The Accumulated Earnings Tax: A Trap for the Unwary or a Workable Statute?

This comment explores the accumulated earnings tax and the impact it exerts on the management of closely-held corporations. Through an examination of the tax and its legislative, administrative and judicial exceptions, the tax planner can proceed more assuredly with business accruals and subsequent investments.

INTRODUCTION

The ultimate goal of a business is success in the marketplace. This success generates profits, increases corporate assets, establishes a business reputation and produces earnings for owners and investors. The distribution of these profits to shareholders, however, is not always as attractive as it might initially seem. Distributing corporate profits as dividends may produce undesirable tax results,1 especially in the case of a closely-held corporation.2

One reason for this paradoxical result is that a corporation does not receive a tax deduction for money paid out as shareholder dividends.3 In fact, any payout of corporate profits actu-

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1 See notes 2-4 and accompanying text infra. The countervailing pressure is the threat of the accumulated earnings tax which imposes a substantial penalty on unreasonable accumulations of corporate earnings and profits. I.R.C. §§ 531-537. See also notes 13-38 and accompanying text infra.

2 In many cases, for example, the shareholders of a closely-held corporation are also key employees of the company and, as such, receive substantial salaries for their services. As a result, many of these employees find themselves in high income tax brackets where it may be financially undesirable to receive corporate dividends. Under I.R.C. § 1348, these shareholders are unable to take advantage of the 50% tax ceiling provided by the maximum tax provisions of the Code. The ceiling only applies to earned or personal service income; dividends do not fall under this category. As a result, dividends may be taxed as ordinary income at marginal rates approaching 70% exclusive of any state taxes.

3 I.R.C. § 161 enumerates all allowable corporate deductions and does not
ally results in double taxation of those earnings.\footnote{4}

A closely-held corporation\footnote{4} may have an alternative to double taxation which is unavailable to most public corporations. Because the closely-held corporation is not subject to the constraints of a publicly-owned corporation,\footnote{8} it may retain all or

include a deduction for dividend payments to shareholders.

\footnote{4} I.R.C. § 11. Corporations now pay income tax according to a slightly progressive rate schedule. A corporation which earns $75,000-100,000 of taxable income will pay 40% of that amount to the federal government.

Assume, for example, that a business pays corporate income tax at the rate of 40% and plans to distribute $100 as a dividend to a shareholder. Before any distribution, however, the federal government will tax $40 of that profit, leaving a net of $60 available for shareholder distribution. Assume also, as is common in a closely-held corporation, that the shareholder is an active employee and receives a substantial salary which places the shareholder in the 70% marginal tax bracket. The dividend is ordinary income to the shareholder. I.R.C. § 61. As a result, the federal government will also take 70% of the remaining $60. Thus, the shareholder nets only $18, while the federal government receives fully $82 of the corporation's $100 earnings.

\footnote{8} As used herein, the term "closely-held corporation" denotes a corporation where ownership and control are vested in a few individuals. A closely-held corporation is usually a small enterprise. H.F. O'NEAL, CLOSE CORPORATION — LAW & PRACTICE, § 1.03 (2d ed. 1971). There is no statutory exclusion from the accumulated earnings tax for publicly-held corporations. As a practical matter, however, the accumulated earnings tax applies primarily to closely-held corporations. In the majority of cases, greater scrutiny of closely-held corporations is necessary because of the increased chance that the corporation will act to benefit specific shareholders. McLean & Noftsinger, The Accumulated Earnings Tax Can Be Avoided, 54 TAXES 497, 498 (1976).

The Tax Court, however, has applied the tax to a publicly-held corporation where a small group of shareholders dominated management. Golconda Mining Corp. v. Commissioner, 58 T.C. 139 (1972). The Ninth Circuit Court of Appeals subsequently reversed, holding as a matter of law that a publicly-held corporation is not subject to the accumulated earnings tax. Golconda Mining Corp. v. Commissioner, 507 F.2d 594 (9th Cir. 1975). Although the Code does not expressly exempt public corporations from the tax, the Court inferred the exemption from the administrative and legislative history of the tax. Id. at 597.

The Internal Revenue Service nevertheless steadfastly maintains there is no legal impediment to applying the accumulated earnings tax to a public corporation in an appropriate case. Rev. Rul. 75-305, 1975-2 C.B. 228.

\footnote{8} The threat of shareholder pressure in a public corporation probably constitutes a greater incentive for corporate management to declare dividends than the fear of the accumulated earnings tax itself. B. Bittker & J. Eustice, FEDERAL INCOME TAXATION OF CORPORATIONS-SHAREHODERS ¶ 8.02, at 8-7, n.11.

In Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919), the Michigan Supreme Court ordered Ford Motor Co. to distribute a dividend on one-
part of its earnings, efficiently and profitably using the funds for the corporation’s advancement. However, a business is not allowed to retain money with impunity; it must carefully justify its accumulations or find itself penalized by the harsh provisions of the accumulated earnings tax.\(^7\)

The accumulated earnings tax generally seeks to force full distribution of corporate earnings and profits.\(^8\) The harshness of this scheme, however, is mitigated by legislative,\(^9\) administrative,\(^10\) and judicial\(^11\) exceptions. Under these exceptions, accumulations may be justified by a range of business needs seemingly as diverse as the character of modern business itself.\(^12\) In reality, however, these exceptions may be traps for the unwary.

This comment explores the parameters of the penalty tax and its specific exemptions. By thus analyzing allowable accumulations, managers of close corporations may better plan for future business needs.

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half of the accumulated cash surplus of the company. The company was successful, had a continuous cash income and did not need the entire surplus it had set aside to finance proposed expansion. The court stated:

A business corporation is organized and carried on primarily for the profit of the shareholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among shareholders in order to devote them to other purposes.

*Id.* at 684.

\(^7\) I.R.C. §§ 531-537.

\(^8\) F. CHOMMIE, FEDERAL INCOME TAXATION 616 (2d ed. 1973).

\(^9\) I.R.C. § 537. The Revenue Act of 1978 added a new provision to section 537(b). This provision declares that self insurance of products liability risks is a reasonable business need. P.L. 95-600, reprinted in [1978] U.S. Code Cong. & Adm. News 7282. This provision is effective with respect to products liability losses deductible in taxable years beginning after September 30, 1979. When issued, the regulations pursuant to this section will likely provide that it is appropriate to take into account the taxpayer's product liability experience, the extent of its commercial coverage for product liability and the tax consequences of the taxpayer's ability to deduct public liability losses and related expenses for income purposes when determining a "reasonable" accumulation. *HOUSE CONF. REPORT NO. 95-1800, reprinted in [1978] U.S. Code Cong. & Adm. News 7282.*


\(^11\) *See* discussion at notes 61-112 infra.

\(^12\) B. BITTKER & J. EUSTICE, supra note 6, at ¶ 8.03. *See* note 31 and accompanying text infra.
I. THE ACCUMULATED EARNINGS TAX

A. In General

The accumulated earnings tax encourages full distribution to shareholders by imposing a significant penalty on excess corporate earnings retained to avoid shareholder taxation. The possibility of this penalty significantly influences corporate tax planners. Because the Internal Revenue Service carefully scrutinizes all corporate accumulations, corporate managers must act cautiously in deciding between retaining earnings and distributing dividends.

The Internal Revenue Code imposes the penalty tax upon the “accumulated taxable income” accumulated in avoidance of taxable shareholder distributions. The tax is 27.5% of the corporation’s first $100,000 of accumulated taxable income plus 38.5% of all accumulated taxable income exceeding $100,000. The figure upon which the tax is computed is the corporation’s taxable income, after adjustment for certain items. The adjusted figure is then reduced by the dividends-paid deduction and the accumulated earnings credit to arrive at “accumulated tax-

13 I.R.C. § 531. Personal holding companies, foreign personal holding companies and tax exempt corporations are not covered by the tax. I.R.C. § 532.

14 INTERNAL REVENUE MANUAL, § 700, reprinted in J. LEWIS, TAX MNGM'T PORTFOLIO, ACCUMULATED EARNINGS TAX, No. 35-5th, at B-3 (BNA 1979) [hereinafter cited as INTERNAL REVENUE MANUAL].

15 The accumulation of any earnings, rather than the amount actually retained, is the critical factor. Smoot Sand & Gravel Corp. v. Commissioner, 274 F.2d 495 (4th Cir.), cert. denied, 363 U.S. 832 (1960).

16 I.R.C. § 535(a).

17 I.R.C. § 531.

18 I.R.C. § 535(b). The corporation’s taxable income, after adding back certain allowable deductions and subtracting certain nonallowable deductions under the penalty tax, equals the adjusted taxable income.

19 I.R.C. § 561. The dividends-paid deduction equals the amount of dividends paid during the last nine and one-half months of the taxable year plus the dividends paid during the first two and one-half months of the year following the taxable year.

