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THE TAX ON CORPORATE ACCUMULATED EARNINGS

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INTRODUCTION

The accumulated earnings tax is a device instituted by the Congress to prevent corporate shareholders from utilizing the corporate form of business organization to gain favorable personal tax rates by any or a combination of the following: (1) To accumulate earnings to be withdrawn as dividends in retirement or other low income years of the shareholders, (2) to retain the earnings in the business and sell the stock at a price reflecting the gain which would be taxed at only capital gains rates, or (3) to retain the earnings until the shareholder's death at which time only the estate tax would be imposed.

The accumulated earnings tax is thus a tax on earnings accumulated beyond the reasonable needs of the business including the reasonably anticipated needs of the business. The tax rate is 27½% on the first $100,000 of accumulated taxable income and 38½% on the amount in excess of $100,000. The accumulated taxable income is the taxable income of the corporation after certain adjustments. The tax is not imposed on the corporate surplus, but rather is on the adjusted taxable income.

This paper recounts some of the history behind the tax and examines in detail the changes in the 1954 Code affecting the accumulated earnings tax. Underlying reasons for the changes in the Code are given. Some of the inconsistencies present in this section of the Code and its interpretation are cited. Finally, a critical examination of the possible economic effects of the Code is given. Certain areas, especially the area concerning what constitutes a "reasonable accumulation," are somewhat limited because of the extensive research previously done in this area.

It is generally recognized that earnings accumulated but not needed by the business are undesirable for three reasons. First, accumulated earnings are not subject to the individual income tax and thus may be realized by the shareholders through the favorable capital gains tax or declared as dividends in a year favorable to the taxpayer. This creates an inequitable situation in the view of the taxpayer outside of the capital-supplying sector of the economy who is unable to utilize the corporate structure as a device for saving and is obliged to pay an immediate individual income tax on his inflow of funds.

Secondly, because the tax system grants an incentive to retain earnings in a corporation, some economists fear that in a period of a rising standard of living, the desire of individuals and/or business to save will exceed the desire of business to invest and thus a recessionary force will be created.

A third reason that may be advanced in support of the accumulated earnings tax is that stockholders rarely have the chance to compare the rate of return earned on investments made from corporate retained earnings with those investments of similar risk available outside the business. Thus, this absence of a comparison creates the danger that economic resources may not be optimally allocated.

The possible danger and inequity of corporations holding large amounts of idle funds is apparent. The author hopes to point out, however, that if the law is too harshly interpreted or applied, the effects may be even more undesirable than those the law was designed to prevent.

HISTORY

The development of the accumulated earnings tax has been closely related to that of the income tax. Prior to the Civil War there had been little need for the government to obtain revenue through internal taxes, because its needs were usually well met by customs duties. The Civil War brought an urgent need for additional revenues and for the first time, an income tax was imposed. This tax expired in 1872, but approximately $376,000,000 was collected from the income tax law and its subsequent modifications.[1]

In 1894 another income tax measure was passed as a part of the Wilson-Gorman tariff. The income tax was held unconstitutional in May, 1895, by a five-to-four decision of the Supreme Court. The grounds for the unconstitutionality of the income tax were that it was a direct tax and the Constitution required all direct taxes to be apportioned among the several states according to their population. An "excise tax" on corporations of 1% of corporate net income after a $5,000 exemption, was passed in 1909. This was held to be constitutional by the U. S. Supreme Court.

The Sixteenth Amendment to the Constitution was declared ratified by the states on February 25, 1913, and was as follows:

> The Congress shall have power to lay and collect taxes on incomes, from whatever sources derived, without apportionment among the several States, and without regard to any census or enumeration.

Under the early tax efforts, the corporate earnings were taxed directly to the stockholders, except for a few special corporations. The "excise tax"

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[1]George C. Haas, "The Taxation of Undistributed Profits from the Point of View of the Federal Tax Structure," How Shall Business Be Taxed (New York: Tax Policy League, Inc., 1937), p. 114.

on corporations effected in 1909 was converted into a clear impost on corporate net income under the income tax bill of the Underwood-Simmons Tariff of 1913, which was passed soon after the Sixteenth Amendment was ratified. Dividend income was deductible for the individual in computation of the normal tax but not for the surtax. This created a situation in which it was beneficial for certain corporate shareholders to accumulate earnings in the business.[2]

The Revenue Act of 1913 provided a tax on the income of individuals "fraudulently" permitting profits to accumulate beyond the needs of the business.[3] The Eisner v. Macomber decision[4] determined the taxability of stock dividends, limiting income to the shareholders under the Sixteenth Amendment, to instances in which there was (1) a severance of corporate assets, and/or (2) a change in the preexisting proportionate interests of the stockholders. This Supreme Court decision raised doubts as to the constitutionality of the tax on unreasonably accumulated corporate earnings at the stockholder level. Consequently in 1921 the impact of the tax was transferred from the stockholders to the corporation.

The identity between the corporate and individual normal tax rate continued until 1917, although the tax rates were increased. The deductibility of dividend income continued until 1936. As the disparity between the corporate and individual income tax rates increased and the income tax rate grew, the importance of the tax on unreasonable accumulations of surplus increased. The purpose of the Revenue Act of 1936 was viewed as follows:

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[2]James K. Hall, "The Taxation of Corporate Surplus Accumulations," Joint Committee on the Economic Report, 82nd Congress, 2nd Sess. (Washington: U. S. Government Printing Office, 1952), p. 3.

[3]<u>Tariff Act of 1913</u>, Sec. II (A) (2).

[4]<u>Eisner</u> v. <u>Macomber</u>, 252 U.S. 189 (1920).

> The schedule of corporation income tax rates, normal and surtax, adopted by the Congress in the Revenue Act of 1936, was designed substantially to equalize, on the average, the income tax burdens borne on the one hand by owners of incorporated business enterprises and on the other by individuals deriving income from other sources, and thereby to increase the Federal revenues by a major part of the previous amount of tax avoidance.[5]

The accumulated earnings tax has varied throughout its existence both in percentage rate and in the retained income subject to the tax. Since 1941 the rates have been 27½% on the first $100,000 of adjusted taxable income, and 38½% on amounts above $100,000.

INCIDENCE OF THE TAX

The accumulated earnings tax developed because of the possibility of individuals using the corporate structure to accumulate earnings, taxed at the corporate rate, which could be withdrawn in years favorable to the owners' own personal income tax rates; or the stock could be sold at a price reflecting the accumulation of earnings in which case the increment would be taxed at capital gains rate; or the earnings could accumulate until the owner's death and the gain would be taxed only by the estate tax.

The intent of the major stockholders and directors is very important. In the Gazette Publishing Company case,[6] the court stated this principle saying:

> This court is certainly not interested in whether the judgment and discretion exercised by the directors and management of the . . . corporation was the best or soundest, or even whether they were mistaken entirely in their judgment. Even conceding they were mistaken in their judgment, it does not convince the court that their motive or intent . . . was the preventing of the assessment of surtaxes against the stockholders.

The law recognizes the need of businesses to accumulate earnings for certain corporate purposes, but the objective of the law is to prevent

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[5]Haas, *op. cit.*, p. 124.

[6]*Gazette Publishing Co.* v. *Self*, 103 F.Supp. 779 (1952).

corporations from being used by their shareholders as a device to lower personal income taxes.

> The ultimate test of liability is the purpose of the accumulation. However, there is a significant presumption in the statute. If corporate earnings are permitted to accumulate beyond the reasonable needs of the business, this is determinative of the purpose to avoid income tax on the shareholders, unless the contrary can be shown by the preponderance of the evidence.[7]

Under the 1939 Code, this provision of the law was by a "clear preponderance of the evidence." In an effort to accomplish the objective of the law, the law is necessarily somewhat vague. It is a question of fact whether earnings accumulated are "reasonable" and whether the stockholder is using the corporate structure to avoid personal income taxes. "Because of the vagueness of the statute and the difficulties of determining 'unreasonableness' of accumulation, the provision has been of greater significance as a threat to business firms than as an actual penalty on firms which accumulate for the purposes indicated."[8] Indeed, "while theoretically these provisions constitute a bar to this type of activity, in fact their requirements can be avoided to create affirmatively artificial investment and business arrangements designed principally, if not solely, to take advantage of the tax rate differentials."[9]

From a practical viewpoint, it is almost always in the smaller corporations that the personal interests of a few stockholders are influential enough to control the dividend policy of the board of directors. In a widely held or public corporation, the interests of the stockholders are so diverse as to

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[7]Henry Sellin (ed.), "Corporate Accumulations: How to Meet the Problems of Section 531: A Panel Discussion of Techniques and Issues," New York University 23rd Annual Institute on Federal Taxation (New York: Matthew Bender and Co., 1965), p. 745.

[8]John F. Due, Government Finance, An Economic Analysis (3rd ed.; Homewood, Illinois: Richard D. Irwin, Inc., 1963), p. 236.

[9]Leonard F. Silverstein, "Forms of Business and Federal Income Taxation," Reappraisal of Business Taxation (Princeton: Tax Institute, Inc., 1962), p. 56.

make such a situation highly unlikely.

