporate intent to avoid taxes with respect to its shareholders. A corporation that accumulates

earnings beyond the reasonable needs of the business is generally presumed to have automatically satisfied the subjective condition. Thus, in developing and applying the model for purposes of this study, only the six criteria listed in Chapter IV relating to the objective condition were considered.

Based on those criteria, the following four questions for determining whether a corporation accumulated earnings beyond the reasonable needs of the business, and therefore could be subject to the accumulated earnings tax, were developed and incorporated within the model:

1. Did the corporation retain and accumulate earnings?
2. Did the corporation have adequate working capital to satisfy its current operating expenses?
3. Did the corporation accumulate earnings in excess of the amount necessary to provide for the reasonable needs of the business? (The reasonable needs of the business include the need to provide for (i) additional working capital; (ii) qualified business investments; (iii) additional purchases of plant and equipment; and (iv) the retirement of outstanding long-term debt).
4. Did the corporation expend at least a portion of its accumulated earnings for purposes considered unjustified and beyond the reasonable needs of the business (e.g., unrelated investments and stock redemptions)?

If, the response to each question is in the affirmative, the corporation being analyzed and examined could be subject to the accumulated earnings tax.

Table 5 lists the six criteria and indicates which of the four questions relate to each specific criterion.

TABLE 5

RELATIONSHIP BETWEEN CRITERIA RELATING TO  
THE OBJECTIVE CONDITION AND QUESTIONS TO BE RESOLVED  
IN DETERMINING WHETHER A CORPORATION COULD BE SUBJECT  
TO THE ACCUMULATED EARNINGS TAX

Criterion	Relates to and Resolves Question Number
1. In the year it accumulated its earnings, did the corporation have a specific, definite and feasible plan?.....	
2. Did the corporation have an adequate amount of working capital?..	2,3
3. Did the corporation expend funds for the expansion and replacement of plant and equipment?.....	3
4. Did the corporation expend funds for qualified business investments?.....	3,4
5. Did the corporation retire any outstanding long-term debt? .....	3
6. Did the corporation expend funds for stock redemptions?.....	4

In reviewing Table 5 two important observations must be made. First, all of the criteria listed above, with the exception of criterion 1, were incorporated into the model.



Criterion 1 was excluded because it describes the general environment within which all of the other five objective criteria must exist. Thus, if a corporation contends that it accumulated earnings for a reasonable business need, to acquire additional plant and equipment (criterion 3) for example, it must also prove that in the year it accumulated the earnings it had a "specific, definite, and feasible" plan for satisfying that need. This fact cannot be extracted from, or measured by, data contained in a corporation's financial statements and it was therefore excluded from the model. The other five criteria listed above were incorporated into the model in accordance with the analysis of each of those criteria presented in Chapter IV.

The second observation worthy of note is that, as reflected in Table 5, none of the five criteria are associated with Question 1 (i.e., to determine whether the corporation retained and accumulated income). The reason is that the question of whether a corporation accumulated earnings is not directly related to the objective condition, but is merely a prerequisite condition which must be satisfied before any other aspect of the corporation is analyzed with respect to the accumulated earnings tax.

#### Financial Data Used in Resolving Each Question

The model was designed so that it tested each publicly-held corporation with respect to each of the above listed

questions for the six year period beginning with 1972 and ending in 1977. The data necessary to answer each of the four questions was extracted from the corporation's financial statements included on the COMPUSTAT tape. Since the precise meaning of certain data may be subject to differing interpretations, the definition provided in the COMPUSTAT manual for each specific data item used in the model is included in Appendix B. The following discussion describes and explains the specific data used for resolving each question.

Question 1: Did the corporation retain and accumulate earnings?

A corporation can only be subject to the accumulated earnings tax if it retained and accumulated earnings within the corporation. Determining whether a corporation accumulated earnings was arrived at by deducting from the net income of the corporation any cash dividends distributed to the shareholders. This can be expressed in equation form as follows:

$$R = \sum_{t=1}^6 (NI - CD)$$

where

R = Accumulated earnings

NI = Net income (The COMPUSTAT data item equivalent to net income is "income before extraordinary items and discontinued operations")

CD = Cash dividends

If, for any corporation, the result for Question 1 was positive, (i.e., the corporation retained and accumulated earnings ( $R > 0$ )), then the model proceeded to test the corporation with respect to the second question.<sup>1</sup>

Question 2: Did the corporation have adequate working capital to satisfy its current operating expenses?

Resolution of this question involved applying the analysis presented in Chapter IV regarding "working capital requirements." As noted therein, the Bardahl formula has been accepted as a valid test for determining the amount of working capital considered adequate for the needs of any particular corporation. Corporations having working capital in excess of the amount determined by the Bardahl formula are generally considered to have working capital in excess of that necessary for the reasonable needs of the business.

In order to eliminate marginal corporations and to adopt a more conservative approach, only those corporations whose

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<sup>1</sup>Note that for purposes of this study, the six years being analyzed (1972-1977) were treated as one year. Thus, in computing the amount of earnings retained within the corporation for example, the net incomes of the corporation for the entire six year period were summed and, similarly, the cash dividends distributed by the corporation for the entire six year period were also summed. In this manner, the effect of unusual and extraordinary items, such as if a corporation had extraordinary earnings in one year or if it paid out an extraordinary amount of dividends in one year, would be smoothed out and divided over the six year period. This method clearly increases the validity of the test results.

working capital was found to exceed 125% of the amount computed by the Bardahl formula was deemed to have working capital in excess of that allowed under the Bardahl formula. This can be expressed in equation form as follows:<sup>2</sup>

$$\sum_{i=1}^6 \frac{WC}{B} > 1.25$$

where

WC = Working capital  
B = Bardahl formula

Since the COMPUSTAT tape does not contain specific financial data items for either working capital itself, or the amount of working capital determined by the Bardahl formula, each of these two items were computed by using various pertinent financial statement data that are contained on the COMPUSTAT tape.

Working capital was computed by subtracting the COMPUSTAT data item "current liabilities" from data item "current assets."

The Bardahl formula was computed by following the six steps described and outlined in Chapter IV. As noted therein,

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<sup>2</sup>Note that an additional constraint was included in this test. Any corporation whose working capital did not exceed 125% of the amount allowed by the Bardahl formula in three of the six years tested was not considered to have excess working capital. Thus, it was possible for a corporation to have satisfied the equation listed above and yet be excluded from the test results. This would occur, for example, if the corporation had an unusually large amount of working capital in one year but small amounts of working capital in the other years.

only three of the six steps involve computations which require extracting data from the corporation's financial statements.<sup>3</sup> These are the computation of the corporation's (1) inventory turnover cycle; (2) accounts receivable turnover cycle; and (3) operating expenses less depreciation and federal income taxes. Each of these computations was arrived at by using the following COMPUSTAT data:

(1) Inventory Turnover cycle. The inventory turnover cycle is computed by multiplying  $\frac{\text{average inventory}}{\text{cost of goods sold}}$  by 365.

(2) Accounts receivable turnover cycle. The accounts receivable turnover cycle is computed by multiplying  $\frac{\text{average accounts receivable}}{\text{sales}}$  by 365.

(3) Operating expenses less depreciation and federal income taxes. The COMPUSTAT tape does not include one specific financial data item for operating expenses less depreciation and federal income taxes. However, this item is the equivalent of the sum of the following data items that are provided by COMPUSTAT: [(sales-operating income before depreciation) + interest expense].

The validity of this equivalence may be explained as follows. The net income of a corporation is generally equal to sales less expenses, or stated in equation form:

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<sup>3</sup>The other three steps merely involve mathematical calculation (i.e., adding, dividing and multiplying).

expenses = sales - net income

Accordingly, since the COMPUSTAT tape only provides the data for "sales" and "operating income before depreciation" (which by definition does not include federal income taxes), determining a corporation's operating expenses may be arrived at initially by computing the difference between "sales" and "operating income before depreciation." In defining "operating income before depreciation" the COMPUSTAT manual specifically notes that "interest expense" is excluded from this item. However, since the Bardahl formula treats interest as a valid expense in determining the operating expenses of a corporation, interest expense was included in computing the corporation's operating expenses less depreciation and federal income taxes.

If a corporation's working capital exceeded 125% of the amount allowed by the Bardahl formula, the model proceeded to test the corporation with the respect to the third question.

Question 3: Did the corporation accumulate earnings in excess of the amount necessary to provide for the reasonable needs of the business?

A corporation cannot be subject to the accumulated earnings tax merely because it accumulated earnings. Rather, it must have accumulated earnings beyond the reasonable needs of the business. Thus, the resolution of this question involved determining the reasonable needs of the business and

subtracting this amount from the corporation's accumulated earnings.

Based on the analysis presented in Chapter IV,<sup>4</sup> the reasonable needs of the business include the need to provide for (i) additional working capital; (ii) additional purchases of plant and equipment; (iii) certain qualified investments; and (iv) retire outstanding long-term debt. Accordingly, determining the amount of accumulated earnings retained by a corporation that is in excess of that which may be necessary to provide for the reasonable needs of the business may be expressed by the following equation:

$$E = R - [(B_6 - B_1) + \sum_{t=1}^6 \Delta PPE + \sum_{t=1}^6 QI + (LTD_1 - LTD_6)]$$

where

- E = Excess retained earnings
- R = Accumulated earnings
- B = Bardahl formula
- PPE = Net additions for property, plant and equipment
- QI = Investments in businesses qualifying as a reasonable business need
- LTD = Long term debt

The following discussion describes and explains the specific COMPUSTAT data used in computing each component of the equation, except for the computation of accumulated earnings (R) which was described fully in connection with

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<sup>4</sup>See Table 4 for a listing of the criteria which relate to the reasonable needs of the business (Chapter IV, page 218).

Question 1. (It is important to note that each of the remaining components of the equation corresponds to one of the four reasonable needs of the business listed above).

(i)  $(B_6 - B_1)$ . This represents the amount of additional working capital that may be required by a corporation. This amount was computed as the difference between the amount of working capital allowed under the Bardahl formula in the most recent year tested (1977) and the amount allowed in the first year tested (1972). The specific COMPUSTAT data used in computing the Bardahl formula was described fully in connection with Question 2.

(ii)  $\sum_{t=1}^6 \Delta PPE$ . This represents the amount of funds needed for additional purchases of property, plant and equipment. However, as discussed in Chapter IV, additional purchases of property, plant and equipment justify an accumulation of earnings only if they exceed the amount of depreciation previously deducted. Similarly, any proceeds received from the sale of old property, plant and equipment reduces the amount of earnings which may be accumulated for the purchase of such new assets. Since the COMPUSTAT tape does not provide a specific data item which takes into account purchases, depreciation, and sales of property, plant and equipment, this component of the equation was computed by combining the following COMPUSTAT data:



$$CE - (DEP'N + SPPE)$$

where

CE = Capital expenditures (This is the same as purchases of property, plant and equipment)

DEP'N = Depreciation

SPPE = Sales of property, plant and equipment

(iii)  $\sum_{i=1}^6 QI$ . This represents investments in businesses which are considered as qualifying for the reasonable needs of the business. As discussed in Chapter IV, investments, diversification and acquisitions of other businesses are considered a reasonable business need only if the corporation controls and manages the business it acquired. The COMPUSTAT data item "acquisitions" includes only these type of qualified investments.

(iv)  $(LTD_1 - LTD_6)$ . This represents the amount of long-term debt retired by the corporation. Computing the amount of long-term debt retired by the corporation involved subtracting the amount of debt it had in the most recent year tested (1977) from the amount of debt it had outstanding in the first year tested (1972)<sup>5</sup>. The COMPUSTAT data item

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<sup>5</sup>Note that if a corporation increased rather than decreased its long-term debt, this component of the equation would result in a negative figure and would have the effect of reducing the amount of earnings considered to have been accumulated for the reasonable needs of the business. This result is consistent with the fact that a corporation cannot engage in "double-dipping" by accumulating earnings for legitimate business needs and also raise the needed funds by obtaining loans from external sources such as banks and other financial institutions.