20 I.R.C. § 535(c). The accumulated earnings credit is a minimum credit designed to ensure that a corporation is not required to distribute earnings which are needed in the business. Enacted by Congress in 1954, its purpose was to permit small businesses to accumulate earnings up to a specified
able income."  

B. The Tax Avoidance Purpose

The ultimate question in an accumulated earnings case is whether the retention of earnings was for the prohibited purpose of avoiding the individual income tax on shareholders.  


The original amount of the credit was $60,000. It was raised to $100,000 in 1958 because many tax experts thought the $60,000 exemption, though helpful, was too limited and afforded no relief to the many small growing companies with accumulated earnings and profits above $60,000. Hart, New Legislation Brings Relief to Small Corporate Taxpayer and Owner, 9 J. Tax. 218 (Oct. 1958). The Tax Reduction Act of 1975 increased the minimum credit to $150,000 for taxable years beginning after December 31, 1974.

In computing the available credit for a corporation, management must consider previous years because the credit is an overall allowance. The accumulated earnings credit is the amount, if any, by which $150,000 exceeds the accumulated earnings and profits at the close of the preceding taxable year or an amount equal to such part of the earnings and profits for the taxable year as is retained for the reasonable needs of the business (adjusted if the corporation had an excess of net long-term capital gains over short-term capital losses), whichever is greater. B. Bittker & J. Eustice, supra note 6, at ¶ 8.01. For illustrative computations, see Treas. Reg. § 1.535-3(b)(3) (1979).

While the $150,000 allowance for the accumulated earnings credit appears to provide a substantial amount of leeway for a small business, a close analysis of the consumer price index indicates otherwise. Since the end of 1974, when the credit increased to $150,000, there has been a 9.2% price rise. See, e.g., Monthly Labor Rev., Feb. 1980, at 93. Today the current $150,000 credit has a purchasing power of $96,600 in 1974 dollars. Thus, the actual amount available to a small business is little over $35,000 more than the original credit which small businesses found inadequate. Hart, supra.

As an additional note, the Small Business Administration has proposed the adoption of a structural definition of a "small business." It proposes to define small businesses on the basis of the number of employees. 45 Fed. Reg. 15,444-53 (1980) (to be codified in 13 C.F.R. § 121). The Small Business Administration found that when size standards are denominated in dollars, the small business sector is undermined by inflation. Id. at 15,443.

11 I.R.C. § 535(a).

12 I.R.C. § 533(a). The regulations explicitly require avoidance of the "individual income tax," Treas. Reg. § 1.532-1(a)(1) (1979). The tax can also be imposed if the purpose is to avoid income tax on shareholders of any other corporation by allowing earnings and profits to accumulate, rather than dividing or distributing them. I.R.C. § 531.
needs of the business.\textsuperscript{23}

Shareholder tax avoidance need not be the dominant motivation for the accrual of earnings; it must only be one of the underlying purposes.\textsuperscript{24} The element of intent, however, is still a necessary part of the claim since penalties are not imposed because there is an unreasonable accumulation, but rather because the purpose of the accumulation was tax avoidance.\textsuperscript{25}

\section*{C. Reasonable Needs of the Business}

The taxpayer, in order to avoid the rebuttable presumption of an improper accumulation, must thus justify the accumulation as a reasonable business need.\textsuperscript{26} Consequently, the parties most