Scant detail is available involving which corporations are actually affected by the tax. The Internal Revenue Service customarily does not make public the information concerning the incidence of the tax, and a study of the litigated cases during the ten year period ending December 31, 1949, (available from a report to Congress) would cover only two percent of the actual closings.[10] It is clear, though, that the corporation most likely to be assessed this penalty tax is the small closely held corporation. In the period 1938-1948, 79% of the cases involved corporations with fewer than five shareholders; 14% of the cases involved corporations with 5-10 shareholders; 5.8%, corporations with 10-50 shareholders; .4%, corporations with over 50 shareholders. In the period 1940-1950, 54% of the cases involved manufacturing corporations; 18%, wholesale and retail corporations; and only 7% involved finance, insurance and real estate corporations. In asset size, 42% of these corporations had assets from $250,000 to $500,000; 10% had less than $100,000 in assets; and 5% had over $5,000,000.[11]

SIGNIFICANCE OF THE TAX

The significance of the accumulated earnings tax must not be minimized. "If the tax is imposed, its cost may be pyramided because of the cumulative nature of an audit. Should a revenue agent assess a deficiency for a particular year, the very facts which made for the imposition in that year probably exist for other taxable years."[12] If the statute of limitations has been extended

[10] Robert S. Holzman, The Tax on Accumulated Earnings (New York: The Ronald Press Co., 1956), pp. 23-24.

[11] Hall, op. cit., pp. 115-125.

[12] Holzman, op. cit., pp. 23-24.

by waivers, the cumulative nature of the tax imposition is magnified. In the Helvering v. National Grocery Co. case,[13] the corporation was assessed a tax of $477,360.68 for one year. For a three year period, the taxpayer corporation in Helvering v. Chicago Stock Yards Co.,[14] paid $4,110,102.70. In the period 1938-1949, the total proposed assessments under Sec. 102 were $20,073,001 involving 919 tax years. Of these, 62% or $14,255,000 were final determinations. The Income Tax Unit closed 726 years with a record of 79%. The Technical Staff closed 173 years with a record of 19%, and the Tax Court, getting the most difficult cases, closed 20 tax years with a record of 2%.[15] These facts clearly indicate that a corporation potentially liable for this tax cannot afford to ignore it.

Once a corporation has been assessed the accumulated earnings tax, it is not only endangered by the fact that the condition probably existed in prior years, but it is also more vulnerable in future tax years. Thus, a corporation that has once been assessed the tax would be more imperiled by an accumulation of earnings for a reason that has not been ruled upon by the courts or for a reason the propriety of which is unclear from past court decisions, than a corporation which has never been assessed the tax.

The accountant or financial officer in these corporations will be more inclined to expense questionable items rather than capitalize them. By decreasing the net income of the corporation, the retained earnings are correspondingly kept at a lower level.

In addition, if the corporation is unwilling to pay dividends or increase dividends either because of the taxes of the main shareholders or otherwise,

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[13] Helvering v. National Grocery Co., 304 U.S. 232 (1938).

[14] Helvering v. Chicago Stock Yards Co., 318 U.S. 693 (1943).

[15] Hall, op. cit., p. 113.

it would appear more likely that the officers might approve a capital expenditure even though it earned an inadequate rate of return, simply because it drained the available funds. They might further be forced to choose an unattractive investment simply because it was in their present line of business and investments outside the company's line of business, even though indicating a better rate of return, would not necessarily qualify as a "reasonable accumulation." The courts have in many cases refused to accept as a justifiable accumulation funds that were used to expand into new lines of business, while an expansion of the present line of business is acceptable. This will be discussed fully in a later section.

In fact, as the situation now exists, "the primary consideration in determining the course of conduct is the effect upon tax liabilities. Officers, accountants, attorneys, experts devote their days to tax computations 'if we do' and tax computations 'if we don't.' And heavy, heavy hangs over the head of him who fails to be governed by tax consequences. Sound business policy can be given little or no consideration."[16]

The contradiction existing in the accumulated earnings tax is apparent:

> . . . The government has been an ardent crusader for the establishment of the principle that tax considerations should not be the sole and motivating force for the adoption of a particular course of business conduct.
>
> Yet now we find the government advocating and enacting a tax which has for its avowed purpose, the adoption of a course of business conduct--i.e., the distribution of corporate earnings--in order to avoid the imposition of the tax.[17]

An almost ever-present problem of small corporations is that of financing. The mortality rate among new businesses is high. The risk is increased as the

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[16] Ellsworth C. Alvord, "The Taxation of Undistributed Profits from the Business Point of View," How Shall Business Be Taxed (New York: Tax Policy League, Inc., 1937), p. 102.

[17] Ibid.

small business is forced to extend debt financing. The inability of the small corporation to obtain outside equity capital or the unwillingness of its owners to dilute their equity forces a dependence on retained earnings. By limiting the expansion possible through retained earnings, the growth potential of the small corporation is stunted. J. Keith Butters and John Lintner summarized the experience of companies seeking outside capital in their book, Effect of Federal Taxes on Growing Enterprises, saying:

> In so far as the experience of companies seeking outside capital is concerned, it appears:
>
> (a) That a substantial demand for capital on the part of small companies has gone unfilled;
>
> (b) That small companies are at a severe competitive disadvantage in comparison with large companies in raising outside capital;
>
> (c) That the disadvantage confronting small firms is in large part the result of circumstances that cannot be altered, such as the greater risks confronting small companies;
>
> (d) That the disadvantage confronting small firms is much greater in times of business depression and market pessimism than when general business activity is at a high level and investors are optimistic; and
>
> (d) That in contrast to small firms, large corporations have been able to raise new capital on relatively favorable terms at least since the late 1930's.[18]

It is, thus, well recognized that the small or medium sized corporation faces problems in financing new ventures not common to larger corporations.

> The corporation of small or medium size is least able to meet the problems of obtaining additional capital from outside sources. Therefore, these corporations have, either from sound fiscal policy or economic necessity, turned increasingly to retained earnings as a source of capital.[19]

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[18] J. Keith Butters and John Lintner, Effect of Federal Taxes on Growing Enterprises (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1945), pp. 89-90.

[19] Andrew Kopperud and J. Bruce Donaldson, "Burden of Proof in Accumulated Surplus Cases," Taxes--The Tax Magazine, XXXV (November, 1957), 827.

The situation of the small corporation regarding the acquisition of outside capital was recognized by the government:

> In almost every hearing on the problems of small business, the major topic has been the difficulty of obtaining capital. During the late thirties, the Reconstruction Finance Corporation and the Federal Reserve Banks were authorized to make so-called intermediary loans to business for covering capital needs. All corporations find it much simpler and cheaper to expand by the use of reinvested earnings than by the issuance of new securities.[20]

Economists sometimes justify the accumulated earnings tax on the basis that if corporate and/or personal savings exceed business investment, a recessionary force is created. The need for income tax revenue and equity considerations are also underlying supports of the accumulated earnings tax. This does not, however, justify why investment in new fields of business is usually viewed as an unreasonable accumulation. One expert in the tax field questioned the soundness of the economic thought behind this tax law saying:

> At least as far back as the time of Adam Smith, it was sound economic thinking to believe that capital automatically flowed to those areas where it could be most profitably employed. But in 1776 there was no man-made law which said that retained earnings (which already have been taxed once) could not be transferred into a more profitable field, except at the peril of a tax upon this retention.[21]

Although most public corporations can properly be viewed as not adjusting their dividend declarations to the personal benefit of a few stockholders, it is unclear why corporate saving or accumulations of funds at a larger level is any less harmful to the economy than those by the smaller corporation. Yet, as a practical matter, the public corporation with fairly widespread ownership is safe from the tax.

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[20]Harold M. Groves, Postwar Taxation and Economic Progress (New York: McGraw-Hill Book Company, Inc., 1946), p. 48.

[21]Holzman, op. cit., p. 143.

It might also be questioned whether or not retained earnings and to a certain extent accumulations of funds are inherently bad. Businesses are not guaranteed a profit and a margin of safety might prove to exemplify sound planning.

During the depression years, the accumulated earnings of businesses enabled them to continue dividend payments to their stockholders. Had these corporations been unable to continue dividend payments to their investors, the economic situation would have been worsened. Secretary of Labor, Frances Perkins, wrote:

> Analysis reveals that the plans used protect investment against unemployment . . . Dividends not earned during the year of 1931 were distributed during that year. No one has ever thought that such continuity of dividend payment was a dole . . . In 1930, corporation earnings fell from 25 to 30 per cent, a large part of the equipment of corporations was idle, and there was unemployment of plants and workers, but investors were very largely paid out of the reserves that had been built up in the past. Nobody suggests that such foresight undermines the initiative and responsibility of the investor.[22]

While corporations necessarily need cash to pay dividends, most states also limit dividends to retained earnings. Permitting corporations to accumulate retained earnings against possible adverse economic conditions, could conceivably prove farsighted and usually necessary for a sound, well-balanced capital structure.

From this basis, it is possible to question the long run effects of a law which makes it difficult for a small corporation to accumulate earnings.

> This construction does not permit the small corporation to accumulate funds for future expansion, for diversification, or even for replacement, unless it can be established that such plans were definite in the taxable year. This places such corporations at a disadvantage with publicly owned corporations, is unsound as a matter of good corporate

[22]Frances Perkins, People at Work (New York: John Day Co., 1934), p. 262.