"long-term debt" was used in computing this component of the equation.

If it was determined that the corporation had accumulated earnings in excess of the amount necessary to provide for the reasonable needs of the business, the model proceeded to test the corporation with respect to the fourth question.

Question 4: Did the corporation expend at least a portion of its earnings for purposes considered unjustified and beyond the reasonable needs of the business?

While there are myriad of investment possibilities which may be considered beyond the reasonable needs of the business, the Guidelines essentially list two specific examples of unreasonable accumulations: (1) investments in unrelated businesses which the corporation does not control or manage, and (2) stock redemptions.

Accordingly, for each corporation responding affirmatively to the first three questions, the model computed the amount of earnings expended for these purposes. The COMPUSTAT data item "investments in and advances to others" was used to determine the corporation's investments in unrelated businesses while the COMPUSTAT data item "purchases of common and preferred stock" was used to determine the corporation's stock redemptions.

It should be pointed out, however, that the significance of the results obtained in response to this question may be somewhat limited. Unrelated investments and stock

redemptions are merely two examples, albeit important ones, of unjustified uses of accumulated earnings. Thus, the fact that a corporation did not use its earnings for unrelated investments and/or stock redemptions does not alone indicate that it is any less susceptible to the accumulated earnings tax. Accordingly, included in the results arrived at in this study is a list of corporations which satisfied only the first three questions.

#### Flowchart Illustration

The flowchart in Figure 5 illustrates the process incorporated into the model with respect to testing each corporation included on the COMPUSTAT tape regarding the four questions previously analyzed.

#### Analysis of Results

In applying the model developed in this study to all the publicly-held corporations included on the COMPUSTAT tape, forty-six corporations were found to have answered all four of the model's test questions in the affirmative. These corporations therefore were found to have: (1) accumulated earnings; (2) working capital in excess of that allowed under the Bardahl formula; (3) accumulated earnings in excess of the amount necessary to provide for the reasonable needs of the business; and (4) expended at least a portion of their accumulated earnings for unrelated investments and/or stock redemptions.

Fig. 5. Flowchart illustration

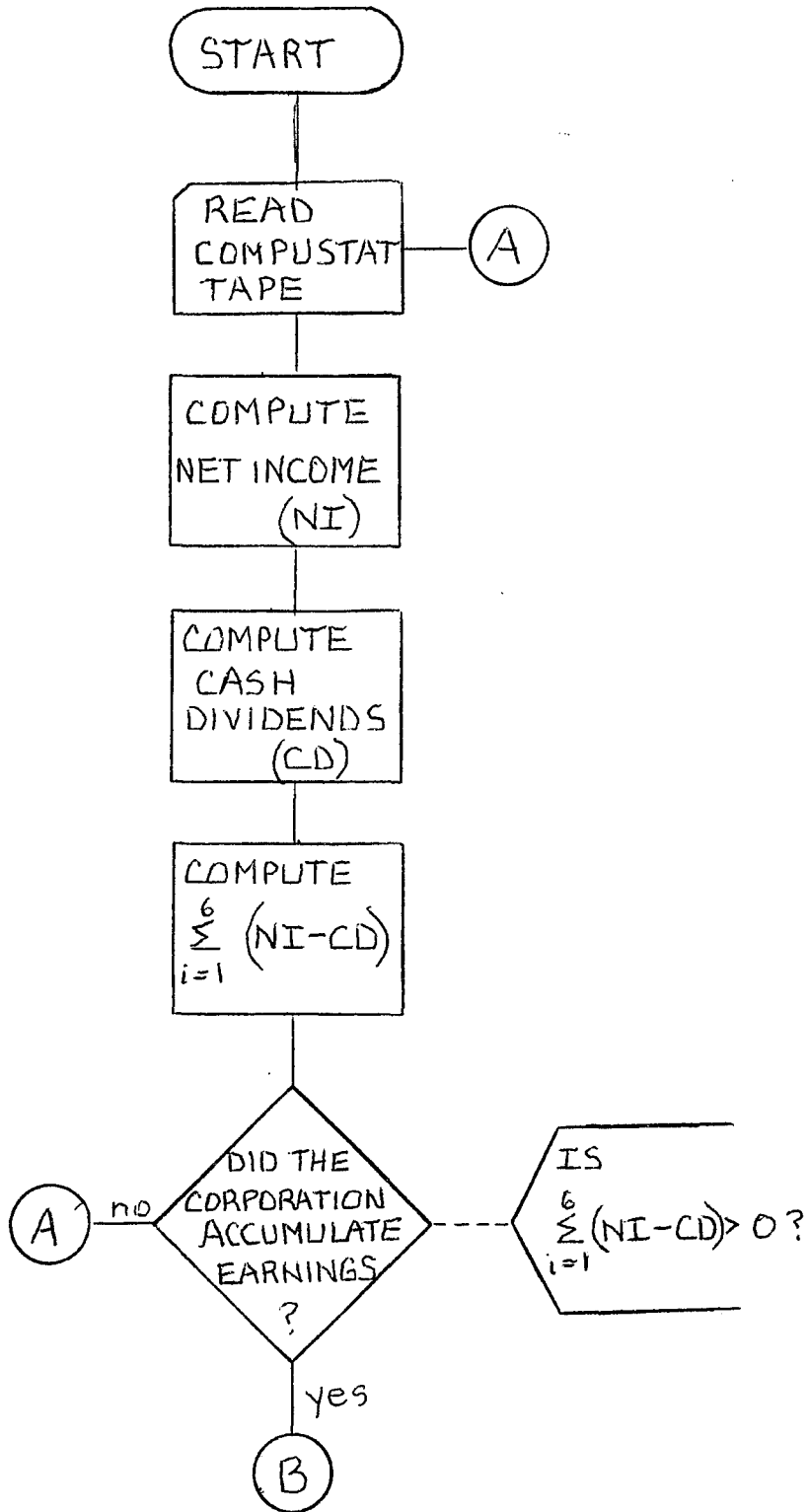


Fig. 5. Flowchart illustration (continued)

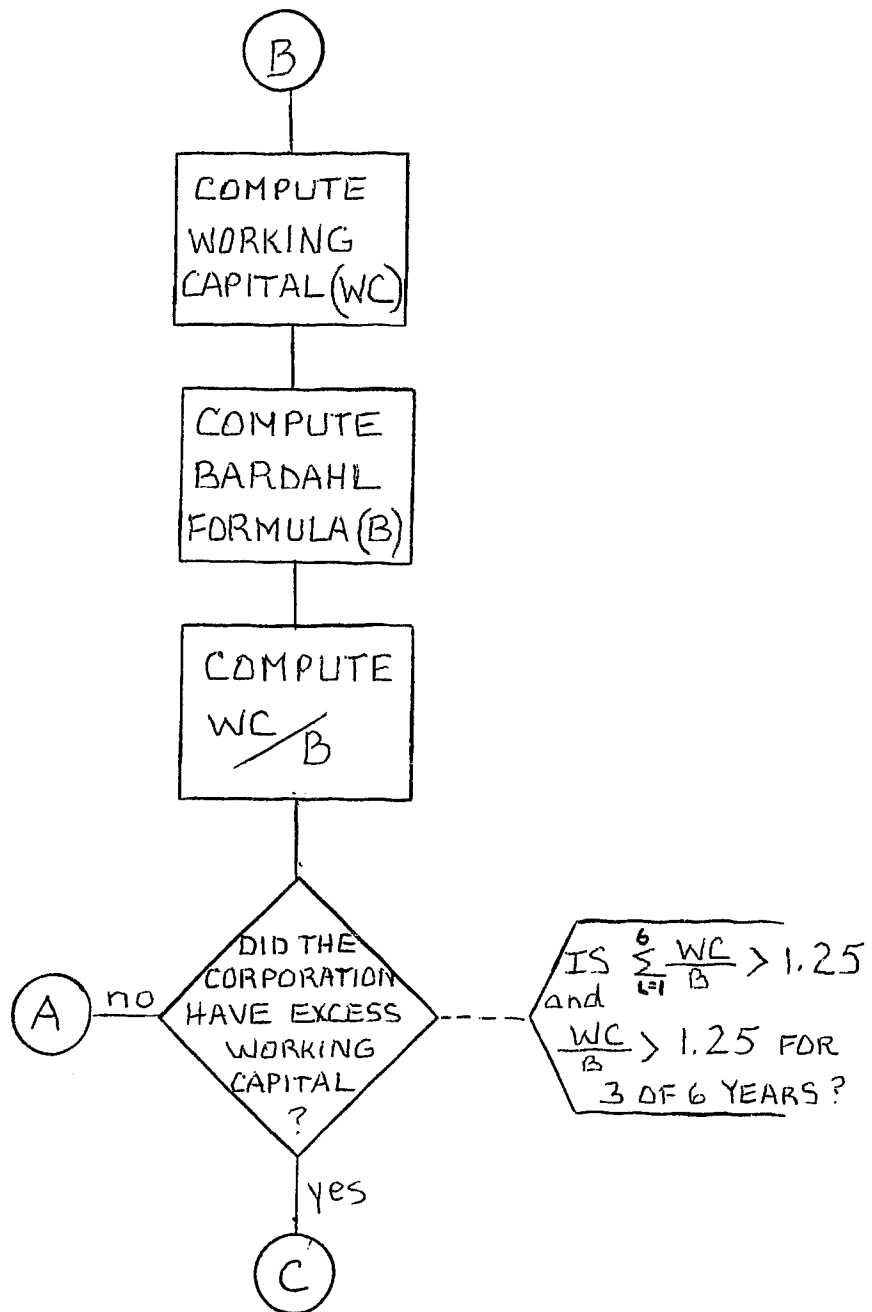


Fig. 5. Flowchart illustration (continued)