\begin{itemize}
\item I.R.C. § 531.
\item United States v. Donruss, 393 U.S. 297 (1969). In deciding that tax avoidance need not be the dominant or sole purpose justifying invalidation of the accumulation, the Court resolved a split among the circuit courts.
\item \textit{Id.} The corporate management’s subjective intent at the time of the accumulation is crucial in determining the purpose underlying the accumulation. The surrounding facts and circumstances contribute to a determination of the purpose behind the failure to distribute dividends. Henry Van Hummell, Inc. v. Commissioner, 23 T.C.M. (CCH) 1765 (1964), \textit{aff’d}, 364 F.2d 746 (10th Cir. 1966), \textit{cert. denied}, 386 U.S. 956 (1967). Whether the accumulation was designed to avoid personal income taxes for shareholders is a question of fact. “Since liability for this tax depends on the purpose underlying the accumulation, enquiry must be made into the state of mind of those controlling the corporation.” Bahan Textile Mach. Co. v. United States, 543 F.2d 1100, 1112 (4th Cir. 1972).
\item Treas. Regs. § 1.533-1(a)(2) (1979) provides that the following facts are to be considered in determining whether the tax avoidance purpose was present:
\begin{itemize}
\item (i) Dealings between the corporation and its shareholders, including loans to shareholders and expenditures of corporate funds for the personal benefit of shareholders;
\item (ii) Investments of undistributed earnings in assets having no reasonable connection with the corporation’s business, and
\item (iii) The corporation’s dividend history.
\end{itemize}
\item I.R.C. § 533. Resolution of the motivation issue is crucial because § 533(a) places the burden on the corporation to prove by a preponderance of the evidence that the accumulation is reasonable. The burden of proof is normally on the taxpayer to establish that the prohibited purpose did not exist. However, if the matter is brought before the Tax Court, section 534(a) permits the court to shift the burden to the Internal Revenue Service. There are two methods by which this burden may be shifted: 1) the Service does not provide the taxpayer with notice of the grounds for a section 531 assessment prior to the issuance of a deficiency; or 2) if, when such notice has been provided, the taxpayer responds with a statement setting forth adequate reasons for retaining the accum-
\end{itemize}
frequently and bitterly contest the finding that the accumulation of corporate earnings is beyond the "reasonable needs of the business." The definition of "reasonable needs" is important for two reasons: 1) it is the principal focus in determining an intent to avoid shareholder taxation, and 2) it is the limit of the accumulated earnings credit. The definition of a corporation's reasonable needs is a question of fact to be determined from all the evidence.

Section 537 includes anticipated future, as well as present, needs in its definition of "reasonable business needs." These reasonably anticipated needs, in turn, depend upon the scope of a corporation's business. At least under the income tax regulations a corporation's business would appear to include any line of business which it may undertake.

Regardless of when the accumulation will be used, the Internal Revenue Service will nevertheless assess a corporation's reasonably anticipated needs as of the close of the corporation's taxable year. Thus, the corporation must justify its future needs at the end of each taxable year. The size of the accumulation is not the crucial factor. Instead, the reasonableness and nature of the year-end surplus are dispositive. There is, however,

mulations about which the Service complained. I.R.C. § 534(a).

27 B. BITTKER & J. EUSTICE, supra note 6, at ¶ 8.01. The importance of this phrase is also a consideration in reference to the accumulated earnings credit. See note 20 supra.


31 Id. The regulations are facially contradictory. In regulation 1.537-3(a), a corporation's business is defined as "any line of business which it may undertake." One could logically interpret this as authorizing the diversification of a corporation and the acquisition of other businesses, regardless of their relationship to the corporation's business. However, in the subsection immediately following, the regulations provide that "investments in properties or securities which are unrelated to the activities of the business of the taxpayer corporation . . ." will be held subject to the penalty tax. Treas. Reg. § 1.537-3(b) (1979).

Case law, however, has not sanctioned such liberal business development without the threat of the penalty tax. See notes 61-112 infra.


33 Smoot Sand & Gravel Corp. v. Commissioner, 274 F.2d 495 (4th Cir.), cert. denied, 363 U.S. 832 (1960). "To the extent the surplus has been translated into plant expansion, increased receivables, enlarged inventories, or other assets related to the business, a corporation may accumulate with impunity."
no uniform standard for measuring reasonably anticipated needs.\textsuperscript{34} The Internal Revenue Service has declared that reasonably anticipated needs of the business must include specific, definite and feasible plans.\textsuperscript{35} But this requirement does not demand that the taxpayer produce meticulously drawn, formal blueprints for action.\textsuperscript{36} In \textit{Motor Fuel Carriers, Inc. v. Commissioner},\textsuperscript{37} for example, the court indicated that a lack of the required specificity may be cured by a "substantially active move toward implementation."\textsuperscript{38} Thus, although detailed plans may be prudent, they are not always necessary.

\section*{II. Permissible Accumulations: Administrative Determination of "Reasonable Needs"}