> management, and certainly was not intended by Congress. The executive and judicial branches seem to assume that profits are bound to continue over future years and in an amount required to meet all needs. Businessmen have no such assurance.[23]

Even if a corporation has no need for profits accumulated in a particular year for immediate investment, the corporation must depend on profits earned in subsequent years—which are uncertain in fact and in amount—to provide for any unplanned expansion or the uncertain outside capital market.

It is conceivable that a corporation might be vulnerable to the tax, and the officers of the corporation inadvertently unaware of the fact. This situation could result from the fact that accumulated earnings for tax purposes may exceed book earnings.

> Part of the tax earnings may have been transferred to a capital account in connection with a stock dividend. Earnings inherited in a reorganization or liquidation transaction may not show up in the book earnings of the surviving corporation. Conservative accounting procedures may have resulted in charging off, for book purposes, certain items which are not deductible for tax purposes.[24]

An example of this would be purchased good will. A corporation, whose officers are unaware of these possibilities, might find itself suddenly and unexpectedly liable for the Sec. 531 penalty tax.

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[23] "How Agents are Attacking Section 531 Cases: Reports by Practitioners from 14 Districts," in the symposium "The 531 Penalty Tax on Accumulated Earnings: How to Avoid It. A Symposium on One of the Most Oppressive Tax Problems Facing Corporations Today," <u>Journal of Taxation</u>, XX (March, 1964), 143.

[24] C. Rudolf Peterson and George W. Beatty, "Preventive Action to Avoid 531 Penalty: Recognition of Problem, Possible Remedies," <u>Journal of Taxation</u>, XX (March, 1964), 134.

EFFECTS ON THE GOVERNMENT

The accumulated earnings tax has several favorable revenue effects for the government. It provides (1) an increase in personal income taxes from increases in dividend distributions, (2) an increase from the accumulated earnings tax itself, (3) the additional dividends decrease the amount to be realized through the lower capital gains rate, and (4) a savings of interest to the government is effected by obtaining the revenue now instead of at a later date.[25]

The accumulated earnings tax has increased in importance in recent years for several reasons: The continued economic prosperity has loaded up the balance sheets of closely held corporations with liquid surplus earnings; government victories regarding this tax have been encouraging in the Tax Court;[26] and Sec. 531 enforcement has been viewed as having "an especially high revenue potential per dollar of audit expenditure as Section 531 deficiency assessments are individually relatively large . . . and . . . such enforcement activity tends to be stimulative of large dividend distributions by close corporations. . ."[27] For the individual assessing agent, the 531 penalty may be more personally satisfying to assess because it involves a separate tax rather than a mere transfer of income or expense from one tax year to the next.[28]

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[25] Carl Shoup, "The Taxation of Undistributed Profits from the Theoretical Point of View," How Shall Business Be Taxed (New York: Tax Policy League, Inc., 1937), pp. 125-127.

[26] "How Agents are Attacking Section 531 Cases: Reports by Practitioners from 14 Districts," op. cit., p. 143.

[27] James K. Hall, "The Accumulated Earnings Tax," Taxes--The Tax Magazine, XXXVIII (November, 1960), 850-851.

[28] "How Agents are Attacking Section 531 Cases: Reports by Practitioners from 14 Districts," op. cit.

THE DERIVATION OF THE PRESENT LAW

Present law stems from Section 102 of the 1939 Internal Revenue Code. The provisions relating to corporations improperly accumulating surplus are consolidated under Subchapter G in the 1954 Code. Under the 1954 Code, the tax rates remain the same as they were under the 1939 Code, 27½% on the first $100,000 of "accumulated taxable income" and 38½% on amounts exceeding $100,000. A corporation is liable for the tax under Sec. 531 when it is formed or availed of to prevent the imposition of the income tax on its shareholders.[29]

> Technically and theoretically at least, a corporation can be subject to the accumulated earnings tax even though its earnings have not been unreasonably accumulated. But this has now become solely a theoretical situation although it is still mentioned in the cases from time to time . . . Conversely, if excess earnings have been accumulated, the corporation still may not be subject to the tax if it can be shown nevertheless that the purpose of this accumulation was not a purpose to avoid the income tax on the shareholders.[30]

The 1954 Code is differentiated from the 1939 Code by some important changes. These include:

(1) Under specified circumstances, the burden of proof is shifted to the Secretary of the Treasury or to his delegate.

(2) The "immediacy test" has been eliminated from the requirements of earned surplus retained for business needs.

(3) An accumulated earnings credit is now allowed.

(4) Provisions for the computation of the tax are simplified.

(5) Dividends paid by the 15th day of the third month following the close of the tax year are considered paid on the last day of the preceding tax year.

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[29]This does not include a personal holding company or a foreign personal holding company.

[30]"Technical Analysis," New York University 23rd Annual Institute on Federal Taxation (New York: Matthew Bender and Co., 1965), pp. 746-747.

The changes in the Code were brought about by Congress in an attempt to correct some of the inequities of the 1939 Code and to provide some measure of protection for the small taxpayer. The new tax was to apply only to that portion of earnings unreasonably accumulated; the reasonably anticipated needs of the business were to be included in consideration of what constituted the reasonable needs of the business, thus eliminating the "immediacy test." In order to minimize litigation expense, the taxpayer was provided with a means of shifting the burden of proof. However, as will be discussed later, the tax, as it is administered, is still distasteful to businessmen. Some problems of the 1939 Code were mitigated and some were not. In fact, some of the intended reliefs were transformed into problems!

Among the reasons for the revision in the accumulated earnings tax annotated by the Senate Committee were:

> The poor record of the Government in the litigated 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 proving that the accumulation was for the reasonable needs of the business. Moreover, the complaints of taxpayers that the tax is used as a threat by revenue agents to induce settlement on other issues appear to have a connection with the burden of proof which the taxpayer is required to assume. It also appears probable that many small taxpayers may have yielded to a proposed deficiency because of the expense and difficulty of litigating their case under the present rules.[31]

The Senate Finance Committee speaks of the small taxpayers because, as indicated previously, the burden of the tax falls on the relatively small closed corporation. However, publicly held corporations[32] were purposely included.

[31] U. S., Congress, Senate, 83rd Cong., 2nd Sess., 1954, Rept. 1622, p. 70.

[32] A publicly held corporation is one which has more than 1500 stockholders and no more than 10 percent of the stock is held by any individual or members of his family.

Under the provision of the bill submitted by the Ways and Means Committee of the House, a publicly held corporation is specifically exempted. The fact that this section of the House version was eliminated by the Senate Finance Committee is remindful that public corporations can be potentially liable for the Sec. 531 tax.[33]

Trico Products Corporation is the only publicly held corporation subjected to the tax to date. Although there were approximately 2,200 shareholders, a small group held 75% of the stock. In a series of suits Trico Products was assessed $7,922,042.72 plus interest for a period of twelve years. Minority stockholders instituted a derivative suit against the directors. In a settlement the directors personally agreed to pay the corporation $2,390,000.[34] The possibility of personal liability for an error causing loss to the corporation has magnified the importance of the accumulated surplus tax to corporate directors. Trico Products Corporation was admittedly in an unusual situation, but this series of cases emphasizes emphatically that publicly held corporations are not necessarily exempt.

"Although there has thus far been only one litigated case involving a publicly held corporation, it is no secret to the initiated that Sec. 531 questions have been raised by examining Agents in connection with the audits of a number of such companies."[35] The possibility of government abuse of the tax is still present as indicated by a tax practitioner who wrote:

> The feeling among tax men is that the attitude of Agents, in general, is moderately equitable, but a problem arises with the exceptional and unreasonable Agent . . . or (one) who is looking for an issue on which to 'horse trade.' This may be

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[33]Senate Rept. 1622, op. cit., p. 69.

[34]Report of Referee Edward Weinfeld in Kohler et al. v. Cishei et al., Supreme Court, New York County, Index No. 28485-1947.

[35]Peterson, op. cit., p. 134.

> inconsistent with the so-called 'quality' audits ordered by the Commissioner, but the experience of a few tax men indicates realistic existence of this situation among some agents.[36]

The 1954 Code alleviated part of the problems noted by the Senate Finance Committee, but it quite obviously did not eliminate all of them.

The 1954 Code did solve some of the inequities of the 1939 Code. The statute provided expressly that the reasonable needs of the business included the "reasonably anticipated" needs of the business. This successfully eliminated the "immediacy test" the courts had invented in their interpretation of the 1939 Code. Under this test, "some courts felt that inasmuch as the plan could not be consummated for a number of years, there was no reason for retention in the taxable year; there was still plenty of time to accumulate earnings before the expenditure could be made."[37] The relevancy of time is not eliminated completely, but it is superseded in importance by the certainty and the conclusiveness of the corporation's plans.

Corporations, which decided the amount of the dividends they wished to pay after the determination of the final net income for the year, or corporations whose income was significantly affected by the business of the last month of the year, were greatly assisted by the new provision extending the dividend payment period 2½ months.

The 1954 Code set a minimum of $60,000 that must be accumulated before the corporation was liable for the tax--whether the earnings accumulated were

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[36]"How Agents are Attacking Section 531 Cases: Reports by Practitioners from 14 Districts," op. cit., p. 146.

[37]Holzman, op. cit., p. 12.

unreasonable or not. During 1958, the minimum credit was raised to its present level of $100,000.