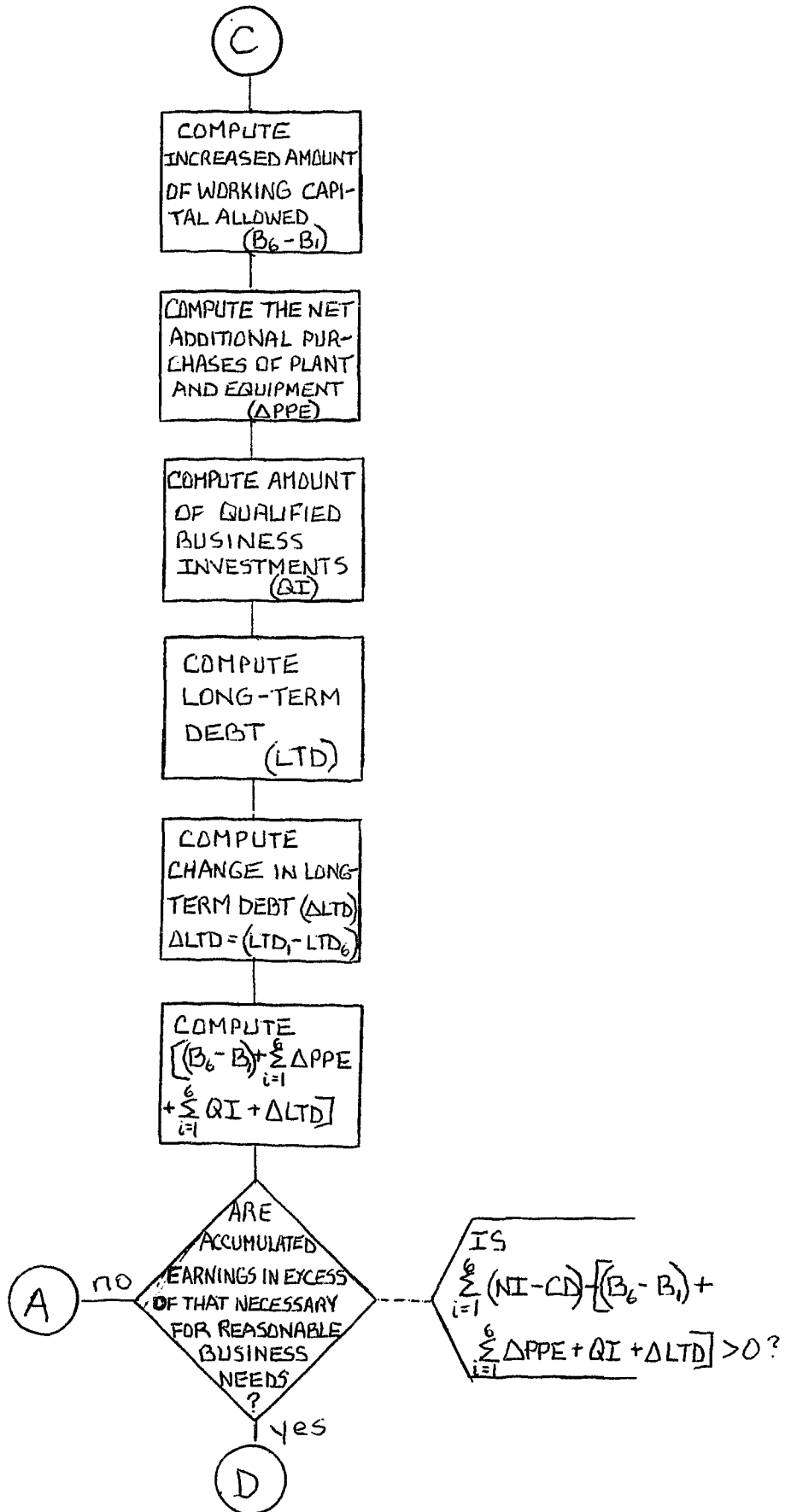
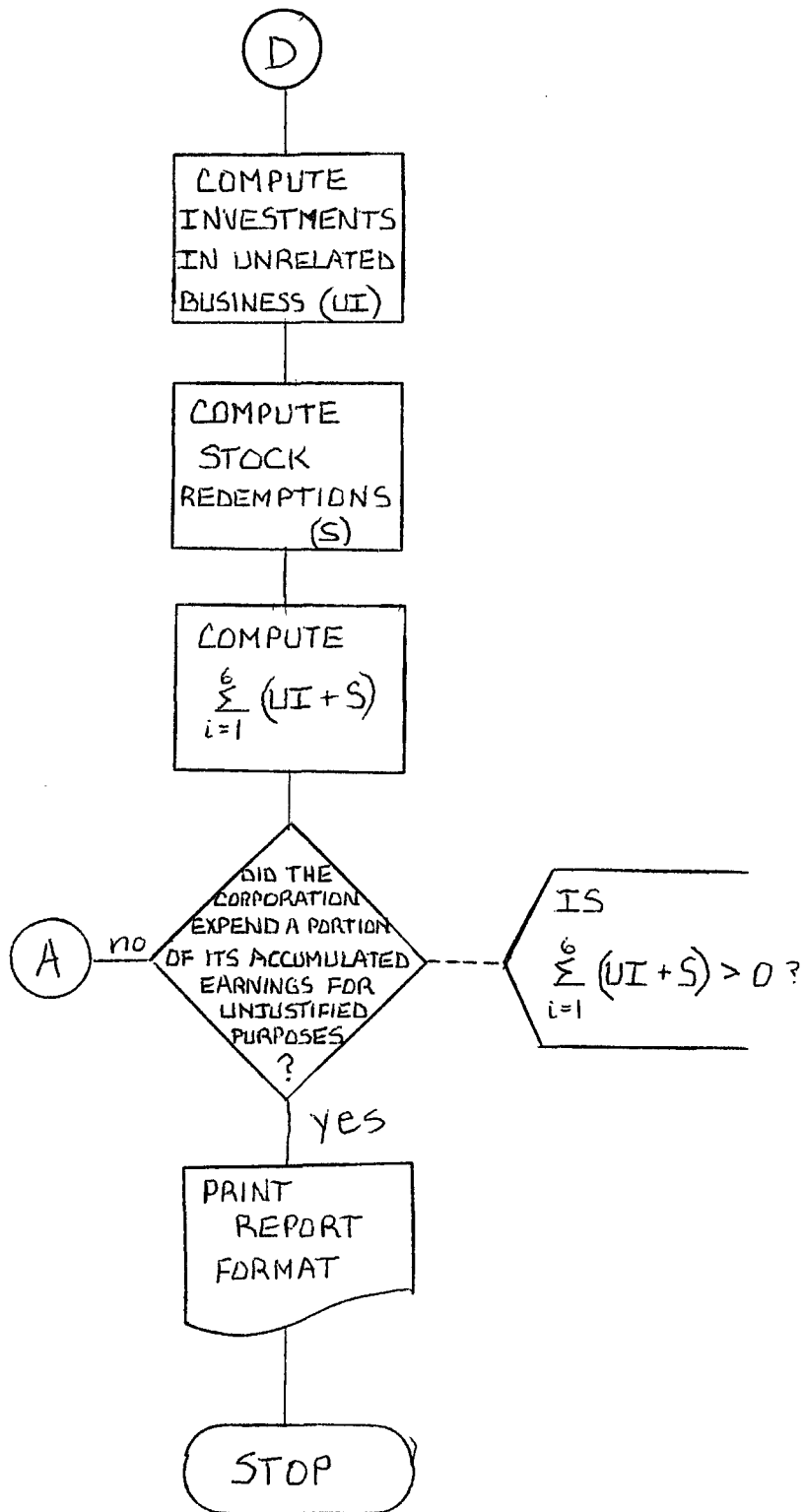


Fig. 5. Flowchart illustration (continued)



Furthermore, when the fourth question regarding unrelated investments and stock redemptions was eliminated from the model and the corporations were tested only with respect to the first three questions, an additional ten corporations were found to have answered all of these questions in the affirmative. Thus, a sum total of fifty-six publicly-held corporations were found to be potentially subject to, and liable for, the accumulated earnings tax.

Table 6 lists the first grouping of forty-six corporations and the related data generated from the COMPUSTAT tape with respect to the four questions. Each of the columns in Table 6 shows the extent to which each corporation answered one of the four questions. Column 1, "Retentions," presents the total dollar amount of the corporation's accumulated earnings; Column 2, "Working Capital/Bardahl Ratio," presents in ratio form the extent to which the corporation's working capital exceeded the amount allowed by the Bardahl formula; Column 3 "Excess Retentions," presents the total dollar amount of accumulated earnings the corporation had in excess of the amount deemed necessary to provide for the reasonable needs of the business; and Column 4 "unjustified expenditures," presents the total dollar amount spent by the corporation on unrelated investments and/or stock redemptions.

Table 7 lists in similar fashion the second grouping of the fifty-six corporations and the related data generated



TABLE 6

CORPORATIONS AFFIRMATIVELY RESPONDING  
TO ALL FOUR QUESTIONS  
(000,000 omitted)

Corporation	Question #1	Question #2	Question #3	Question #4
	Retentions	Working Capital/ Bardahl Ratio	Excess Retentions	Unjustified Expenditures
1. Cleveland-Cliffs.....	\$103.4	1.3	\$ 28.4	\$ 294.0
2. New Mexico & Arizona Land.....	3.3	7.9	.3	6.9
3. Pacific Tin Cons.....	5.4	1.8	1.3	3.2
4. Callahan Mining.....	12.8	2.1	3.6	28.0
5. Northgate Explorat'n	9.5	2.4	25.7	81.8
6. ASA.....	59.1	182.0	59.1	1151.2
7. Campbell Red Lake...	27.3	3.6	19.0	6.1
8. Day Mines.....	3.4	6.0	.3	17.0
9. Dome Mines.....	83.8	3.6	70.0	48.6
10. Hollinger Mines.....	22.6	16.7	21.9	328.2
11. Homestake Mining.....	74.7	2.1	5.9	.5
12. Canadian Superior...	172.6	3.6	152.6	90.8
13. Crestmont Oil & Gas.	3.6	1.9	.2	.8
14. Louisiana Land & Exploration.....	284.1	8.2	13.4	36.2

TABLE 6--Continued

Corporation	Question #1	Question #2	Question #3	Question #4
	Retentions	Working Capital/ Bardahl Ratio	Excess Retentions	Unjustified Expenditures
15. Wichita Industries...	\$ 2.5	.8	\$ .9	\$ .9
16. Freeport Minerals...	116.8	1.6	.8	9.5
17. Lilli Ann.....	2.1	1.2	2.9	.7
18. Pacific Lumber.....	70.3	1.5	35.6	24.5
19. Skyline.....	33.1	1.9	38.9	.3
20. Glatfelter (P.H.)...	33.2	1.8	25.0	8.6
21. Simkins Industries..	13.5	1.2	6.7	37.3
22. Simplicity Pattern..	48.4	1.8	47.4	12.0
23. Lawter Chemicals....	17.6	2.4	1.5	5.6
24. Caressa.....	6.9	1.4	3.7	.3
25. Olla Industries.....	5.1	1.2	3.1	.2
26. Ideal Basic.....	90.1	1.3	13.0	44.8
27. Tecumseh Products...	101.9	1.3	12.7	6.9
28. American Controlled.	3.4	1.8	1.1	20.5
29. Canadian Marconi....	8.5	1.6	26.1	2.0
30. Sunair Electronics..	5.1	1.3	1.8	5.7
31. Telescience.....	9.4	1.9	.9	.2
32. United Aircraft.....	3.6	1.2	1.6	.4

TABLE 6--Continued

Corporation	Question #1	Question #2	Question #3	Question #4
	Retentions	Working Capital/ Bardahl Ratio	Excess Retentions	Unjustified Expenditures
33. Cross & Co.....	\$ 23.6	1.3	\$ 4.5	\$ .1
34. Roadway Express.....	171.5	2.2	16.6	22.6
35. World Airways.....	23.1	2.6	64.8	165.3
36. Gross Telecasting....	3.8	7.6	4.0	.1
37. Weis Markets.....	65.4	1.5	26.1	1.5
38. Miller-Wohl.....	25.6	1.0	26.4	5.9
39. Deltec Int'l.....	10.8	1.1	22.4	34.0
40. Crum & Forster.....	220.1	1.3	110.1	7,121.8
41. Coldwell Banker.....	19.2	1.9	3.0	89.6
42. Hubbard Real Estate.	31.4	15.3	37.5	505.3
43. Block H & R.....	58.8	17.6	51.8	90.4
44. National CSS.....	12.8	1.1	4.5	3.1
45. Comm't'y Psychiatric.	9.6	1.4	1.0	13.8
46. Flight Safety Int'l.	16.8	1.2	1.7	.2

TABLE 7

CORPORATIONS, CATEGORIZED BY INDUSTRY,  
AFFIRMATIVELY RESPONDING TO FIRST THREE QUESTIONS  
(000,000 omitted)