The current income tax regulations set forth five "non-exclusive" grounds which can justify a corporation's accumulation of earnings and profits.\textsuperscript{39} Accumulations may also be justified by a

\begin{itemize}
\item \textsuperscript{34} "There is no set standard of measurement. Prominent factors in one case may be minor in another. Each case rests upon its peculiar circumstances and facts." Universal Steel Co. v. Commissioner, 5 T.C. 627 (1947), \textit{acq.} 1947 C.B. 7.
\item Events may occur after the close of the taxable year which point to the taxpayer’s true intent in accruing earnings and profits. The regulations provide that subsequent events, such as the failure to build as planned, do not destroy the efficacy of the accumulation if it was justified at the close of the taxable year. Treas. Reg. § 1.537-1(b)(2) (1979). \textit{See} Simons-Eastern Co. v. United States, 354 F. Supp. 1003 (N.D. Ga. 1972), allowing accumulations even though reserves did not result in a building.
\item John P. Scripps Newspapers v. Commissioner, 44 T.C. 453 (1965).
\item 559 F.2d 1348 (5th Cir. 1977).
\item \textit{Id.} at 1352. "Whether or not the plan was definite during these years depends upon whether [the taxpayer's] intent was manifested by some 'substantially active move toward implementation'."
\item In Smoot Sand & Gravel Corp. v. Commissioner, 274 F.2d 495 (4th Cir.), \textit{cert. denied}, 363 U.S. 832 (1960), the court indicated that "some contemporaneous course of conduct directed toward the claimed purpose" would be adequate. In Henry Van Hummell, Inc. v. Commissioner, 364 F.2d 746, 750 (10th Cir. 1966), \textit{cert. denied}, 386 U.S. 956 (1967), the court stated that it would accept "some clear action . . . to include the adoption of specific plans or programs."
\item Treas. Reg. § 1.537-2(b) (1979):
  \begin{quote}
  \textit{Reasonable accumulation of earnings and profits. Although the following grounds are not exclusive, one or more of such grounds, if supported by sufficient facts, may indicate that the earnings and}
  \end{quote}
\end{itemize}
myriad of business needs beyond those set out in the regulations. In addition to the provisions of the regulations, businesses may look to case law to justify the retention of earnings and profits.

A. Accumulations Allowed by the Regulations

Only three of the five grounds enumerated in the regulations have received considerable attention in the courts: 1) Accumulations for business expansion and replacement of plant and equipment;\(^{40}\) 2) Accumulations to provide for retirement of bona fide indebtedness created in connection with the taxpayer's trade or business;\(^{41}\) and 3) Accumulations to provide necessary working capital for the business.\(^{42}\)

If the taxpayer immediately uses earnings to expand its business or to replace its plant or equipment, the government will not ordinarily challenge the accumulation.\(^{43}\) More frequently, however, expansion or replacement occurs in the future. In analyzing the propriety of future expansion plans, the government uses a two-tiered inquiry. First, the plan must be real, and not remote or unproved. This is true even where the business only considers expansion in the taxable year and does not consum-

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profits of a corporation are being accumulated for the reasonable needs of the business provided the general requirements under §§ 1.537-1 and 1.537-3 are satisfied:

(1) To provide for bona fide expansion of business or replacement of plant;

(2) To acquire a business enterprise through purchasing stock or assets;

(3) To provide for the retirement of bona fide indebtedness created in connection with the trade or business, such as the establishment of a sinking fund for the purpose of retiring bonds issued by the corporation in accordance with contract obligations incurred on issue;

(4) To provide necessary working capital for the business, such as, for the procurement of inventories; or

(5) To provide for investments of loans to suppliers or customers if necessary in order to maintain the business of the corporation.


mate its plans until a later year.⁴⁴ Second, the amount required for the expansion must be proportionate to the amount of earnings accumulated. That is, if the proposed expansion requires only a fraction of the actual earnings, the full accumulation is not proper.⁴⁵ The controlling standard is the prudent businessperson standard.⁴⁶

In order to avoid a claim of an unwarranted accumulation by the Service, the corporation must carefully document these types of future plans.⁴⁷ Such documentation would include the

⁴⁵ Treas. Reg. § 1.537-1(a) (1979); Jerome E. Casey v. Commissioner, 16 T.C.M. (CCH) 1024 (1967), rev’d on other grounds, 267 F.2d 26 (2d Cir. 1959) (holding that where a corporation has liquid assets exceeding liabilities in the taxable years in issue, an accumulation is impermissible).
⁴⁶ Treas. Reg. § 1.537-1(a) (1979): “An accumulation of the earnings and profits . . . is the 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.”

Plans to replace specific assets are acceptable reasons for accumulating earnings. Such plans are often acceptable where the likelihood is strong that the business will actually replace the equipment. Helvering v. National Grocery, 304 U.S. 282 (1938). Actual depreciation in the value of any of the taxpayer’s assets is important evidence in determining whether the accumulation exceeded the company’s reasonable needs. INTERNAL REVENUE MANUAL, supra note 14, at § 776.4. Depreciation deductions are current charges against earnings. An additional reserve for the purpose of replacing plant or equipment must be justified by proof that the taxpayer’s depreciation reserves are inadequate; otherwise, there would be a double accumulation for replacing the same plant or equipment. Farmers & Merchants Inv. Co. v. Commissioner, 29 T.C.M. (CCH) 705 (1970) (holding that business-connected loans to fund reserves were reasonable business needs.)