The accumulated earnings credit was aimed to eliminate the inequity caused a corporation when, under Sec. 102, the accumulated earnings tax was applied on all accumulated income, although only a portion of it was unreasonably accumulated. Under the 1954 Code the tax is automatically limited to the amount unreasonably accumulated. This naturally leads to the question of what is a reasonable accumulation, and this part of the law is still not precise. The facts in each case vary, but there are some general guides both from the Regulations and case history. Some relevant cases and the Regulations concerning this matter will be discussed in a later section.

Under the 1939 Code, a corporation had to disprove the Commissioner's contention that the corporation was improperly accumulating surplus. Under the present law, this is not necessarily so. If the corporation pays the deficiency and sues for recovery, it still must sustain the burden of proof. If the proceedings are brought before the Tax Court, however, the taxpayer corporation may be able to shift the burden of proof to the government. The burden of proof rests with the government if (a) the taxpayer failed to receive a 90 day proposed deficiency notice concerning the accumulated earnings tax, or (b) the taxpayer returned the statement within thirty days with grounds supported by facts justifying the accumulation of earnings. If the taxpayer corporation does not support its grounds with sufficient facts or if it does not submit a statement, the burden of proof still rests with the taxpayer.

The Senate Committee changed the section concerning the magnitude of facts required in the taxpayer's statement from the form submitted by the House:

"Facts sufficient to apprise the Secretary or his delegate of the basis thereof" to the supposedly less rigid "facts sufficient to show the basis thereof."[38] Not surprisingly, this passage in the bill is still nebulous and open to question.

The Regulations contain guides as to what will be considered reasonable and unreasonable accumulations. Reg. 1.537-2 (b) cites the following as examples of reasonable accumulations: (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 business; (4) To provide necessary working capital; (5) To provide for investments or loans to suppliers or customers if necessary in order to maintain the business of the taxpayer corporation. No "rules of thumb" have proved more than a very general and vague guide. It appeared at one time as if the amount of cash necessary to meet one year's operating expenses might become an acceptable guide developed from the Goodman Furniture case, but subsequent cases have disproved this.

Under the J. L. Goodman Furniture Co. case,[39] the court permitted the retention of cash to cover one year's operating expenses saying, "The evidence shows a large amount of cash was necessary in order to operate the business . . . There was a reasonable necessity for sufficient capital to meet operating expenses for at least one year." In a footnote to the F. E. Watkins Motor Co. case,[40] the Tax Court strengthened this position by referring to the Goodman case saying: "This court has consistently held that the accumulation of funds to meet operation expenses for at least 1 year is reasonable."

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[38] Senate Rept. 1622, op. cit., p. 71.

[39] J. L. Goodman Furniture Co., 11 TC 530 (1948).

[40] F. E. Watkins Motor Co., 31 TC 288 (1959).

The fact that this "rule of thumb" is not impregnable is illustrated by the Dixie, Inc. case.[41] In this case the court emphasized that the type of business and the particular situation of the taxpayer at the time would have greater importance. It said, "The rule of thumb so stated may be one proper for administrative convenience but should rise to no higher level. The search must always be concerned with the needs of the particular business as they existed during the particular year." It is under this, perhaps more logical, point of view the court now operates. From the taxpayer's point of view, it is less desirable because it is less definite, but it appears unlikely to change.

Reg. 1.537-2 (c) provides examples of what will be considered by the Commissioner as unreasonable accumulations: (1) Loans to shareholders or expenditures of corporate funds for the benefit of the shareholders; (2) Loans to shareholders' friends or relatives or other persons having no reasonable relation to the business; (3) Loans to another corporation, the business of which is not that of the taxpayer corporation, if the capital stock of the other corporation is owned directly or indirectly by the shareholders of the taxpayer corporation and they are in control of both corporations; (4) Investments in property or securities not related to the business activities of the corporation; (5) The retention of earnings and profits to provide against unrealistic or generalized hazards.

The Senate Committee further provided that:

> Reasonably anticipated needs of a business must be considered. 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

[41]Dixie, Inc., 277 F2d 526 (1960), aff'd 31 TC 415.

accumulation. In any case where there exists a definite plan for the investment of earnings and profits, such corporation need not necessarily consummate these plans in a relatively short period after the close of the taxable year.[42]

An important change in the 1954 Code concerns the interpretation given the acquisition of other business enterprises through retained earnings. The Senate Committee reported:

> Under existing interpretations, retained earnings may be invested in a business enterprise operated directly by the taxpayer, but doubt exists as to the operation of such a business through a subsidiary corporation controlled by the taxpayer. Your committee again agrees with the House that where the taxpayer has 80 percent or more of the voting stock of another corporation, the taxpayer should be viewed as though it engaged directly in the business of such other corporation. If the taxpayer's ownership of stock is less than 80 percent in the other corporation, a factual determination should be made as to whether the funds are employed in a business operated by the taxpayer. However, the operation, through stock ownership of a personal holding company, an investment company, or a corporation not engaged in the active conduct of a trade or business, should not provide a basis for the exclusion of the funds from possible application of the accumulated earnings tax.[43]

COMPUTATION OF THE TAX

In the computation of the tax under Sec. 531 of the 1954 Code, taxable income is similar to "undistributed Sec. 102 net income" under the 1939 Code. The taxable income is adjusted as follows:

(1) The net operating loss deduction is added back;

(2) The capital loss carryover is added back;

(3) The deduction for dividends received is added back;

(4) The excess of the charitable deduction allowed on the return over the amount actually paid during the year is added back;

[42] Senate Rept. 1622, op. cit., pp. 317-318.

[43] Ibid.

(5) The excess of charitable contributions actually paid during the tax year over the charitable contributions allowed is subtracted.

(6) Federal income tax is subtracted;

(7) Income, war-profits and excess-profits taxes of a foreign country or U. S. possession included in the foreign tax credit are subtracted.

(8) A disallowed net capital loss is subtracted.

(9) The excess of net long-term capital gains over net short-term capital lossec (figured without regard to the carryover) reduced by the taxes attributable to the excess is subtracted.

Under the 1939 Code, a corporation could not take income and similar taxes of foreign countries and of U. S. possessions as credits against its federal income tax, and use them in computing its Section 102 tax. If it used them as a credit against its federal income taxes, it could use them neither as a deduction nor as a credit in the computation of its Section 102 tax. After the computation of adjusted taxable income by way of the above adjustments to taxable income, the dividends paid deduction and the accumulated earnings credit are computed.

A new provision concerning the dividends paid deduction in the 1954 Code requires dividends paid after the close of a tax year but on or before the 15th day of the third month of the following year to be included in the dividends paid figure.[44] Thus, dividends paid during the tax year, dividends paid within 2½ months after the close of the tax year, and consent dividends[45] are deducted for adjusted taxable income.

The accumulated earnings credit was designed as a relief feature so that the tax on accumulated earnings would apply only to the amount unreasonably

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[44]Naturally, the dividends in this two and one half month period are not deductible the following year.

[45]In a consent dividend, the transfer of cash from the corporation to the shareholder does not take place. The shareholder agrees to be taxed as if he had received the dividend and immediately reinvested it in the business.

accumulated. Previously under Sec. 102 of the 1939 Code, although only part of the earnings were unreasonably accumulated, the tax was based on all of the year's retained income.

Also, under Sec. 102 (c) of the 1939 Code, if the taxpayer accumulated reasonable earnings in the business—and the needs of the business and the desire to avoid personal income taxes were co-determinative—then the taxpayer was still liable for the tax, providing this could be proven. Under Sec. 531, the accumulated earnings credit protects the earnings required by the business, and thus in the instance cited, the taxpayer would owe no penalty tax.

The credit is figured as the greater of (1) The earnings and profits of the tax year retained for the reasonable needs of the business, less: (the excess of the net long-term capital gain over the net short-term capital loss computed without any capital loss carryover) minus (the capital gains tax), or (2) $100,000 less (accumulated earnings and profits at the end of the preceding tax year reduced by dividends paid during the first 2½ months of the tax year).

The dividends paid deduction and the accumulated earnings credit are subtracted from adjusted taxable income leaving the accumulated income. This is the figure to which the tax rates are applied.

PROBLEMS IN THE 1954 CODE

The aims of Congress, to eliminate certain inequities and to provide relief in other areas, have been in some cases thwarted. In this writer's opinion, one of the major inequities under the 1954 Code concerns the interpretation given Sec. 534 by the Tax Court. This provision of the Code concerns the shifting of the burden of proof from the taxpayer to the Commissioner. This provision is unique in tax law, as in all other areas, the burden of proof is on the taxpayer. The legislative intent is expressed in the committee reports, as previously cited. In addition, the Congress passed a law[46] making the burden of proof rule applicable to all Tax Court cases arising under Sec. 102 which are tried on the merits after August 11, 1955, as well as to cases arising under Sec. 531.

As the situation exists,

> The taxpayer, in effect, may be in a worse position under the accumulated earnings tax than under Section 102 of the 1939 Code, as he not only must carry the burden of proof, apparently, but, in addition to the extent that he avails himself of Sec. 534, must disclose to his adversary in advance the grounds on which he proposes to justify the earnings accumulation with respect to the reasonable needs of the business. Taxpayers consequently find themselves impaled on the horns of a dilemma--whether or not to comply with the requirements of Section 534, and whether the apparent advantage to the taxpayer as found therein represents in fact a real disadvantage.[47]

How has this situation come about which is contrary to legislative intent? The Commissioner's approach has been that the taxpayer is still subject to the ultimate burden of proof, despite Section 534. Substantial support has been forthcoming from the Tax Court on this position.