Corporation	Industry	Question #1	Question #2	Question #3
		Retentions	Working Capital/ Bardahl Ratio	Excess Retentions
1. U.S. Sugar.....	Agriculture	\$ 98.6	1.8	\$ 11.9
2. Cleveland-Cliffs....	Metal Mining	103.4	1.3	28.4
3. New Mexico & Arizona Land.....	Metal Mining	3.3	7.9	.3
4. Pacific Tin Cons....	Metal Mining	5.4	1.8	1.3
5. Callahan Mining.....	Metal Mining	12.6	2.1	3.6
6. Northgate Explorat'n	Metal Mining	9.5	2.4	25.7
7. ASA.....	Metal Mining	59.1	182.0	59.1
8. Campbell Red Lake...	Metal Mining	27.3	3.6	19.0
9. Day Mines.....	Metal Mining	3.4	6.0	.3
10. Dome Mines.....	Metal Mining	83.8	3.6	70.0
11. Hollinger Mines.....	Metal Mining	22.6	16.7	21.9
12. Homestake Mining.....	Metal Mining	74.1	2.1	5.9
13. Canadian Superior...	Oil & Gas	172.6	3.6	152.6
14. Crestmont Oil & Gas.	Oil & Gas	3.6	1.9	.2
15. Louisiana Land & Exploration.....	Oil & Gas	284.1	8.2	13.4

TABLE 7--Continued

Corporation	Industry	Question #1		Question #2		Question #3	
		Retentions		Working Capital/ Bardahl Ratio		Excess Retentions	
16. Wichita Industries.....	Oil & Gas	\$ 2.5	\$	.8		.9	
17. Freeport Minerals.....	Minerals	116.8		1.6		.8	
18. Lilli Ann.....	Apparel	2.1		1.2		2.9	
19. Winter (Jack).....	Apparel	35.1		1.2		27.7	
20. Pacific Lumber.....	Wood Products	70.3		1.5		35.6	
21. Skyline.....	Mobile Homes	33.1		1.9		38.9	
22. Glatfelter (P.H.).....	Paper	33.2		1.8		25.0	
23. Simkins Industries.....	Paper	13.5		1.2		6.7	
24. Simplicity Pattern....	Apparel	48.4		1.8		47.4	
25. Tampax.....	Drugs	68.7		2.1		25.6	
26. Lawter Chemicals.....	Chemical	17.6		2.4		1.5	
27. Globe Industries.....	Plastics	15.9		1.2		6.8	
28. Caressa.....	Footwear	6.9		1.4		3.7	
29. Shaer Shoe.....	Footwear	1.8		2.3		1.3	
30. Olla Industries.....	Leather Goods	5.1		1.2		3.1	
31. Ideal Basic Industries	Cement	90.1		1.3		13.0	
32. Consolidated Refining.	Rolling Metal	5.1		1.5		2.9	
33. Tecumseh Products.....	Appliances	101.9		1.3		12.7	
34. American Controlled...	Appliances	3.4		1.8		1.1	

TABLE 7--Continued

Corporation	Industry	Question #1		Question #2		Question #3	
		Retentions	\$	Working Capital/ Bardahl Ratio		Excess Retentions	
35. Canadian Marconi.....	Electronics	8.5	\$	1.6		26.1	\$
36. Sunair Electronics.....	Electronics	5.1		1.3		1.8	
37. Telescience.....	Electronics	9.4		1.9		.9	
38. United Aircraft.....	Aircraft	3.6		1.2		1.6	
39. Cross & Co.....	Office Supplies	23.6		1.3		4.5	
40. Roadway Express.....	Trucking	171.5		2.2		16.6	
41. World Airways.....	Airlines	23.1		2.6		64.8	
42. Gross Telecasting.....	Broadcasting	3.8		7.6		4.0	
43. Weis Markets.....	Supermarkets	65.4		1.5		26.1	
44. Miller-Wohl.....	Women's Wear	25.6		1.0		26.4	
45. Petrie Stores.....	Women's Wear	102.6		4.0		78.5	
46. Howard Johnson.....	Restnt's-Motel	112.1		2.9		12.4	
47. Deltec Int'l.....	Security	10.8		1.1		22.4	
48. Crum & Forster.....	Insurance	220.1		1.3		110.1	
49. Marsh & McLennan.....	Insurance	149.2		1.8		94.9	
50. Coldwell Banker.....	Real Estate	19.2		1.9		3.0	
51. Hubbard Real Estate....	Real Estate	31.4		15.3		37.5	
52. Block H & R.....	Tax Service	58.8		17.6		51.8	
53. National CSS.....	Computer	12.8		1.1		4.5	

TABLE 7--Continued

Corporation	Industry	Question #1		Question #2		Question #3	
		Retentions		Working Capital/ Bardahl Ratio		Excess Retentions	
54. Harrah's.....	Recreation	\$ 45.3		1.2		\$ 26.9	
55. Commt'y Psychiatric...	Hospitals	9.6		1.4		1.0	
56. Flight Safety Int'l....	Education	16.8		1.2		1.7	

from the COMPUSTAT tape with respect to the first three questions only. This table also categorizes the various corporations by industry. It is interesting to note that the fifty-six corporations cover a broad range of industries from manufacturing concerns to retail and service oriented businesses, and that with but one exception no particular industry has a predominant concentration of accumulating corporations.

The one exception is corporations in the extraction and production of precious metals industry. These corporations comprise the largest single group within the list and eleven of the fifty-six corporations, or approximately 20% of the test results, are included in this group.

Furthermore, forty-one of the fifty-six corporations, or approximately 73% of the test results, accumulated earnings in excess of 25% more than the amount of earnings required to be retained by the corporation for its reasonable business needs. This was computed by dividing the results obtained for Question 3 (i.e., excess retentions) by the results obtained for Question 1 (i.e., the amount of earnings retained and accumulated with the corporation). Table 8 presents for all fifty-six corporations the percentage of retentions accumulated beyond the reasonable needs of the business.

These results clearly indicate that a majority of the corporations selected by the model accumulated a significant



TABLE 8

PERCENTAGE OF RETENTIONS ACCUMULATED  
BEYOND THE REASONABLE NEEDS OF THE BUSINESS  
FOR ALL CORPORATIONS SATISFYING  
FIRST THREE QUESTIONS  
(000,000 omitted)

Corporation	Retentions	Excess Retentions	Excess Retentions = % Retentions
1. U.S. Sugar.....	\$ 98.6	\$ 11.9	12.0
2. Cleveland-Cliffs.....	103.4	28.4	27.5
3. New Mexico & Arizona Land.....	3.3	.3	9.4
4. Pacific Tin Cons.....	5.4	1.3	23.3
5. Callahan Mining.....	12.6	3.6	28.9
6. Northgate Explorat'n....	9.5	25.7	27.1
7. ASA.....	59.1	59.1	100.0
8. Campbell Red Lake.....	27.3	19.0	69.6
9. Day Mines.....	3.4	.3	9.8
10. Dome Mines.....	83.8	70.0	83.5
11. Hollinger Mines.....	22.6	21.9	96.9
12. Homestake Mining.....	74.7	5.9	7.9
13. Canadian Superior.....	172.6	152.6	88.4

TABLE 8--Continued

Corporation	Retentions	Excess Retentions	Excess Retentions = % Retentions
14. Crestmont Oil & Gas.....	\$ 3.6	\$ .2	5.1
15. Louisiana Land & Exploration.....	284.1	13.4	4.7
16. Wichita Industries.....	2.5	.9	36.4
17. Freeport Minerals.....	116.8	.8	.7
18. Lilli Ann.....	2.1	2.9	138.2
19. Winter (Jack).....	35.1	27.7	79.0
20. Pacific Lumber.....	70.3	35.6	50.6
21. Skyline.....	33.1	38.9	117.5
22. Glatfelter (P.H.).....	33.2	25.0	75.3
23. Simkins Industries.....	13.5	6.7	49.8
24. Simplicity Pattern.....	48.4	47.4	97.9
25. Tampax.....	68.7	25.6	37.3
26. Lawter Chemicals.....	17.6	1.5	8.5
27. Globe Industries.....	15.9	6.8	42.8
28. Caressa.....	6.9	3.7	54.2
29. Shaer Shoe.....	1.8	1.3	73.3
30. Idea Basic.....	90.1	13.0	14.5
31. Olla Industries.....	5.1	3.1	60.3

TABLE 8--Continued

Corporation	Retentions	Excess Retentions	Excess Retentions = % Retentions
32. Consolidated Refining.....	\$ 5.1	\$ 3.0	56.7
33. Tecumseh Products.....	101.9	12.7	12.5
34. American Controlled.....	3.4	1.1	31.7
35. Canadian Marconi.....	8.5	26.2	307.1
36. Sunair Electronics.....	5.1	1.8	34.6
37. Telescences.....	9.4	.9	9.3
38. United Aircraft.....	3.6	1.6	45.1
39. Cross & Co.....	23.6	4.5	19.1
40. Roadway Express.....	171.5	16.6	9.7
41. World Airways.....	23.1	64.8	280.8
42. Gross Telecasting.....	3.8	4.0	105.8
43. Weis Markets.....	65.4	26.1	39.9
44. Miller-Wohl.....	25.6	26.4	103.3
45. Petrie Stores.....	102.6	78.5	76.5
46. Howard Johnson.....	112.1	12.4	11.1
47. Deltec Int'l.....	10.8	22.4	207.2
48. Crum & Forster.....	220.1	110.1	50.0
49. Marsh & McLennan.....	149.1	94.9	63.6

TABLE 8--Continued

Corporation	Retentions	Excess Retentions	Excess Retentions = % Retentions
50. Coldwell Banker.....	\$ 19.2	\$ 3.0	15.7
51. Hubbard Real Estate.....	31.4	37.5	119.2
52. Block H & R.....	58.8	51.8	88.1
53. National CSS.....	12.8	4.5	34.9
54. Harrah's.....	45.3	26.9	59.3
55. Cmmt'y Psychiatric.....	9.6	1.0	10.4
56. Flight Safety Int'l.....	16.8	1.7	9.9

portion of their earnings beyond the reasonable needs of the business.

In a separate analysis, all of the corporations included on the COMPUSTAT tape were tested with regard to the first two questions only, in order to determine which specific corporations had working capital in excess of the amount allowed by the Bardahl formula. The results of this test were then compared with the results presented in Table 8 which listed fifty-six corporations as having responded affirmatively to the first three questions (and were therefore considered to have accumulated earnings beyond the reasonable needs of the business). Comparing the results obtained from these two separate tests may indicate to what extent corporations which are found to have working capital in excess of the amount allowed by the Bardahl formula may also be found to have accumulated earnings beyond the reasonable needs of the business.

One hundred and seven corporations were found to have responded affirmatively to the first two questions only. Table 9 lists these corporations and presents the related data for resolving these questions.

Accordingly, approximately 52% ( $\frac{56}{107}$ ) of the corporations found to have working capital in excess of the amount allowed by the Bardahl formula were also found to have accumulated earnings beyond the reasonable needs of the business.