⁴⁷ Treas. Reg. § 1.537-2(b) (1979); Henry Van Hummel, Inc. v. Commissioner, 364 F.2d 746, 750 (10th Cir. 1966), cert. denied, 386 U.S. 956 (1967) (denying an accumulation where there was a “conspicuous absence of evidence of corporate action directed toward remodeling or expansion”).

In Federal Ornamental Iron & Bronze Co. v. Commissioner, 28 T.C.M. (CCH) 391 (1969), the taxpayer submitted a list of grounds for which its accumulations had been made. Included in this list was the expansion of business and the possibility of entering into a new business. In rejecting these claims, the court stated that:

each one of the claimed grounds. . . was based upon a plan or contention which, at the end of each taxable year, was not a specific, definite and feasible plan for the projected uses of accumulation within a reasonably definite time in the future; and was vague, generalized, without substance, and related to only the possible use of
adoption of specific plans or programs. Thus, the purpose for the retention must be expressed in some tangible way or by some action directed toward its fulfillment. Failure to do so prompts the imposition of the penalty tax.

The Internal Revenue Service closely regulates accumulations for expansion into new business ventures. Regulation 1.537-3(a) seems to contemplate active entry into new businesses. Thus, the Service carefully scrutinizes passive corporate investment to determine its business purpose. Courts, however, acknowledge that passivity alone does not make an accumulation unreasonable where two conditions are satisfied: 1) the investment is liquid, and (2) the taxpayer shows that there is a legitimate business need for the liquidity.

The regulations also permit a corporation to accumulate earnings and profits to retire business-connected loans. A corporation, however, must be very careful in initially making "business-related" loans. The treasury regulations specify that loans to shareholders, their friends and relatives which bear "no reasonable relation to the conduct of the business" are not justifiable accumulations.

Retaining earnings and profits for working capital is the final, and perhaps the most important, justification for an accumulation under the regulations, yet working capital needs are the most difficult to ascertain. "Working capital" is an essentially accumulations at an indefinite time in the future.

*Id. at 407. See also J. Gordon Turnbull, Inc. v. Commissioner, 373 F.2d 87 (5th Cir. 1967), cert. denied, 389 U.S. 842 (1967); Cheyenne Newspapers, Inc. v. Commissioner, 32 T.C.M. (CCH) 234 (1973), aff'd 449 F.2d 429 (10th Cir. 1974).

Regulation 1.537-1 provides that subsequent events will not destroy the propriety of an accumulation which was justified at the close of the taxable year.

*48 J. Gordon Turnbull, Inc. v. Commissioner, 373 F.2d 87 (5th Cir.), cert. denied, 389 U.S. 842 (1967).


*50 Comment, The Accumulated Earnings Tax and the Problem of Diversification, 64 Mich. L. Rev. 1135, 1139 (1966). "Active" conduct of the new business is clearly required by regulation 1.537-3(a), according to the author of the above article. When an entire business is passive, the author argues, it is policed through the provisions of the Code dealing with personal holding companies. I.R.C. §§ 541-547.

*51 Comment, supra note 50, at 1139.


*54 Treas. Reg. § 1.537-2(b)(4) (1979); the regulations provide no specific
recurring fund of liquid assets which are necessary to finance the recurring operations of a business during its typical operating cycle. The working capital requirements of businesses differ as a result of dissimilar economic environments and conditions. Therefore, any rule of thumb in this area is no more than a rule of administrative convenience. A company can accumulate liquid assets for current and future business needs. To the extent that such needs are substantiated, the business can either hold the current assets to provide for such needs now or invest the assets until the expenditure must be made. A corporation rely-

guidelines which the corporation can use to compute actual working capital needs. As a result, the courts have attempted to establish reliable, objective standards to determine a corporation's working capital needs. See Bardahl Mfg. Corp., 24 T.C.M. (CCH) 1030 (1965); Electric Regulator Corp. v. Commissioner, 336 F.2d 339 (2d Cir. 1964); Apollo Industries v. Commissioner, 358 F.2d 867 (1st Cir. 1963), discussed in note 57 infra.