> It appears that the Service realizes that to accept the burden of proof . . . is to underwrite a most difficult, if not impossible, task in its efforts to enforce the statute. Statute enforceability appears to depend largely on the extent to which taxpayers are compelled . . . to carry the burden of proof.[48]

The Tax Court in many cases refuses to rule in advance as to who has to carry the burden of proof. Although the overwhelming majority of statements filed under Section 102 and Section 531, to which Section 534 is applicable, have set forth facts well beyond that required by the statute, the Commissioner has consistently denied the sufficiency of the grounds and the adequacy of the facts set forth in the taxpayer's Section 534 statements.[49]

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[46] Pub. L. 367, 84th Cong., 1st Sess., Sec. 4.

[47] James K. Hall, "The Accumulated Earnings Tax," Taxes--The Tax Magazine, XXXVIII (November, 1960), 855.

[48] Ibid., p. 852.

[49] Richard B. Barker, "Penalty Tax on Corporations Improperly Accumulating Surplus," Taxes--The Tax Magazine, XXXV (December, 1957), 940-951.

> This denial naturally raises the question of who should determine whether the burden of proof has been shifted. The Commissioner by his answer, denying the sufficiency of the statement but in the alternative pleading affirmatively on the issue of reasonable accumulation for business needs, has left the determination to the Tax Court.[50]

The effect of the actions of the Tax Court is to

> . . . make everything depend on the so-called 'ultimate issue,' viz., the prohibited purpose of avoiding shareholder dividend taxation. By this simple expedient and by thereby minimizing the question of whether accumulations were reasonable, the Tax Court virtually nullified any advantages which should accrue to the taxpayer from being able to shift the burden of proof on such questions to the Commissioner.[51]

Three major reasons have been submitted as to why the Tax Court has failed to rule on motions of who bears the burden of proof before a trial. These reasons are presented with comments as follows:[52]

(1) The judge presiding at the hearing may not preside at the trial. (However, it is not uncommon for the Tax Court to bind the trial judge as to the issues involved and/or the facts contested by an interlocutory order.)

(2) The 534 (c) statement may be a sham. (The Commissioner has more than adequate means of ascertaining if a statement is a sham. The statement is sworn to by a corporate officer and in absence of any claim by the government, it seems unwarranted for the Tax Court to refuse to rule.)

(3) The Tax Court has contended that in order for it to rule on burden of proof it must decide if the facts and grounds presented in the statement are sufficient to justify the accumulation, and that is the issue to be resolved at trial. (Section 534 provides that the government must bear the burden of proof when the taxpayer files a statement of grounds "sufficient to show the basis thereof." The burden of proof decision does not, and was not intended to, eliminate the necessity of the trial.)

The Tax Court by refusing to rule in advance in many cases is in a "seemingly unsupportable position, and one which as a practical matter, is enormously unfair

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[50] Ibid., p. 951.

[51] David Altman, "Recent Litigation Shows 531 Cases Can Be Won Despite Growing Pressure by the I.R.S.," Journal of Taxation, XX (March, 1964), 130.

[52] Barker, op. cit., p. 952.

to the taxpayer . . . the taxpayer is deprived of the benefit of the burden shift in its preparation for trial."[53] This practice has an adverse effect on administrative and pre-trial settlements as well as on the taxpayer's litigating position at the trial itself.

Also to be considered is the fact that legal expenses will not be lessened in many cases, as Congress intended, by the Government bearing the burden of proof. As the law is presently interpreted, the taxpayer's counsel must prepare to carry the burden of proof. When the decision that the Commissioner bears the burden of proof is postponed until the case is decided on its merits or probably when the decision is not made until just before the trial, the extensiveness of preparation by the counsel is not decreased. Therefore, any possibility of decreased legal expenses is virtually nil.

One writer in commenting on the reason for the Tax Court's behavior says:

> The judges hearing pretrial motions have candidly admitted that the statute (534) is novel to them and that they are not sure of its meaning. I fear that the Tax Court intends to circumvent the intent of Section 534 by postponing a decision upon the issue of burden of proof in each case until a final decision on the merits of such case.[54]

Another writer noted in a footnote that:

> In all of the Tax Court cases holding that the burden of proof has shifted to the Commissioner, not one case has held that he has failed to sustain such burden without also stating that the taxpayer has affirmatively proved its case—showing how meaningless the shifting of the burden question has become.[55]

Examples of this can be illustrated by the Pelton Steel Casting Co. case [56] in which the Court said:

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[53]Altman, op. cit., p. 131.

[54]Barker, op. cit., p. 952.

[55]Altman, op. cit., p. 131.

[56]Pelton Steel Casting Co., 251 F.2d 278 (1958), aff'd 28 TC 153.

The legislative history of . . . (the accumulated earnings tax) clearly expresses the intent of Congress to place the ultimate burden of proof on taxpayers. There is no expression of intent in the applicable 1954 Code sections or in the legislative history to alter or reverse the existing law relative to burden of proof except with respect to accumulation of profits beyond the reasonable needs of the corporation.

This case emphasized that in the opinion of the Tax Court corporate liability depended upon the presence or absence of interdicted purpose, and that the burden of proof is on the taxpayer except with respect to whether the retained earnings exceed the reasonable needs of the business.

The Court sidesteps the issue in the Kerr-Cochran, Inc. case.[57] The taxpayer listed nine grounds for accumulation of earnings and no facts were given to support one of these grounds. Even in the judgment the Court did not rule on the sufficiency of the facts supporting the remaining eight grounds saying, "It is unnecessary for us to decide, since, assuming that the burden of proof has been shifted to the respondent, he has successfully met this burden."

The burden of proof issue is an important one because at trial, if each party rests without producing proof, the party having the ultimate evidentiary burden fails. Assuming the corporation has the burden of proof, it must initially proceed or fail. By attempting to take advantage of this "relief" portion of the statute, the corporation could conceivably be in a worse position than if it had not. This would be the effect of revealing all the facts it based its case on to its opponent before the trial, and still having to carry the burden of proof.

Legislative intent is clear in the House Report which stated:

The Senate amendment provided that the shift in the burden of proof under section 534 from the taxpayer to the Government applied not only in determining whether the earnings and profits

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[57] Kerr-Cochran, Inc., 30 TC 69, dismissed (January 21, 1960).

of the corporation have been permitted to accumulate beyond the reasonable needs of the business, but also in determining the extent to which the earnings and profits of a corporation have accumulated during the tax year beyond the reasonable needs of the business.[58]

Relatively recently, the Court of Appeals has rebuffed the Tax Court and thus forced it to pay more than lip service to Section 534.

WHAT CONSTITUTES A REASONABLE ACCUMULATION

Another section of the Code which is difficult to comprehend is what will be considered a reasonable accumulation. There is no objective standard to apply to the corporation's proposed accumulations, and if their reasons are found insufficient, it is too late to correct the situation, as the tax year will be long past. Under the 1939 Code, the penalty could be possibly anticipated by applying Treasury Decision 4914 issued in 1939, by which revenue personnel determined whether Section 102 was applicable. Any of the five conditions would indicate unreasonable accumulation of earnings by a corporation.

(1) Corporations which have not distributed at least 70 percent of their earnings as taxable dividends.

(2) Corporations which have invested earnings in securities or other properties unrelated to their normal business activities.

(3) Corporations which have advanced sums to officers or shareholders in the form of loans out of undistributed profits or surplus from which taxable dividends might have been declared.

(4) Corporations, a majority of whose stock is held by a family group or other small group of individuals, or by a trust or trusts for the benefit of such groups.

(5) Corporations, the distributions of which, while exceeding 70 percent of their earnings, appear to be inadequate when considered in connection with the nature of the business or

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[58] U. S., Congress, House, 83rd Cong., 2nd Sess., 1954, Rept. 2543, p. 49.

> the financial position of the corporation or corporations with accumulations of cash or other quick assets which appear to be beyond the reasonable needs of the business.

The Senate Finance Committee objected to this practice saying, "Some of the standards informally employed in the past, such as distribution of 70 percent of earnings have been erroneous or irrelevant."[59] This criticism was warranted because certainly 70 percent was no magical percentage; some corporations could not afford to distribute any of their earnings, and a rigid standard fails to take this into account.

Criticism has been leveled at the Courts and the Commissioner for substituting their own judgment for that of the businessman in what justifies an accumulation of earnings.

> There has also been a tendency by the Courts in a number of cases to substitute judicial judgment for the business judgment of the corporate directors and officers. For example, there is judicial authority to the effect that in determining the reasonable needs of the business, the Court may take into account the . . . credit resources which would enable it (the corporation) to make certain acquisitions. Thus Nemours Corp. 38 TC 585 (1962) aff'd CA-3 12/26/63, held that since the taxpayer corporation had followed a course of financing its previous oil and gas property acquisitions, it was not necessary to accumulate earnings for future acquisitions of such properties.[60]

When another corporation advanced the justification that earnings were retained against the hazardous nature of the business, the court said in regard to this specific reason, "We are not impressed . . . After all, Defiance had survived whatever business hazards there were for a good many years . . ."[61] In another case when the corporation wanted to hold funds of subsidiaries to conceal the funds from creditors and landlords, the Court said, "Even if it

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[59] Senate Report No. 1622, op. cit., p. 69.