TABLE 9

CORPORATIONS ACCUMULATING EARNINGS WHOSE  
 "WORKING CAPITAL/BARDAHL RATIO" IS  $> 1.25$

Corporation	Question #1	Question #2
	Retentions	Working Capital/ Bardahl Ratio
1. San Carlos Milling.....	\$ 3.5	1.2
2. U.S. Sugar.....	98.6	1.8
3. Cleveland-Cliffs.....	103.4	1.3
4. Hecla Mining.....	2.1	0.8
5. New Mexico & Arizona Land.....	3.3	7.9
6. Pacific Tin Cons.....	5.4	1.8
7. Callahan Mining.....	12.6	2.1
8. Placer Development.....	90.5	1.4
9. Northgate Exploration...	9.5	2.4
10. ASA.....	59.1	182.0
11. Campbell Red Lake.....	27.3	3.6
12. Day Mines.....	3.4	6.0
13. Dome Mines.....	83.8	3.6
14. Giant Yellowknife.....	1.8	2.3
15. Hollinger Mines.....	22.6	16.7
16. Homestake Mining.....	74.7	2.1
17. Aquitaine.....	127.8	2.8
18. Canadian Superior.....	172.6	3.6
19. Crestmont Oil & Gas.....	3.6	1.9
20. Gen. Amer. Oil.....	95.3	3.9
21. Houston Oil.....	108.7	1.1
22. Hudson's Bay Oil.....	241.6	1.3
23. Louisiana Land & Exploration.....	284.1	8.2
24. Numac Oil & Gas.....	17.1	9.5

TABLE 9--Continued

Corporation	Question #1	Question #2
	Retentions	Working Capital/ Bardahl Ratio
25. Prairie Oil.....	\$ 5.4	51.9
26. Scurry Rainbow Oil.....	5.3	3.6
27. Wichita Industries.....	2.5	0.8
28. Anglo.....	8.2	4.7
29. Chieftain Development...	7.3	1.8
30. Helmerich & Payne.....	65.8	1.2
31. Rowan.....	60.3	1.3
32. Freeport Minerals.....	116.8	1.6
33. Banister Cont.....	18.9	2.7
34. Dr. Pepper.....	37.7	2.0
35. Lilli Ann.....	2.1	1.2
36. Winter (Jack).....	35.1	1.2
37. Pacific Lumber.....	70.3	1.5
38. Skyline.....	33.1	1.9
39. Glatfelter (P.H.).....	33.2	1.8
40. Simkins Industries.....	13.5	1.2
41. Simplicity Pattern Co...	48.4	1.8
42. Capital Cities.....	159.6	1.1
43. Harland (John H.).....	18.9	1.4
44. Ethyl.....	283.6	1.3
45. Canadian Occidental.....	46.6	3.2
46. Tampax.....	68.7	2.1
47. Lawter Chemicals.....	17.6	2.4
48. Asamera Oil.....	28.8	1.5
49. Pacific Petroleum.....	215.1	1.5
50. U.S. Rubber.....	1.1	2.3
51. Globe Industries.....	15.9	1.2
52. Caressa.....	6.9	1.4
53. Shaer Shoe.....	1.8	2.3

TABLE 9--Continued

Corporation	Question #1	Question #2
	Retentions	Working Capital/ Bardahl Ratio
54. Olla Industries.....	\$ 5.1	1.2
55. Giant Portland.....	4.0	3.1
56. Ideal Basic.....	90.1	1.3
57. Louisville Cement.....	24.2	1.2
58. Friedman Industries.....	7.6	1.2
59. Northwestern Steel.....	72.1	1.7
60. Consolidated Refining...	5.1	1.5
61. Chicago Rivet.....	4.1	1.5
62. IBM.....	5,616.1	1.4
63. Tecumseh Products.....	101.9	1.3
64. American Controlled.....	3.4	1.8
65. Canadian Marconi.....	8.5	1.6
66. Sunair Electronics.....	5.1	1.3
67. Telescience.....	9.4	1.9
68. Tyco Lab.....	20.1	1.5
69. Checker Motors.....	3.8	1.5
70. TRE.....	18.8	1.6
71. United Aircraft.....	3.6	1.2
72. Cross & Co.....	23.6	1.3
73. American Technical.....	3.4	1.2
74. Roadway Express.....	171.5	2.2
75. Moore McCormack.....	113.8	1.7
76. Southwest Airlines.....	13.0	1.7
77. World Airways Inc.....	23.1	2.6
78. Communications Satellite	170.1	8.9
79. Gross Telecasting.....	3.8	7.6
80. Weis Markets.....	65.4	1.5
81. Loehmann's.....	8.4	1.4
82. Miller-Wohl.....	25.6	1.0



TABLE 9--Continued

Corporation	Question #1	Question #2
	Retentions	Working Capital/ Bardahl Ratio
83. Petrie Stores.....	\$ 102.6	4.0
84. Gino's.....	33.5	1.0
85. Howard Johnson.....	112.1	2.9
86. Kapok Tree Inns.....	7.8	1.5
87. Child World.....	12.5	1.2
88. Reliance Group.....	43.9	3.4
89. Ticor.....	45.7	1.1
90. Deltec Int'l.....	10.8	1.1
91. Crum & Forster.....	220.1	1.3
92. Marsh & McLennan.....	149.2	1.8
93. Coldwell Banker.....	19.2	1.9
94. Southland Royalty.....	79.3	4.0
95. Hubbard Real Estate.....	31.4	15.3
96. Mortgage Growth Inves- tors.....	4.1	8.7
97. Block H & R.....	58.8	17.6
98. Automatic Data Proc.....	71.3	2.0
99. National CSS.....	12.8	1.1
100. Electronic Data Systems.	37.9	2.1
101. Redlaw.....	3.6	1.3
102. Saunders Leasing.....	13.9	1.3
103. Scheib Earl.....	3.5	1.5
104. San Juan Racing.....	15.6	7.0
105. Harrah's.....	45.3	1.2
106. Comm't'y Psychiatric.....	9.6	1.4
107. Flight Safety Int'l.....	16.8	1.2

The significance of this test lies in the fact that the Internal Revenue Service generally bases its decision of whether to pursue an audit of a corporation with respect to the accumulated earnings tax on the results it obtains when applying the Bardahl formula to the corporation under examination. Thus, if the IRS also used the Bardahl formula as the litmus test for deciding whether to pursue an audit of a publicly-held corporation with respect to the accumulated earnings tax, it could ultimately find that approximately 50%, or one out of every two corporations which have working capital in excess of the amount allowed under the Bardahl formula could be subject to the accumulated earnings tax.

## CHAPTER VI

### SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

#### Summary

The accumulated earnings tax is a penalty tax levied in addition to the regular corporate income tax and is imposed on any corporation which satisfies two conditions:

(1) The corporation accumulated earnings beyond the reasonable needs of the business (referred to as the objective condition) and (2) the corporation is formed or availed of for the purpose of avoiding income taxes with respect to its shareholders (referred to as the subjective condition).

The basic purpose of this penalty tax is to eliminate corporate shareholders' propensity to avoid the double taxation on corporate income by having the corporation accumulate earnings within the corporation instead of distributing them as dividends.

Although the Code specifically states that "every corporation" could be subject to the accumulated earnings tax, the Internal Revenue Service has levied the tax only against closely-held corporations. Closely-held corporations

contend that by merely applying the accumulated earnings tax against their corporations, the Internal Revenue Service has, in effect, stunted their ability to grow and expand.

Accordingly, this study provided a thorough review and analysis of the accumulated earnings tax in order to determine whether the accumulated earnings tax could be, and indeed should be, applied to publicly-held corporations.

In Chapter II, Review of the Related Literature, four significant findings were presented which were particularly relevant and cogent to this study. First, the results of a comprehensive study of the accumulated earnings tax conducted for Congress by Dr. James Hall were presented. Among the conclusions of the study was a recommendation urging the Internal Revenue Service to review its administrative policy with respect to applying the accumulated earnings tax only to closely-held corporations and not against publicly-held corporations. This indicated that there was a sound basis for assuming that publicly-held corporations could be subject to the accumulated earnings tax.

Second, a study was presented which showed that the criteria included in the Internal Revenue Manual's Tax Audit Guidelines are valid and may be relied upon for determining whether a corporation could be subject to the accumulated earnings tax. Accordingly, the model used in this study for determining whether a corporation could be

subject to the accumulated earnings tax was developed from the criteria included in the Guidelines.

Third, a study was presented which found that as a result of the United States Supreme Court decision in Donruss, the Internal Revenue Service no longer is required to prove that a corporation satisfied the subjective condition regarding corporate intent. Under current law, once it is determined that a corporation accumulated earnings beyond the reasonable needs of the business, the corporation is automatically presumed to have satisfied the subjective condition unless it can prove otherwise. Accordingly, in determining whether publicly-held corporations may be subject to the accumulated earnings tax, the focal point of this study was to determine if the corporation accumulated earnings beyond the reasonable needs of the business.

Fourth, studies were presented which showed that the board of directors of publicly-held corporations do in fact consider their shareholders' tax preferences when determining dividend policy. The results of these studies were used to refute the argument presented by those who contend that the accumulated earnings tax cannot be applied to publicly-held corporations because such corporations do not consider their shareholder tax preferences when determining dividend policy and therefore could never satisfy the subjective condition.

Chapter III provided a review of the legislative history of the accumulated earnings tax. It was found that although an accumulated earnings tax provision was included in every legislative tax bill enacted since the Tariff Act of 1913, the first official income tax law, the original provisions included in the earlier statutes were so vague and weak as to render them essentially ineffective and inoperative. Congress initially refused to strengthen the accumulated earnings tax provision because it feared that this could ultimately result in penalizing corporations which were legitimately accumulating earnings--curiously, an argument used today by those criticizing the current accumulated earnings tax provision.

However, Congress eventually acquiesced to strengthening the provision such that by 1947, a Special Tax Study Committee found evidence indicating that the accumulated earnings tax was being applied against small business corporations in a harsh manner never intended by Congress. The Tax Study Committee concluded that the accumulated earnings tax may be adversely affecting successful corporations attempting to grow and expand.

Thus, in drafting an accumulated earnings tax provision for inclusion in the Internal Revenue Code of 1954, Congress adopted many significant changes and revisions in order to remedy the inequities inherent in the old statute. However, there was one issue which Congress addressed but

did not resolve. Congress drafted a provision which would have specifically exempted publicly-held corporations from the accumulated earnings tax. This provision was deleted from the final bill and was never enacted into law.

Congressional intent for deleting this provision has been subject to differing and conflicting interpretation. The Internal Revenue Service, however, has adopted the position that there is no legal impediment in applying the accumulated earnings tax to a publicly-held corporation.

The results of the analysis obtained in reviewing the legislative history of the accumulated earnings tax were then applied in Chapter IV to help understand and identify the specific criteria used by the Internal Revenue Service when determining if a particular corporation is subject to the accumulated earnings tax. The criteria were developed from the twenty-five factors listed in the Tax Audit Guidelines which are supposed to be referred to by Internal Revenue Service agents when determining whether to pursue an audit of a corporation with respect to the accumulated earnings tax.

The following six criteria, expressed in question form, were found to be particularly significant when determining if a corporation could be subject to the accumulated earnings tax.

1. In the year it accumulated its earnings, did the corporation have a specific, definite and feasible plan

detailing the purpose for which the earnings would be used?

2. Did the corporation have an adequate amount of working capital to satisfy its current operating expenses?

3. Did the corporation expend a portion of its funds for expansion and replacement of plant and equipment?

4. Did the corporation expend a portion of its funds for investments, diversification, and acquisition which qualify as legitimate business needs (i.e., investments which it controls and manages)?

5. Did the corporation expend a portion of its funds to retire outstanding long-term debt obligations?

6. Did the corporation expend a portion of its funds for stock redemptions?

It is important to note that all the six criteria relate to the objective condition regarding the reasonable needs of the business and not to the subjective condition regarding corporate intent to avoid income taxes on behalf of its shareholders. No criteria were developed for the subjective condition because, under current law, any corporation found to have accumulated earnings beyond the reasonable needs of the business is automatically presumed to have satisfied the subjective condition.

In Chapter V a model was developed for determining which specific publicly-held corporations could be subject to the accumulated earnings tax. The model consists of four test questions which were formulated on the basis of



the criteria developed in Chapter IV.

The model was applied to the universe of all corporations listed on the New York and American Stock Exchanges whose financial statement data are included in the COMPUSTAT computer tape for a six year period beginning with calendar or fiscal year 1972 and ending with 1977. In essence, the model tested every corporation listed on the COMPUSTAT tape with respect to the following four questions:

1. Did the corporation retain and accumulate earnings?
2. Did the corporation have adequate working capital to satisfy its current operating expenses?
3. Did the corporation accumulate earnings in excess of the amount necessary to provide for the reasonable needs of the business? (The reasonable needs of the business include the need to provide for (i) additional working capital; (ii) qualified business investments; (iii) additional purchases of plant and equipment; and (iv) the retirement of outstanding long-term debt).
4. Did the corporation expend at least a portion of its accumulated earnings for purposes considered unjustified and beyond the reasonable needs of the business (e.g., unrelated investments and stock redemptions)?