Working capital is the excess of current assets over current liabilities. This figure identifies a relatively liquid portion of total enterprise capital constituting a margin or buffer for meeting obligations within the ordinary operating cycle of the business. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCTG. RSCH. BULLETIN No. 43, ch. 3, § A, ¶2 (1975).

The operating cycle of a business entails the ordinary operations of business involving the circulation of capital within the current asset group. Cash is expended for materials, finishing products, operating supplies, labor and other factory services, and such expenditures are accumulated as inventory cost. Inventory costs are converted into trade receivables and ultimately into cash again upon the sale of the products to which such costs attach. The average time between the acquisition of materials or services entering this process and their final cash realization constitutes an operating cycle. Id. at ¶ 15.

Dixie, Inc. v. Commissioner, 277 F.2d 520 (2d Cir. 1960).

A few operating cycle formulae have captured the attention and favor of various courts. The original formulation in 1965 resulted from Bardahl Mfg. Corp., 24 T.C.M. (CCH) 1030 (1965). The approach taken by the Bardahl court was to use a mathematical formula for determining the length of the corporation's ordinary operating cycle and the amount of working capital needed to operate the business for one full cycle. In Bardahl, the court apparently used the "peak cycle" approach — i.e., the inventory and accounts receivable used in the computation were the amounts for the month-end during which the total dollars tied up in inventory and accounts receivable were the greatest.

A number of courts, however, have refused to use the "peak cycle" approach, opting instead for the "average cycle." W.L. Mead, Inc. v. Commissioner, 34 T.C.M. (CCH) 924 (1975). Cf. Apollo Industries, Inc. v. Commissioner, 358 F.2d 867 (1st Cir. 1966); Electric Regulator Corp. v. Commissioner, 40 T.C. 757 (1963), rev'd, 336 F.2d 339 (2d Cir. 1965).

The section 531 Audit guidelines have an express direction that the examining agent compute the Bardahl formula for most taxpayers. INTERNAL REVENUE
ing on this regulation 68 must justify the accumulation of earnings and profits by an analysis of its cash flow. Cash flow, in turn, is a function of the exigencies of the particular business. 69 Future needs, however, need not be certain. Contingent needs may also justify accumulations. 66

These five grounds thus provide “safe harbors” for the small corporation planner. Yet the regulations are expressly nonexclusive. In order to keep pace with the changing needs of the modern small business, judicial decisions have sanctioned several additional accumulations.

B. Judicially Authorized Accumulations

A business can accumulate earnings for a contingent future need if there is reasonable ground to believe the contingency will occur. 61 In order to evaluate the appropriateness of an accumulation for a business contingency, the taxpayer must use the “reasonable needs of the business” analysis. 62 Three major factors justifying corporate accumulations have emerged from case law under the accumulated earnings tax. First, the accumulation must be reasonably adapted to a present or future need of the business. 63 Second, the contingency for which the money is set aside cannot be too remote; there must be a reasonable likelihood that the anticipated need will actually arise in the future. 64 Third, any money set aside for the future must be accounted for carefully. It is crucial that the business maintain corporate records as to any future needs, present or future threats of monetary loss and any other basis upon which the corporation believes it requires an additional amount of liquid capital. In short,

Manual, supra note 14, at § 784(1).


69 Cash flow is a function of operating expenses, cost of goods sold, inventory size, rate of inventory turnover, credit policies, accounts receivable, collection rates and availability of credit. Smoot Sand & Gravel Corp. v. Commissioner, 274 F.2d 495 (4th Cir.), cert. denied, 362 U.S. 976 (1960).


62 For further discussion, see notes 26-38 and accompanying text supra.


64 Henry Van Hummell, Inc. v. Commissioner, 364 F.2d 746, 752 (10th Cir. 1966).
before any such money is accrued, the need for such money must be carefully considered, realistically appraised and reasonably retained.

Retaining earnings and profits to avoid "unrealistic hazards" is not justifiable. Just what constitutes an "unrealistic hazard" is unclear. While an uncertain monetary impact is insufficient, such uncertainty, when coupled with a low likelihood of occurrence, is adequate. Judicial decisions have given content to this justification. These decisions may be analyzed according to the specific contingency they authorize.

1. Pending or Threatened Litigation

An increasingly prevalent basis for retaining corporate earnings and profits is the need to defend the business in pending or threatened litigation. In Wm. C. Atwater & Co., Inc. v. Commissioner, the corporation retained earnings and profits in response to a suit filed by an employee. Over five years passed between the date of the complaint and the date of the final judgment. Atwater's business declined during this period; it suffered reduced earnings and after-tax losses. The value of Atwater stock dropped below its original cost. Under the state corporation law, the legality of dividend payments was in doubt. The Tax Court held that the accumulation was permissible since the company's financial position was weak, the legality of dividends was doubtful, and the lawsuit presented a realistic contingency.