[60] Altman, op. cit., p. 131.

[61] Defiance Lumber Co. TC Memo Docket #34067, July 8, 1953.

were admitted that there was a positive plan to convey in fraud of certain creditors, purpose to evade surtax would not follow."[62]

In a recent case involving Ted Bates & Co.,[63] an advertising agency, although Bates took the proper steps, Tax Court Judge William M. Fay reserved decision on who had the burden of proof. The question at hand was how large the working capital of the company should be, and whether or not their plans for foreign operations were definite. It is quite obviously difficult for a company to prove the amount of working capital necessary in their business when the circumstances of any company are individualistic and not completely comparable with even another company in the same industry. A business publication leveled this criticism: "The only real asset a service company has--besides cash in the bank--is brainpower. Now, in a very broad sense, the Internal Revenue Service is telling brainpower companies that the cash isn't necessary."[64] In a company such as this prominent advertising agency, or for that matter any service company, wealth does not lie in their inventory and fixed assets, but rather in the quality of their personnel. In the case of a firm in this situation, their liquid reserves are their only protection against business adversities.

Reg. Sec. 1.537-1 (a) "apparently results from Congressional criticism leveled at the Service that, in absence of adequate guidance, revenue agents in examining cases had applied their individual concepts as to business needs."[65]

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[62]Delaware Terminal Corp., 40 BTA 1180 (1939).

[63]T. Bates & Co., 24 TCM 1346 (1965).

[64]"Does Brainpower Require Capital," Business Week (December 12, 1964), p. 83.

[65]Edward N. Delaney, "What is 'Accumulation Beyond Reasonable Needs' of the Business," Taxes--The Tax Magazine, XXXIX (May, 1961), 408.

This regulation is at least a small measure of protection for the corporation. It states:

> An accumulation of the earnings and profits (including the undistributed earnings and profits of prior years) is in excess of the reasonable needs of the business if it exceeds the amount that a prudent businessman would consider appropriate for the present business purposes and for the reasonably anticipated future needs of the business.

There is, of course, always the question of what the nonexistent "prudent businessman" would do if he were in the taxpayer's circumstances since he isn't available to be questioned.

The absence of loans to stockholders or directors is an important factor considered by the courts in determining whether or not a company can afford to distribute dividends. The court reasons that if a corporation can afford to make loans to its stockholders (and be deprived of the funds) it can afford to distribute the funds in dividends. Also, if the stockholders utilize the funds as a loan, they are not paying income tax on them. The presence of stockholder loans is almost considered prima facie evidence of a purpose to avoid income tax by the stockholders. In the case of Cecil B. DeMille,[66] the absence of stockholder loans was referred to by the Courts in its decision for the taxpayer. In the companion case of William C. DeMille Productions, Inc.[67] where there were loans to stockholders, the penalty tax was sustained.

The Courts did not look upon stockholder loans adversely in the case of California Motor Transport Co., Ltd.[68] because the stockholder used the funds to acquire assets for the corporation which, because of state regulations, it could not acquire for itself immediately.

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[66] Cecil B. DeMille, 90 F.2d 12 (1937), aff'd 31 BTA 1161.

[67] William C. DeMille Productions, Inc., 30 BTA 826 (1934).

[68] California Motor Transport Co., Ltd., 1 TCM 974 (1943).

In the case, Wean Engineering Co.[69] the Court held that there is no objection to expanding through retained earnings instead of debt or increased capitalization. However, the ploughing back must be into the corporate enterprise and not other fields.[70] In Gazette Publishing Co. v. Self[71] it was held: "This court knows of no line of authorities which requires this corporation, or any other taxpayer to do its financing in any particular way, so long as the way it selects is a legitimate way, and has no ulterior motivation, nor improper purpose in making the selection." This court's logical reasoning appears completely contradictory to that in the previously mentioned Nemours Corp. case. In the Nemours case, the court held that it was unnecessary for the taxpayer corporation to accumulate earnings for acquisitions since prior acquisitions had been financed through credit resources.

There is somewhat of a contradiction in the regulations concerning the reasonableness of accumulation. Only one of these regulations is favorable in interpretation for the taxpayer:

> Sec. 1.537-3 (a) states: 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.
>
> Sec. 1.537-2 (4) states: Investments in properties or securities which are unrelated to the activities of the business of the taxpayer corporation, represents an example of an unreasonable accumulation.

The courts have generally followed the reasoning behind the unfavorable regulation. In the Raymond I. Smith, Inc. case[72] when the favorable regulation was cited, the taxpayer lost.

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[69] Wean Engineering Co., T.C. Memo Docket Nos. 107584 and 109876, July 24, 1943.

[70] Southland Industries Inc., T.C. Memo Docket No. 3387, Oct. 31, 1946.

[71] Gazette Publishing Co. v. Self, 103 F.Supp. 779 (1952).

[72] Raymond I. Smith, Inc., 292 F.2d 470 (1961), aff'd 33 TC 141.

The interpretation under the 1939 Code was:

> The regulations took the position that the business of the second corporation was to be considered the business of the first only when the second corporation was a mere instrumentality of the first; and to establish this fact to the satisfaction of the Commissioner, it was ordinarily essential that the first corporation own all or substantially all of the stock of the second.[73]

As the law is presently interpreted, a business acquired by a corporation must be an actively conducted business whether it is operated as a division of the taxpayer corporation or whether it is a controlled subsidiary corporation. The important factor is that the investment is either related to the taxpayer's present business, or else it is actively operated by the taxpayer.

This would indicate that it was possible for a corporation to expand their present operations and line of business through retained earnings or any other method of financing. Should the corporation alter their line of business through expansion, however, retained earnings represents a vulnerable method of financing.

The corporation most likely to be assessed the tax, as indicated previously, is the small, closely held company. This forces the small corporation to either seek expansion through increased debt or equity financing. As is well recognized, a firm with an unproven earnings record has difficulty obtaining outside financing.

> In the initial operating phases of an expanding company's activities, capital must ordinarily be raised on a local or sectional basis and usually by means of private placements . . . Only in unusual circumstances will the organized financial markets and institutions of the country be available until the company has proved its earning capacity by a considerable period of profitable operations and by growing to a size sufficient to support a public flotation of securities.[74]

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[73]Delaney, op. cit., p. 405.

[74]J. Keith Butters, Lawrence E. Thompson, and Lynn L. Bollinger, Effects of Taxation on Investment by Individuals (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1953), p. 6.

Thus if a corporation's owners are unwilling to dilute their equity, they are almost forced to obtain debt financing or avoid diversified expansion. The potential danger to small business was recognized by a tax practitioner who said:

> We are seeing a steady decrease in small and family controlled corporations. Sooner or later they liquidate or merge with publicly owned corporations. This is not a desirable situation and is so recognized when Congress goes through the form of providing so-called relief for small business corporations. Yet the tax laws impose--through estate taxes, Section 531, discrimination in pension and other deferred compensation plans, salary restrictions, and other provisions--difficult, if not impossible for small and family corporations to survive through the years.[75]

The accumulated earnings tax, if strictly construed and enforced, can effectively impede the growth of the small corporation. The possible inequity of the tax advantages gained through the corporate structure by its shareholders should be weighed against the costs of the destruction of the small corporation. The Congress acknowledged the importance of small business saying:

> Once the opportunity to begin small and grow big is shut off, the American system of free enterprise will have been effectively destroyed. We, as a people, will have lost our individual opportunities to become the architects of our own fortunes. We need small business, not necessarily because it is small, but because it is a symbol of opportunity.[76]

The final result of limiting the possible expansion of small corporations through their retained earnings by means of the accumulated earnings tax, may be to extirpate the small corporation. Increased debt financing increases the risk of bankruptcy and the high mortality rate among new businesses is well known. By forcing the small corporation to merge with larger corporations, in order to expand in new fields, the small corporation, nonetheless, loses its existence.

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[75]"How Agents are Attacking Section 531 Cases: Reports by Practitioners from 14 Districts," op. cit., p. 147.

[76]U. S., Congress, House, 82nd Cong., 2nd Sess., 1952, Rept. 2513, p. xv.

Two of the major underlying thoughts supporting the accumulated earnings tax are that (1) an inequity among taxpayers is created if one taxpayer may postpone payment of his personal income tax on his increase in funds by use of the corporate structure, and (2) if corporate saving as well as personal saving exceed business investment, a recessionary force is created. These views may be challenged.

According to one authority, from 1947 through 1950, accumulations of new investable funds by spending units were as follows:

> (1) That as a minimum estimate, the top 1% of all spending units with net incomes of about \$15,000 and over accounted for more than one-quarter of the annual accumulations of investable funds made by all spending units in 1948, and presumably also in the other postwar years.
>
> (2) That, again as a minimum estimate, the top 3% of all spending units with net income of \$10,000 and over accounted for more than 40% of the total.
>
> (3) That the top 5% of all spending units with net incomes of \$7500 and over accounted for more than 55% of the total.[77]

This author questions whether it is truly in the best interests of the economy to discourage investment in small corporations by the mid and upper income brackets who are the ones most likely to benefit from the use of the corporate structure. It would be interesting, if it were possible to do so, to measure the effect on entrepreneurial spirit of the accumulated earnings tax and other such taxes distasteful to the small businessman.