If the response to each question was in the affirmative, the corporation being analyzed and examined was listed as being potentially liable for the accumulated earnings tax. Forty-six corporations were found to have answered all four of the model's test questions in the affirmative.

Conclusions

This study showed that publicly-held corporations could be subject to the accumulated earnings tax if the same criteria used to determine whether a closely-held corporation is subject to the accumulated earnings tax are applied to publicly-held corporations. Thus, the results presented in this study enable small business corporations, whose stock is closely-held, to present a forceful argument supporting their contention that the accumulated earnings tax is being applied in a discriminatory and subjective manner which may be adversely affecting the viability of their corporations.

This argument is particularly valid in our present inflationary times, with interest rates at record high levels. Since small closely-held business corporations are prohibited from accumulating earnings within the corporation, any expansion program must generally be financed by externally generated funds obtained from financial institutions. However, these corporations may find the cost of borrowing the necessary capital prohibitive, or as has been true of late, they may be unable to borrow the money because the funds of many financial institutions have literally "dried-up" and small business corporations are among the first to be rejected for loans, regardless of the price they are willing to pay for such funds.

Publicly-held corporations, on the other hand, may accumulate, and do accumulate earnings and profits without the fear of being subject to the accumulated earnings tax. The resulting advantage publicly-held corporations maintain thereby may have also contributed in part to the increasing number of corporate mergers and acquisitions, many of which are financed either in whole, or in part, by internally generated funds. Such merger and acquisition activity, in turn, further contributes to the elimination of small businesses in our economy.

Accordingly, the Internal Revenue Service must reconsider its administrative policy with respect to the accumulated earnings tax and either adopt an even-handed policy of levying the penalty tax against publicly-held corporations as well as closely-held corporations or join the forces of those advocating the position of closely-held corporations who have consistently urged Congress to repeal this tax in its entirety.

This study also illustrates the important role research could, and should, play in the area of tax education. Currently, tax education is primarily concerned with the rote memorization of tax laws and rules as it relates to their practical application. The historical background and legislative intent underlying these laws and rules are seldom considered.

However, there is a genuine need for those involved with tax education, both at the undergraduate and graduate level, to convey to their students the significance for understanding the broad conceptual and philosophical intent when analyzing specific tax laws.

This study clearly showed that the Internal Revenue Service's policies and procedures with respect to applying the accumulated earnings tax to closely-held corporations and not to publicly-held corporations may be predicated on incorrect and unsubstantiated assumptions. However, if an intensive effort were made at both the academic and professional levels to encourage research in the area of taxation such inaccuracies and misconceptions could be more readily identified and corrected.

#### Recommendations for Future Research

The findings of this study suggest that future research concerning the accumulated earnings tax should emphasize the following.

1. Interview revenue agents from the Internal Revenue Service who have audited corporations which were subject to the accumulated earnings tax. The revenue agents could provide additional insight into the manner in which the Internal Revenue Service implements the policies and procedures outlined in the Tax Audit Guidelines.

2. Interview tax experts from large and reputable accounting firms whose clients were subject to an audit with

respect to the accumulated earnings tax. These experts could point out which factors the Internal Revenue Service focuses on and emphasizes in determining whether to pursue an audit with respect to the accumulated earnings tax. Furthermore, they could detail the procedures and arguments they used in defending their corporation-clients from being subject to the accumulated earnings tax and indicate which specific arguments were particularly successful.

3. Interview executives of publicly-held corporations who set the dividend policy for their corporation in order to determine (a) to what extent they consider shareholder tax preferences when determining dividend policy and (b) whether their corporations would be seriously affected if the accumulated earnings tax were applied to them. These results would indicate whether there is justification for exempting publicly-held corporations from the accumulated earnings tax.

4. The model developed and used in this study for determining which publicly-held corporations could be subject to the accumulated earnings tax could be applied to all publicly-held corporations for all years since 1977, the last year of this study. The results obtained from such a future study could then be compared with the findings included in this study to indicate (a) which publicly-held corporations are continuing to take advantage of the Internal Revenue Service's policy of not applying the accumulated

earnings tax to publicly-held corporations and (b) whether the number of publicly-held corporations accumulating earnings is increasing.

APPENDIX A

INTERNAL REVENUE CODE SECTIONS 531-537

**SEC. 531. IMPOSITION OF ACCUMULATED EARNINGS TAX.**

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of—

- (1) 27½ percent of the accumulated taxable income not in excess of \$100,000, plus
- (2) 38½ percent of the accumulated taxable income in excess of \$100,000.

**SEC. 532. CORPORATIONS SUBJECT TO ACCUMULATED EARNINGS TAX.**

(a) **General Rule.**—The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) 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.

(b) **Exceptions.**—The accumulated earnings tax imposed by section 531 shall not apply to—

- (1) a personal holding company (as defined in section 542),
- (2) a foreign personal holding company (as defined in section 552), or
- (3) a corporation exempt from tax under subchapter F (section 501 and following).

**SEC. 533. EVIDENCE OF PURPOSE TO AVOID INCOME TAX.**

(a) **Unreasonable Accumulation Determinative of Purpose.**—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.

(b) **Holding or Investment Company.**—The fact that any corporation is a mere holding or investment company shall be prima facie evidence of the purpose to avoid the income tax with respect to shareholders.

**SEC. 534. BURDEN OF PROOF.**

(a) **General Rule.**—In any proceeding before the Tax Court involving a notice of deficiency based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, the burden of proof with respect to such allegation shall—

- (1) if notification has not been sent in accordance with subsection (b), be on the Secretary, or
- (2) if the taxpayer has submitted the statement described in subsection (c), be on the Secretary with respect to the grounds set forth in such statement in accordance with the provisions of such subsection.

(b) **Notification by Secretary.**—Before mailing the notice of deficiency referred to in subsection (a), the Secretary may send by certified mail or registered mail a notification informing the taxpayer that the proposed notice of deficiency includes an amount with respect to the accumulated earnings tax imposed by section 531.

*Prior amendments.*—Sec. 534(b) was previously (qualified effective date rule in Sec. 89(d) of P.L. amended by the following: 35-866).\*

*Sec. 89(b) of Public Law 85-866, Sept. 2, 1958, Sec. 5 of Public Law 367, Aug. 11, 1955.\**

\*Sec. 534(b) as so amended is in P-H Cumulative Changes.

(c) **Statement by Taxpayer.**—Within such time (but not less than 30 days) after the mailing of the notification described in subsection (b) as the Secretary may prescribe by regulations, the taxpayer may submit a statement of the grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business.

(d) **Jeopardy Assessment.**—If pursuant to section 6861(a) a jeopardy assessment is made before the mailing of the notice of deficiency referred to in subsection (a), for purposes of this section such notice of deficiency shall, to the extent that it informs the taxpayer that such deficiency includes the accumulated earnings tax imposed by section 531, constitute the notification described in subsection (b), and in that event the statement described in subsection (c) may be included in the taxpayer's petition to the Tax Court.

(e) [Repealed]

**Prior amendment.**—Former Sec. 534(e) was amended by Sec. 4 of Public Law 367, Aug. 11, 1955. Sec. 534(e) as it read before this amendment is in P-H Cumulative Changes.

**Deadwood changes.**—Sec. 534 was amended by Title XIX, P.L. 94-455, 10-4-76.

## SEC. 535. ACCUMULATED TAXABLE INCOME.

(a) **Definition.**—For purposes of this subtitle, the term "accumulated taxable income" means the taxable income, adjusted in the manner provided in subsection (b), minus the sum of the dividends paid deduction (as defined in section 561) and the accumulated earnings credit (as defined in subsection (c)).

(b) **Adjustments to Taxable Income.**—For purposes of subsection (a), taxable income shall be adjusted as follows:

(1) **Taxes.**—There shall be allowed as a deduction Federal income and excess profits taxes and income, war profits, and excess profits taxes of foreign countries and possessions of the United States (to the extent not allowable as a deduction under section 275(a)(4)), accrued during the taxable year or deemed to be paid by a domestic corporation under section 902(a) or 960(a)(1) for the taxable year, but not including the accumulated earnings tax imposed by section 531, the personal holding company tax imposed by section 541, or the taxes imposed by corresponding sections of a prior income tax law.

**Last amendment.**—Sec. 535(b)(1) appears above as amended by Sec. 1033(b)(3) of Public Law 94-455, Oct. 4, 1976 (qualified effective date rule in Sec. 1033(c) of P.L. 94-455).

Sec. 207(b)(4) of Public Law 88-272, Feb. 26, 1964, effective (Sec. 207(c) of P.L. 88-272) for taxable years beginning after Dec. 31, 1964.\*

**Prior amendments.**—Sec. 535(b)(1) was amended by the following:

Sec. 9(d)(2) of Public Law 87-834, Oct. 16, 1962 (qualified effective date rule in Sec. 9(e) of P.L. 87-834).\*

\*Sec. 535(b)(1) as so amended is in P-H Cumulative Changes.

(2) **Charitable contributions.**—The deduction for charitable contributions provided under section 170 shall be allowed without regard to section 170 (b)(2).

**Last amendment.**—Sec. 535(b)(2) appears above as amended by Sec. 31(a) of Public Law 85-866, Sept. 2, 1958 (qualified effective date rule in Sec. 1(c)(1)

of Public Law 85-866, Sept. 2, 1958). Sec. 535(b)(2) as it read before this amendment is in P-H Cumulative Changes.

(3) **Special deductions disallowed.**—The special deductions for corporations provided in part VIII (except section 248) of subchapter B (section 241 and following, relating to the deduction for dividends received by corporations, etc.) shall not be allowed.

(4) **Net operating loss.**—The net operating loss deduction provided in section 172 shall not be allowed.

(5) **Capital losses.**—There shall be allowed as deductions losses from sales or exchanges of capital assets during the taxable year which are disallowed as deductions under section 1211(a).

(6) **Net capital gains.**—There shall be allowed as a deduction the net capital gain for the taxable year (determined without regard to the capital loss carryback or carryover provided in section 1212) minus the taxes imposed by this subtitle attributable to such net capital gain. The taxes attributable to such net capital gain shall be an amount equal to the difference between—

(A) the taxes imposed by this subtitle (except the tax imposed by this part) for such year, and

(B) such taxes computed for such year without including in taxable income the net capital gain for the taxable year (determined with regard to the capital loss carryback and carryover provided in section 1212).

**Prior amendments.**—Sec. 535(b)(6) was previously amended by the following:

Sec. 512(f)(5) of Public Law 91-172, Dec. 30, 1969, effective (Sec. 512(g) of P.L. 91-172) with respect to net capital losses sustained in taxable years begin-

ning after Dec. 31, 1969.\*

Sec. 31(b) of Public Law 85-866, Sept. 2, 1958 (qualified effective date rule in Sec. 1(c)(1) of P.L. 85-866).\*



(7) **Capital Loss.**—No allowance shall be made for the capital loss carryback or carryover provided in section 1212.

**Last amendment.**—Sec. 535(b)(7) appears above as amended by Sec. 512(f)(6) of Public Law 91-172, Dec. 30, 1969, effective (Sec. 512(g) of Public Law 91-172, Dec. 30, 1969) with respect to net capital

losses sustained in taxable years beginning after Dec. 31, 1969. Sec. 535(b)(7) as it read before this amendment is in P-H Cumulative Changes.

(8) [Repealed]

(9)—(10) [Repealed]

**Addition.**—Former Sec. 535(b)(9) and (10) was added by Sec. 3(b) of Public Law 87-403, Feb. 2, 1962, effective (Sec. 3(g) of P.L. 87-403) with respect

to distributions made after the date of the enactment of this Act. Former Sec. 535(b)(9); (10) as so added is in P-H Cumulative Changes.

**(c) Accumulated Earnings Credit.**—

(1) **General rule.**—For purposes of subsection (a), in the case of a corporation other than a mere holding or investment company the 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). For purposes of this paragraph, the amount of the earnings and profits for the taxable year which are retained is the amount by which the earnings and profits for the taxable year exceed the dividends paid deduction (as defined in section 561) for such year.

(2) **Minimum credit.**—The credit allowable under paragraph (1) shall in no case be less than the amount by which \$150,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

**Last amendment.**—Sec. 535(c)(2) appears above as amended by Sec. 304(a) of Public Law 94-12, Mar. 29, 1975, effective (Sec. 305(c) of Public Law 94-12, Mar. 29, 1975) for taxable years beginning after Dec. 31, 1974.

ously amended by Sec. 205(a) of Public Law 85-866, Sept. 2, 1958, effective (Sec. 205(b) of Public Law 85-866, Sept. 2, 1958) for taxable years beginning after Dec. 31, 1957. Sec. 535(c)(2) as so amended is in P-H Cumulative Changes.

**Prior amendment.**—Sec. 535(c)(2) was previ-

(3) **Holding and investment companies.**—In the case of a corporation which is a mere holding or investment company, the accumulated earnings credit is the amount (if any) by which \$150,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

**Last amendment.**—Sec. 535(c)(3) appears above as amended by Sec. 304(a) of Public Law 94-12, Mar. 29, 1975, effective (Sec. 305(c) of Public Law 94-12, Mar. 29, 1975) for taxable years beginning after Dec. 31, 1974.

ously amended by Sec. 205(a) of Public Law 85-866, Sept. 2, 1958, effective (Sec. 205(b) of Public Law 85-866, Sept. 2, 1958) for taxable years beginning after Dec. 31, 1957. Sec. 535(c)(3) as so amended is in P-H Cumulative Changes.

**Prior amendment.**—Sec. 535(c)(3) was previ-

(4) **Accumulated earnings and profits.**—For purposes of paragraphs (2) and (3), the accumulated earnings and profits at the close of the preceding taxable year shall be reduced by the dividends which under section 563(a) (relating to dividends paid after the close of the taxable year) are considered as paid during such taxable year.

(5) **Cross reference.**—

For denial of credit provided in paragraph (2) or (3) where multiple corporations are formed to avoid tax, see section 1551, and for limitation on such credit in the case of certain controlled corporations, see sections 1561 and 1564.

**Last amendment.**—Sec. 535(c)(5) appears above as amended by Sec. 401(b)(2)(C) of Public Law 91-172, Dec. 30, 1969, effective (Sec. 401(h)(2) of Public Law

91-172, Dec. 30, 1969) with respect to taxable years beginning after Dec. 31, 1969.

**Deadwood changes.**—Sec. 535 was amended by Title XIX, P.L. 94-455, 10-4-76.

**SEC. 536. INCOME NOT PLACED ON ANNUAL BASIS.**

Section 443(b) (relating to computation of tax on change of annual accounting period) shall not apply in the computation of the accumulated earnings tax imposed by section 531.

**SEC. 537. REASONABLE NEEDS OF THE BUSINESS.**

(a) **General rule.**—For purposes of this part, the term "reasonable needs of the business" includes—

- (1) the reasonably anticipated needs of the business,
- (2) the section 303 redemption needs of the business, and
- (3) the excess business holdings redemption needs of the business.

(b) **Special Rules.**—For purposes of subsection (a)—

(1) **Section (303) redemption needs.**—The term "section 303 redemption needs" means, with respect to the taxable year of the corporation in which a shareholder of the corporation died or any taxable year thereafter, the amount needed (or reasonably anticipated to be needed) to make a redemption of stock included in the gross estate of the decedent (but not in excess of the maximum amount of stock to which section 303(a) may apply).

(2) **Excess business holdings redemption needs.**—The term "excess business holdings redemption needs" means, the amount needed (or reasonably anticipated to be needed) to redeem from a private foundation stock which—

(A) such foundation held on May 26, 1969 (or which was received by such foundation pursuant to a will or irrevocable trust to which section 4943(c)(5) applies), and

(B) constituted excess business holdings on May 26, 1969, or would have constituted excess business holdings as of such date if there were taken into account (i) stock received pursuant to a will or trust described in subparagraph (A), and (ii) the reduction in the total outstanding stock of the corporation which would have resulted solely from the redemption of stock held by the private foundation.

(3) **Obligations incurred to make redemptions.**—In applying paragraphs (1) and (2), the discharge of any obligation incurred to make a redemption described in such paragraphs shall be treated as the making of such redemption.

**Prior amendment.**—Sec. 537(a)—(b)(3) was previously amended by Sec. 906(a) of Public Law 91-172, Dec. 30, 1969 (qualified effective date rule in Sec. 906(b) of P.L. 91-172). Sec. 537(a)—(b)(3) as so amended is in P-H Cumulative Changes.

(4) **Product liability loss reserves.**—The accumulation of reasonable amounts for the payment of reasonably anticipated product liability losses (as defined in section 172(i)), as determined under regulations prescribed by the Secretary, shall be treated as accumulated for the reasonably anticipated needs of the business.

**Addition.**—Sec. 537(b)(4) was added by Sec. 371(c) of Public Law 95-600, Nov. 6, 1978, effective (Sec. 371(d) of P.L. 95-600) for taxable years beginning after Sept. 30, 1979.

(5) **No inference as to prior taxable years.**—The application of this part to any taxable year before the first taxable year specified in paragraph (1) shall be made without regard to the fact that distributions in redemption coming within the terms of such paragraphs were subsequently made.

**Last amendment.**—Sec. 537(b)(5) (formerly (b)(4)) appears above as amended by Sec. 371(c) of Public Law 95-600, Nov. 6, 1978, effective (Sec. 371(d) of P.L. 95-600) for taxable years beginning after Sept. 30, 1979. (b)(4) was amended by Sec. 906(a) of Public Law 91-172, Dec. 30, 1969 (qualified effective date rule in Sec. 906(b) of P.L. 91-172). Sec. 537(b)(5) (formerly (b)(4)) as so amended is in P-H Cumulative Changes.

**Prior amendment.**—Sec. 537(b)(5) (formerly

**Deadwood changes.**—Sec. 537 was amended by Title XIX, P.L. 94-465, 10-4-76.

## APPENDIX B

### DEFINITIONS OF COMPUSTAT DATA

#### ACQUISITIONS (STATEMENT OF CHANGES IN FINANCIAL POSITION)

- A. This item represents the funds for, or the costs relating to, the acquisition of a company in a current or prior year as reported on the Statement of Changes in Financial Position.
- B. This item includes
  - 1. Costs in excess of net assets of business acquired
  - 2. Acquisition of additional ownership (i.e., decrease in minority interest)
  - 3. Additional investment in a company (if the company is consolidated)
  - 4. Net assets of businesses acquired
  - 5. Property, plant, and equipment of acquired companies
- C. This item is not available for banks, utilities, life insurance, property and casualty, or Canadian companies.

#### CAPITAL EXPENDITURES (STATEMENT OF CHANGES IN FINANCIAL POSITION)

- A. This item represents the funds used for additions to the company's property, plant, and equipment, excluding amounts arising from acquisitions (i.e., fixed assets of purchased companies) as reported on the Statement of Changes in Financial Position.
- B. This item includes increase in funds for construction.
- C. This item excludes
  - 1. Net assets of businesses acquired
  - 2. Property, plant, and equipment of acquired companies
  - 3. Capital expenditures of discontinued operations

#### CASH DIVIDENDS (STATEMENT OF CHANGES IN FINANCIAL POSITION)

- A. This represents the total amount of cash dividends listed for both *common* and *preferred* stock as reported on the Statement of Changes in Financial Position.
- B. This item includes
  - 1. Cash paid for fractional shares on splits and conversion of debt.
  - 2. Pooled-company dividends
- C. This item excludes
  - 1. The dollar value of *stock* dividends
  - 2. The minority shareholders' dividends
- D. This item is not available for banks, utilities, life insurance, property and casualty, or Canadian companies.

## COST OF GOODS SOLD

- A. This item includes all costs directly allocated by the company to production, such as material, labor, and overhead, etc.
- B. The total operating costs for non-manufacturing companies are considered as Cost of Goods Sold if a breakdown is not available.
- C. This item includes
  - 1. Taxes other than income taxes
  - 2. Pension, retirement, profit-sharing, provision for bonus and stock options, and other employee benefits for manufacturing companies listed separately will be included since the majority of all labor and related costs are involved in the production of the finished product (for non-manufacturing companies, this expense is reported in Selling, General, and Administrative Expenses)
  - 3. Maintenance and repairs
  - 4. Direct labor
  - 5. Heat, light, and power
  - 6. Operating expenses
  - 7. Salary expenses
  - 8. Terminals and traffic
  - 9. Transportation
  - 10. Warehouse expense
  - 11. Supplies
  - 12. Amortization of deferred costs
  - 13. Freight-in
  - 14. Improvements to leased property
  - 15. Insurance and safety
  - 16. Licenses
  - 17. Rent and royalty expense
  - 18. Motion picture industries' amortizations of film expense
  - 19. Extractive industries' lease and mineral rights charged off and development cost written off
- D. This item excludes
  - 1. Depreciation allocated to Cost of Goods Sold -- when the total amount of depreciation and amortization cannot be broken out, the total is deducted from Cost of Goods Sold
  - 2. Amortization of intangibles (included in Depreciation)
  - 3. Amortization of negative intangibles (included in Non-operating Income/Expense)
  - 4. Foreign exchange adjustments above the line (included in Non-operating Income/Expense)
  - 5. Miscellaneous expense (included in Non-operating Income/Expense)
  - 6. Idle plant expense (included in Non-operating Income/Expense)
  - 7. Moving expense (included in Non-operating Income/Expense)
  - 8. Purchase discounts (netted against Cost of Goods Sold)
  - 9. Cigar, cigarette, liquor, oil, and rubber industries' excise taxes
  - 10. Amortization of tools and dies
- E. This item is not available for banks, utilities, life insurance, or property and casualty companies.

**CURRENT ASSETS (TOTAL)**

- A. Total Current Assets represents cash and other assets which, in the next 12 months, are expected to be realized in cash or used in the production of revenue.
- B. This item includes
  - 1. Planters' growing crops and advances when listed as current assets
  - 2. Real estate companies' land purchase option deposits, land held for development and completed homes, and developed land for sale to customers when listed as current assets
- C. This item is not available for banks, life insurance, or property and casualty companies.

**CURRENT LIABILITIES (TOTAL)**

- A. Total Current Liabilities represents liabilities due within one year, including the current portion of long-term debt.
- B. This item is not available for banks, life insurance, or property and casualty companies.

**DEPRECIATION AND AMORTIZATION**

- A. This item represents non-cash charges for obsolescence of and wear and tear on property, allocation of the current portion of capitalized expenditures, and depletion charges.
- B. This item includes
  - 1. Amortization of patents, trademarks, and other intangibles
  - 2. Amortization of book plates
  - 3. Depletion charges
  - 4. Amortization of leasehold improvements
  - 5. Real estate companies' amortization of development and production expense if it is part of property, plant, and equipment
  - 6. Utilities' amortization charged to operation
  - 7. Extractive industries' abandonments, dry hole expenses, retirements, and intangible drilling costs
  - 8. Preproduction expenses when companies use the *full-cost* method of reporting such expenses
  - 9. Amortization of tools and dies
- C. This item excludes
  - 1. Expenses for unsuccessful drilling outside their area of interest (included in Selling, General, and Administrative Expenses)
  - 2. Amortization of debt discount or premium (treated as Interest Expense)
  - 3. Amortization of deferred cost (included in Cost of Goods Sold)
  - 4. Depreciation on discontinued operations (it is part of the Extraordinary Item)
  - 5. Amortization of deferred investment tax credits (will be shown as a credit to depreciation on Schedule VI of the 10-K)
- D. This data item is not available for banks, property and casualty, or life insurance companies.