Also, it is the accumulation of <u>idle</u> funds that represents a recessionary force on the economy. It should be of no consequence in what fields these funds are invested as long as they are <u>actively</u> invested. Corporations could be discouraged from investing in securities in which the company did not

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[77] Butters, op. cit., p. 142.

actively participate by allowing the dividend credit only if the investment represented a majority holding in a subsidiary, or a subsidiary's holding in its parent's stock. Thus, only idle accumulated funds would be subject to the tax.

As might be expected and justified in order to prevent the taxpayer from suddenly remembering in court that the corporate officials had had plans for corporate expansion in mind or some other plans for their retained earnings in the tax year in question, the courts generally require that the taxpayer produce by the corporate minutes or other evidence that some definite and concrete steps were taken. Proof that engineers or contractors were consulted is usually viewed favorably by the courts as indicating concreteness of plans.[78] But where plans were not definite the Court said, "It is not enough that a nebulous plan may have passed through the minds of the taxpayer's officers and directors without any definite commitments."[79] In another case the Court said:

> An accumulation of earnings for the construction of new buildings may be reasonable under certain conditions, but where, as here, nothing has been agreed upon and no definite action has been taken . . . there is no justification . . . for further accumulating earnings . . .[80]

It is quite difficult to perceive in advance in many instances what will be determined to justify an accumulation of earnings in the business. "A review of the decisions shows that most often no one single factor results in an accumulation being held to be reasonable or unreasonable. Rather, it is the culmination of a series of events."[81] Not " . . . all competently presented cases

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[78] Hansen Baking Co., Inc., T.C. Memo Docket No. 35612, June 18, 1953.

[79] Smoot Sand & Gravel Corp., T.C. Memo., 1956-82, April 10, 1956.

[80] General Smelting, 4 TC 313 (1945).

[81] Delaney, op. cit., p. 408.

have been won by the taxpayers. Probably the most convincing rationale for this is that the trier of fact is not left with the conviction that the reasons advanced by the management . . . at the trial were in truth and in fact the motivating purposes of the particular retention at issue, however good the reasons may have been in a general business sense."[82] One tax expert laments that although "many of the litigated cases were flawed by such perennial accumulated earnings tax weaknesses as stockholder loans, failure to effectuate plans, or vagueness . . . these are the cases which supply the precedents."[83]

A factor which is perhaps especially irritating to the businessman is the fact the Government is able to make more effective use of hindsight than the taxpayer is. The Government does have to declare the penalty tax within the period of the statute of limitations, but this gives the revenue agent a chance to observe the uses actually made of retained earnings. Some corporations would undoubtedly be motivated to carry out their nebulous plans if they realized at the time that their delay and lack of definiteness might make them liable for the Sec. 531 penalty tax. It has been said that, "A revenue agent is often gifted with 20-20 hindsight . . ."[84] In certain cases such as the Latchis Theatres of Keene, Inc.,[85] the taxpayer has not been as effective in utilizing hindsight. In this case the Court held that evidence was insufficient to support a finding that funds accumulated in tax years ending June 30, 1948, and 1949, were retained with the intent to make expenditures in 1950 and 1951.

[82] David H. Nelson, "How to Present the 531 Case to the IRS: Developing Evidence to Convince the Agent," Journal of Taxation, XX (March, 1964), 136.

[83] Robert S. Holzman, "Expansion Plans and the Accumulated Earnings Tax," Reappraisal of Business Taxation (Princeton: Tax Institute Inc., 1962), p. 145.

[84] Holzman, The Tax on Accumulated Earnings, op. cit., p. 20.

[85] Latchis Theatres of Keene, Inc., et al., 286 F.2d 237 (1961), aff'd 18 TCM 1171.

A major development or growth of the law in the accumulated earnings tax area has been in stock redemption plans. In the Emeloid Company, Inc. case[86] the taxpayer corporation had borrowed a substantial sum to purchase single premium life insurance against the lives of its two stockholders. The corporation was to purchase the stock of its owners upon the death of either. The basic question involved was whether the indebtedness qualified for the borrowed investment capital credit (under the excess profits tax) and this turned on whether the indebtedness was incurred for business reasons. The Tax Court said:

> The benefit to the petitioner of such a transaction appears highly remote . . .
>
> Concluding, as we must from the evidence before us, that the policies here were purchased as part of a stock purchase plan for the personal interests of petitioner's two common stockholders and not for any business purpose of petitioner itself, we must approve the respondent's determination.

The Circuit Court reversed the determination of the Tax Court and gave this basis for its judgment:

> The trust was designed to implement that original purpose, and, at the same time, add a further business objective, viz., to provide for continuity of harmonious management. Harmony is the essential catalyst for achieving good management; and good management is the <u>sine qua non</u> of long term business success. Petitioner, deeming its management sound and harmonious, conceived of the trust to insure its continuation . . .
>
> . . . The <u>petitioner</u>, not the <u>survivor</u>, is to purchase the stock of the decedent. The difference between a contract of purchase on the part of the corporation and one on behalf of the surviving stockholder is more than a highly technical distinction. Significantly different legal incidents flow therefrom.

This was an important case in the stock redemption area. In another case related to this somewhat, the outcome was not so satisfactory for the taxpayer. Pelton Steel Casting Company[87] had three shareholders who held 60%, 20%, and

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[86] <u>Emeloid Company, Inc.</u>, 189 F.2d 230 (1951), rev'g 14 TC 1295.

[87] <u>Pelton Steel Casting Co.</u>, 251 F.2d 278 (1958), aff'd 28 TC 153.

20%, of the common stock. Two of the stockholders wished to sell their stock--the individual owning 60% and one of the individuals owning 20%. The corporation accumulated earnings to purchase the stock. The penalty was imposed on the tax year ended November 30, 1946. The stock had been redeemed for $800,000 on May 31, 1947. The Court held that this was not a corporate business purpose. It was emphasized in the judgment that the selling shareholders (of 80% of the ownership) acquired their entire share of accumulated earnings as capital gains, while the gain to the corporation by avoiding new management if the stock had been sold to outsiders was problematical.

In a case[88] which involved both of the prior mentioned cases, the Court of Appeals found that the Emeloid case was applicable and not the Pelton Steel case. In the case involved, which has since become an important case in its own right, a widow had made arrangements to sell her stock and that of her two daughters to the taxpayer corporation. Ben Miller died in 1945 and left his rights in a partnership with Harold Stratton to his widow and two daughters. The business was incorporated in 1947. The widow was a director of the corporation but took no active part in the management. Upon being unable to sell her stock to outsiders, arrangements were made for the corporation to purchase the stock under some long term loans.

The Circuit Court reversed the holding of the Tax Court that the reasoning of the Pelton Steel case was applicable. It held that a stock redemption can be for a valid corporate purpose. The desire of the widow to sell and the desire of Stratton, the other stockholder, to keep the business going was a proper corporate purpose. The Millers and Strattons had a basic divergence in purpose in that the Millers were interested in dividends and the Strattons in

[89]<u>Mountain State Steel Foundries Inc.</u> v. <u>Comm.</u>, 284 F.2d 737 (1960), rev'g 18 TCM 306.

investment of earnings and expansion. The Court said that the fact that it was less costly than financing the venture through dividend income was immaterial.

> The fact of redemption, of itself, however, furnishes no basis for imposition of the Section 102 tax . . . Nor is the situation altered by the fact that the Strattons may have been aware that travel along another route would have cost something more in taxes. If they had a choice of routes, they were not required to choose the one which would be most costly to them in taxes.

The Dill Manufacturing Co.[89] involved a 41 percent redemption. The stock of these shareholders, who were inactive in the corporation, was redeemed to leave the three remaining stockholders in complete control. The Court reasoned, "The petitioner constituted the life work of its operating officers. They had built it and were proud of it. The protection of the economic and financial independence of that work was scarcely less warranted as a business purpose than if petitioner had been an individual."

The Gazette Publishing Co. case[90] involved the redemption of 20 percent of the outstanding stock of a newspaper. The Court held that the redemption was justified in that it prevented the stockholder involved from possibly selling his stock to parties adverse to the established editorial policy of the paper.

Noticeably, in the cases favorable to the taxpayer mentioned here, there was involved 50% ownership or less. There appears to be a distinction at this level.

> This seems unduly mechanical and without a direct relationship to the substance of the question involved . . . (A) redemption is not undertaken for corporate business purposes would seem to be justified only by a finding that there will be no significant change in the manner in which the business is operated, irrespective of whether the stock is redeemed or not.[91]

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[89] Dill Manufacturing Co., 39 BTA 1023 (1939).

[90] Gazette Publishing Co. v. Self, 103 F.Supp. 779 (1952).

[91] Deshler D. Armstrong, "Section 531--Recent Cases Suggest New Problems," Taxes--The Tax Magazine, XXXIX (November, 1961), 857.

Retained earnings serves three major functions for the corporate enterprise. First, the availability of retained earnings makes the declaration of dividends possible, since a distribution of assets to the owners from any other source would be a return of capital. In many states, the payment of dividends from any source except retained earnings, unless it is a liquidating dividend, is prohibited by state law.

Secondly, retained earnings serves as a risk buffer for the corporation. It can be used to absorb losses so that unless the losses exceed the balance of the retained earnings, the "trust fund" of the creditors is unimpaired. Retained earnings is an increase in the equity base of the corporation and thus provides additional protection to the creditors. It may also enable the corporation to expand its debt at a favorable rate of interest.