## INCOME BEFORE EXTRAORDINARY ITEMS AND DISCONTINUED OPERATIONS

- A. The Income before Extraordinary Items and Discontinued Operations represents income of a company after all expenses, including special items, income taxes, and minority interest — but before provisions for common and/or preferred dividends. This item does not reflect discontinued operations (appearing below taxes) or extraordinary items.
- B. This item includes (when reported below taxes)
  - 1. Amortization of intangibles
  - 2. Equity in earnings of unconsolidated subsidiaries
  - 3. Gain or loss on the sale of securities when they are a regular part of a company's operations
  - 4. Shipping companies' operating differential subsidies (current and prior years)
- C. The Income before Extraordinary Items and Discontinued Operations will be reduced by the amount of deferred taxes that have not been charged to the accounts, but stated in a note.
- D. This item, for banks, is before net after-tax and after-minority interest profit or loss on securities sold or redeemed.

## INTEREST EXPENSE

- A. The Interest Expense represents the periodic expense to the company of securing short- and long-term debt.
- B. This item includes
  - 1. Interest expense on both short- and long-term debt
  - 2. Amortization of debt discount or premium
  - 3. Expenses related to the issuance of debt (i.e., underwriting fees, brokerage costs, advertising costs, etc.)
- C. This item excludes
  - 1. Interest income (included in Non-operating Income/Expense). If interest expense is reported net of interest income, then the net figure is collected.
  - 2. Interest capitalized (included in Non-operating Income/Expense)
- D. This item may be estimated if not reported.
- E. This item will be a gross number unless a Q4 footnote appears in footnote field 6.

## INVENTORIES

- A. This item represents merchandise bought for resale and materials and supplies purchased for use in production of revenue.
- B. This item includes, among other things
  - 1. Deposits and/or advances on material purchases
  - 2. Work in process and advances to subcontractors (net of progress payments)
  - 3. Advance manufacturing costs

4. Bullion in transit, bullion, uranium in transit, etc.
  5. Revenue stamps
  6. Unbilled costs on contracts (costs in excess of related billings)
  7. Motion picture companies' film costs, distribution rights, and advances to other producers
  8. Merchandise in transit
  9. Real estate companies' land purchase option deposits, land held for development, and completed homes and developed land for sales to customers. If these are classified as non-current assets, then they are included in Property, Plant, and Equipment.
  10. Distillers' storage charges
  11. Agricultural companies' advances to planters and growing crops (when both are classified as current assets)
  12. Bottles, cases, and kegs (when classified as a current asset)
  13. Brokerage firms' securities inventory
  14. Lumber companies' short-term lumber leases
- C. This item excludes
1. Tools that are listed in current asset section (treated as Other Current Assets)
  2. Supplies and prepaid expenses for companies that combine these item together (treated as Other Current Assets)
  3. Contract billings and expense contracts (treated as Receivable)
  4. Unbilled shipments received by customers (treated as Receivable)
- D. This item is not available for banks, utilities, life insurance, or property and casualty companies.

## INVESTMENTS IN AND ADVANCES TO UNCONSOLIDATED SUBSIDIARIES

- A. This item includes long-term investments and advances to unconsolidated subsidiaries and affiliates in which the parent company has significant control, as stated in the consolidated financial statements.
- B. This item for 1972 and forward (after Accounting Principles Board Opinion No. 18), includes all investments carried at *equity*. Investments carried at cost of less than 20%, of more than 20% but uncertain control (i.e., unconsolidated subsidiaries subject to possible expropriation), joint ventures not yet operating, and partnership in which there is no control will be excluded from this item.
- C. The items, prior to 1972 (before Accounting Principles Board Opinion No. 18), that were included consisted of investments and advances to affiliates (at cost or equity), stock ownership of 50% or more, and unconsolidated subsidiaries. Associates, joint ventures, and partnerships were excluded.
- D. This item is not available for utilities.

## LONG-TERM DEBT (TOTAL)

- A. Long-Term Debt represents debt obligations due more than a year from the company's balance sheet date.
- B. This item includes
  - 1. Purchase obligations and payments to officers (when listed as long-term liabilities)
  - 2. Notes payable, due within one year and to be refunded by long-term debt, when carried as non-current liability
  - 3. Long-term lease obligations (capitalized lease obligations)
  - 4. Industrial Revenue Bond
  - 5. Advances to finance construction
  - 6. Loans on insurance policies
  - 7. Indebtedness to affiliates
  - 8. Bonds, mortgages, and similar debt
  - 9. All obligations that require interest payment
  - 10. Film producers' film contracts
  - 11. Publishing companies' royalty contracts payable
  - 12. Timber contracts for forestry and paper
  - 13. Extractive industries' advances for exploration and development
- C. This item excludes
  - 1. Subsidiary preferred stock (treated as Minority Interest)
  - 2. The current portion of long-term debt (treated as Current Liabilities)
  - 3. Accounts payable due after one year (treated as Other Liabilities)
  - 4. Accrued interest on long-term debt (treated as Other Liabilities)
  - 5. Customers' deposits on bottles, kegs, and cases (treated as Other Liabilities)
  - 6. Production payments and advances for exploration and development
- D. Long-term debt should be reported net of premium or discount according to Accounting Principles Board Opinion No. 21. When debt is reported net of premium or discount, SPCS will collect the net figure.



**OPERATING INCOME BEFORE DEPRECIATION**

- A. Operating Income represents net sales less cost of goods sold and operating expenses before deducting depreciation, amortization, and depletion.
- B. Operating expenses include, but are not limited to
  - 1. Cost of goods sold (materials, labor, and overhead)
  - 2. Selling, general, and administrative expenses
  - 3. Repairs and maintenance expense
  - 4. Rent and royalty expense
  - 5. Research and development expense
  - 6. General taxes (other than income taxes)
  - 7. Strike expense
  - 8. Profit-sharing contributions
  - 9. Bad debt expense (provision for doubtful accounts)
  - 10. Pension costs, including past service pension costs (except when written off in one year)
  - 11. Exploration expense
  - 12. Parent company charges for administrative service
  - 13. Motion picture and entertainment companies' amortization of film costs
- C. The following items, when separately listed, are treated as non-operating income/expense rather than as *operating expenses*:
  - 1. Moving expenses
  - 2. Recurring foreign exchange adjustments
  - 3. Idle plant expenses
  - 4. Profit on sales of properties (except for securities, etc.) for the companies in the oil, coal, airline, and other industries where these transactions are considered a normal part of doing business
  - 5. Amortization of negative intangibles
- D. Finance companies' operating income is stated after deducting additions to reserve for losses.
- E. Current year's results of discontinued operations are not considered operating expenses and are shown as an extraordinary item.
- F. Utility companies' operating income is after state taxes.
- G. This item is not available for banks, life insurance, or property and casualty companies.

**PURCHASE OF COMMON AND PREFERRED STOCK (STATEMENT OF CHANGES IN FINANCIAL POSITION)**

- A. This represents any item appearing as a use of funds which decreases common and/or preferred stock.
- B. This item includes
  - 1. Purchase of treasury stock
  - 2. Retirement or redemption of preferred stock
  - 3. Conversion of preferred stock into common
  - 4. Conversion of Class A, Class B, special stock, etc. into common
- C. This item excludes
  - 1. Reductions in stock of a subsidiary
  - 2. Purchase of warrants
- D. This item is not available for banks, utilities, life insurance, property and casualty, or Canadian companies.

**RECEIVABLES**

- A. This item represents claims against others (after applicable reserves) collectible in money, generally within 12 months.
- B. This item includes, but is not limited to
  - 1. Trade, miscellaneous, and other receivables
  - 2. Amounts due from unconsolidated subsidiaries
  - 3. Income tax refunds, recoverable income taxes, etc.
  - 4. Money due from sales of securities
  - 5. Unbilled shipments received by customers
  - 6. Amounts listed as current assets due from officers and employees
  - 7. Property to be sold under lease-back arrangement
  - 8. Commercial paper issued by unconsolidated subsidiaries to the parent company
  - 9. U.S. government contract billings and expensed contracts
  - 10. Accrued operating differential subsidies (shipping companies)
  - 11. Miscellaneous receivables when stated separately
  - 12. Claims in litigation
  - 13. Dividends receivable
  - 14. Costs and estimated profit on uncompleted contracts (if billed)
  - 15. Area development grants when treated as a current asset
  - 16. Accrued interest
  - 17. Due from factor
  - 18. Investment in bank participation notes
  - 19. Recoverable costs on lease-back agreements
  - 20. Unbilled lease revenues
  - 21. Expenditures billable to clients for advertising agencies
- C. This item excludes
  - 1. Advances on material purchases (treated as an inventory item)
  - 2. Work in process and advances to subcontractors (treated as an inventory item)
  - 3. Estimated future income tax benefits (treated as Other Current

- Assets)
4. Reserves for unearned charges on commercial installment and equipment lease receivables (Receivables are stated after deducting these items.)
  5. Allowance for doubtful accounts (Receivables are stated after deducting these items.)
  6. Reserves for losses for finance companies (Receivables are stated after deducting these items.)
  7. Unbilled receivables (treated as an inventory item)
- D. This item is not available for banks or utilities.

**SALE OF PROPERTY, PLANT, AND EQUIPMENT (STATEMENT OF CHANGES IN FINANCIAL POSITION)**

- A. This item represents the funds received from the sale of property, plant, and equipment.
- B. This item is not available for banks, utilities, life insurance, property and casualty, or Canadian companies.

**SALES - NET**

- A. Sales consists of gross sales (the amount of actual billings to customers for regular sales completed during the period) reduced by cash discounts, trade discounts, and returned sales and allowances for which credit is given to customers.
- B. This item includes
  1. Any revenue source that is expected to continue for the life of the company
  2. Other *operating* revenue
  3. Installment sales
  4. Franchise sales (when corresponding expenses are available)
- C. Special cases (by industry) include
  1. Royalty income when considered operating income (i.e., oil companies, extractive industries, publishing companies, etc.)
  2. Retail companies' sales of leased departments when corresponding costs are available and included in expenses (If costs are not available, the net figure is included in Non-operating Income/Expense)
  3. Shipping companies' income on reserve fund securities when shown separately, and operating differential subsidies
  4. Finance companies' earned insurance premiums and interest income. For finance companies, the sales are counted only after net losses on factored receivables purchased.

8. Bank and utilities' net sales is total current operating revenue.
  9. Life insurance, and property and casualty companies' net sales is total income.
  10. Advertising companies' net sales are commissions earned, not gross billings.
  11. Franchise operations' franchise and license fees.
  12. Leasing companies' rental or leased income.
  13. Hospitals' sales net of provision for contractual allowances (will sometimes include doubtful accounts).
  14. Security brokers' other income.
- D. This item excludes
1. Non-operating income
  2. Interest income (included in non-operating income)
  3. Equity in earnings of unconsolidated subsidiaries (included in non-operating income)
  4. Other income (included in non-operating income)
  5. Rental income (included in non-operating income)
  6. Gain on sale of securities or fixed assets (included in special item)
  7. Discontinued operations (included in special item)
  8. Excise taxes (excluded from sales and also deducted from cost of goods sold)
  9. Royalty income (included in non-operating income)
- E. Any differences that occur between the company report and the definitions will be indicated by a footnote in item 1. Footnote definitions can be found in Section 8 of this manual.

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