The third function of retained earnings is to provide a means of expansion. Retained earnings can be the basis for the expansion of a corporation's assets just as the sale of additional capital stock can. Retained earnings has major advantages over the sale of an additional issue of stock in that it involves no expensive brokerage or other such fees and also does not alter the original stockholders' percentage ownership.

The small corporation has difficulty in obtaining both additional capital and debt, as has been discussed in earlier sections. The restriction of the amount of earnings the small corporation may retain through strict imposition of the accumulated earnings tax, can threaten the long term existence of the small corporation. Retained earnings would be limited to performing only the first function--making possible the declaration of dividends. Expansion through retained earnings must, under the regulations, be in the same line of business as previously pursued by the corporation, regardless of the comparative profitability of an investment in that line. The restriction of a corporation's growth certainly increases the risk involved in an investment in its securities. Thus, the strict imposition of the accumulated earnings tax could obliterate the usefulness of retained earnings in its functions as a risk buffer and a means of expansion.

The retainment of earnings by a corporation should be based on several factors:

(1) The rate of return available on investments of retained earnings as compared with the rate that may be earned on an investment of comparable risk outside the firm.

(2) The selling costs of new stock issues in conjunction with the anticipated expansion needs of the business.

(3) The established dividend policy of the firm.

(4) Contractural obligations and the debt to equity ratio.

In the small corporation, an additional factor merits consideration: the marginal tax rates of the stockholders.

The first factor is theoretically sound but practically, it may be difficult to determine and may be superseded in importance in the view of the directors by any of the other factors. Because it is usually impossible to obtain a marginal tax applicable to the stockholders in general, directors often feel obliged to maintain a constant dividend policy. This enables the individuals purchasing the stock to do so with knowledge of what the dividend policy will be. This is a type of "compromise" employed by directors of large corporations because it is impossible to adopt a dividend policy acceptable to stockholders of diverse income levels, and thus the individuals purchasing the corporation's stock will tend to do so only if that dividend policy is satisfactory in relation to their income.

All firms that have an unlimited life will in times of a rising price level require an expansion of retained earnings to maintain a static productive capacity.

Depreciation allowances will be inadequate measures of the funds required to replace existing equipment. Thus an expansion of retained earnings may be expected as the source of the higher priced assets if additional debt or equity financing is considered undesirable.

Most firms desire expansion and the cost of additional outside financing must be weighed against the cost of retained earnings. This may prove it desirable to expand through internally generated funds or through a combination of internal and external funds. An increase in the equity base may make it possible to obtain favorable terms on debt financing.

The management of retained earnings involves ascertaining the best interests of the stockholders and the firm and constructing a dividend policy as closely aligned with both as possible. The capable management of retained earnings is inextricably related to the effective management of the firm's investments and the overall management of the corporation to maximize the welfare of the stockholders.

STEPS TO AVOID THE TAX

There have been implied suggestions throughout this paper of steps a corporation can take to insure that it is in the best possible position regarding the imposition of the accumulated earnings tax, such as the avoidance of stockholder loans. A regular dividend policy and the absence of stockholder loans are considered important factors in the taxpayer's favor by most courts. The importance of up-to-date records cannot be overemphasized. These records indicate whether they are substantial enough to impress a court. For example, for a firm contemplating the erection of a building, the consultation of an architect would lend more credence to the plan than the mere notation in the corporate minutes. The testimony of witnesses isn't as impressive evidence as records of their thoughts and intentions during the tax year in question. Also, some individuals, who were important influences on policy in the time period concerned in the trial, might not be available to testify at the trial.

A possible preventive to the imposition of the accumulated earnings tax is to reflect corporate purposes on the financial statements.

> Since the subdivision of retained earnings will reflect both past accomplishments and future plans, it is doubtful if in many cases the unappropriated balance will be large enough to warrant questioning by the tax department . . . This assumes . . . that the corporation presents substantial and acceptable evidence of serious intent to support its functional breakdown of retained earnings.[92]

Probably, the main thing that corporate directors should do, is to be alert to the possible implications of certain actions with respect to the accumulated earnings tax, and to weigh the relative cost of such actions. In certain cases, after calculating the cost of a proposed move, the corporate directors may find it more favorable to risk the imposition of the penalty tax—but their possible liability to minority stockholders must also be a factor of consideration.

SUMMARY AND CONCLUSIONS

The accumulated earnings tax is the legal device used in the attempt to make it too expensive tax-wise to accumulate earnings in a corporation that is not subject to the high personal holding company tax rates. Earnings accumulated have been taxed only by the corporate tax. A possible inequity is created between the taxpayer who must pay high personal tax rates, and one who through the use of the corporate structure, can withdraw earnings in low tax years as dividends, or pay only capital gains or estate tax on the ultimate disposition of the stock.

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[92] Harry G. Brown, "Division of Retained Earnings to Reflect Business Needs," Accounting Review, XXXII (April, 1957), 263.

The difference between the corporate income tax rate and the individual income tax rate will always create a situation in which the corporate form can be used to avoid personal income taxes. This is true not only in a small corporation, but also in a large one. The accumulated earnings tax, as it is now administered, is inequitable to small corporations.

An economic justification often cited for the accumulated earnings tax is that if business saving and/or personal saving exceed investment, a recessionary force is created. The tax discourages business saving. The tax has favorable revenue effects for the government, not only through the judgments assessed, but also for the stimulation of increased dividend distribution.

There are dangers inherent in the accumulated earnings tax. The accumulated earnings tax, as well as several other taxes, substantially reduces the attractiveness of investment in small corporations. It would be impossible to measure the effect on entrepreneurial spirit these laws have had, but it has possibly been substantial.

By restricting the possible expansion through retained earnings of small corporations generally to their present line of business, the possible growth of these organizations is limited. Debt financing, if available, increases the risk of bankruptcy. Unestablished businesses have a high death rate and this increased risk is undesirable. The owners may be unwilling to dilute their equity or even if they are willing to accept dilution, outside capital is often difficult and expensive for the small corporation to obtain. Retained earnings, thus, represents the most feasible means of financing expansion for the small business.

Businesses which use their earnings in active investments whether or not these activities are related to their original corporate purposes, should be allowed to do so. It is <u>idle</u> funds that create a recessionary force in the economy. The restriction of the dividend credit for corporations should be effective in helping eliminate the attractiveness of idle investments. This would apply to both the large and small corporation. It would seem reasonable that the accumulation of idle funds by large corporations is as undesirable for the economy as those of small corporations. Yet, the tax as administered, is discriminatory towards small business.

The continued growth and expansion by American enterprise in profitable areas should be encouraged. Also, businesses should be allowed a reasonable surplus as a safety factor which was so useful to them in the depression years of the 1930's. Businesses, after all, are not guaranteed a profit.

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THE TAX ON CORPORATE ACCUMULATED EARNINGS

by

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The accumulated earnings tax has been developed over a long period of time. There are three reasons generally given in support of this tax. First, accumulated earnings are not subject to the individual income tax and thus may be realized by the shareholders through the favorable capital gains tax or declared as dividends in a year favorable to the taxpayer. This creates an inequitable situation in the view of the taxpayer outside of the capital-supplying sector of the economy who is unable to utilize the corporate structure as a device for saving and is obliged to pay an immediate individual income tax on his inflow of funds.

Secondly, because the tax system grants an incentive to retain earnings in a corporation, some economists fear that in a period of a rising standard of living, the desire of individuals and/or business to save will exceed the desire of business to invest and thus a recessionary force will be created.

A third reason that may be advanced in support of the accumulated earnings tax is that the stockholders rarely have the chance to compare the rate of return earned on investments made from corporate retained earnings with those investments of similar risk available outside the business. Thus, this absence of a comparison creates the danger that economic resources may not be optimally allocated.

The accumulated earnings tax is not applied to the corporation's surplus, but rather to the taxable income of the corporation after certain adjustments. The tax rate is 27½% on the first $100,000 of accumulated taxable income and 38½% on amounts above $100,000.

The relevance of the accumulated earnings tax to the corporation is not limited to its assessment, but also includes its effects on corporate policy from the implied or actual threat of its imposition.

The accumulated earnings tax is especially inimical to small business corporations. In most cases, the possible expansion through retained earnings of small corporations is limited to their present line of business. Debt financing, if available, increases the risk of bankruptcy. Unestablished businesses have a high death rate and this increased risk is undesirable. The owners may be unwilling to dilute their equity or even if they are willing to accept dilution, outside capital is often difficult and expensive for the small corporation to obtain. Retained earnings, thus, represents the most feasible means of financing expansion for the small business.

Businesses which use their earnings in active investments whether or not these activities are related to their original corporate purposes, should be allowed to do so. It is idle funds that create a recessionary force in the economy. The restriction of the dividend credit for corporations should be effective in helping eliminate the attractiveness of idle investments. This would apply to both the large and small corporation. It would seem reasonable that the accumulation of idle funds by large corporations is as undesirable for the economy as those of small corporations. Yet, the tax as administered, is discriminatory towards small business.

The interpretation and application of the law is an important factor in its effect. Harshly administered, it may have the undesirable effect of stifling the growth and expansion of small business corporations. Businesses are not guaranteed a profit and the removal of a major incentive to growth and expansion has an implied danger and warning.