The amount of permissible accumulation is set by the amount

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68 Cheyenne Newspapers, Inc. v. Commissioner, 32 T.C.M. (CCH) 234 (1973), aff'd, 494 F.2d 429 (10th Cir. 1966).
69 In Smoot Sand & Gravel Corp. v. Commissioner, 274 F.2d 495, 497, (4th Cir.), cert. denied, 362 U.S. 976 (1960), the court stated that "a contingency is a reasonable need for which a business may provide, if the likelihood, not merely the remote possibility, of its occurrence, reasonably appears to a prudent business firm."
65 Wm. C. Atwater & Co., Inc. v. Commissioner, 10 T.C. 218, 242 (1948), acq. 1948-1 C.B. 1. "It is well established that a corporation can accumulate funds to satisfy a contingent liability."
70 10 T.C. 218 (1948), acq. 1948-1 C.B. 1.
70 In the face of after-tax losses and the contingent liability from the lawsuit, the state corporation law would not permit the issuance of dividends.
of the reasonably expected liability.\textsuperscript{71} In \textit{Steelmasters, Inc. v. Commissioner},\textsuperscript{72} for example, the Tax Court concluded that the possible liability arising from a trademark infringement suit was a reasonably foreseeable contingency and was so treated by the taxpayer's management. The Internal Revenue Service argued that the uncertainty of the amounts involved prevented Steelmasters from realistically planning for the contingency and, therefore, that the accumulation was unjustifiable. Recognizing the difficulty of precisely predicting a potential recovery, the court maintained that uncertainties regarding outcome and damages are inherent in all litigation. The court then reasoned that Steelmasters should not be prevented from protecting itself against a foreseeable liability. In addition, the court found that exposure to a substantial money judgment was a clear threat during the taxable years in question.\textsuperscript{73}

A further requirement under the exception is that the corporation must be a principal party to the litigation and must actually stand to suffer losses beyond those covered by any liability insurance.\textsuperscript{74} The taxpayer in \textit{J. Gordon Turnbull, Inc. v. Commissioner},\textsuperscript{75} for example, was one of five defendants in eight tort suits resulting from a construction project accident. Turnbull retained earnings as a reserve for the contingent liability from the tort suits although it carried two general liability insurance policies. In addition, the company's asset-to-liability ratio\textsuperscript{76} was sufficient to provide reserves far beyond the business needs of the company. Accordingly, the court disallowed the accumulation and imposed the section 531 penalty. The court cited two principal reasons for disallowing the accumulation. First, the company was not one of the principal defendants.\textsuperscript{77} Second, the company

\textsuperscript{71} Steelmasters, Inc. v. Commissioner, 35 T.C.M. (CCH) 1460 (1976).

\textsuperscript{72} \textit{Id}.

\textsuperscript{73} "Inherent in any litigation are uncertainties regarding outcome. In this instance, the usual certainties were further aggrandized by the precarious nature of the litigation involved." \textit{Id.} at 1468.

\textsuperscript{74} \textit{J. Gordon Turnbull, Inc. v. Commissioner}, 373 F.2d 87 (5th Cir.), \textit{cert. denied}, 389 U.S. 842 (1967).

\textsuperscript{75} \textit{Id}.

\textsuperscript{76} In 1952 the asset-to-liability ratio was 11.12 to 1; in 1953 it was 6.97 to 1. \textit{Id.} at 90.

\textsuperscript{77} The taxpayer in Turnbull was not a principal defendant since his liability was based on the architectural services he rendered to the construction company. The accidents occurred at the construction site itself and the construction company was, therefore, the principal defendant. \textit{J. Gordon Turnbull, Inc.}
carried ample public liability insurance to cover its losses.\footnote{78}

2. Fear of Losing a Principal Customer

The loss of a principal customer and the subsequent need to restructure or move the business can also justify the retention of earnings.\footnote{79} For thirteen years prior to the taxable years in issue, the taxpayer in \textit{L.R. Teeple Co. v. Commissioner}\footnote{80} sold nearly all of its output to a single customer. Teeple never actively attempted to solicit new business because of an oral agreement with its principal customer that it would not solicit new business. However, Teeple did begin accumulating reserves to provide for the possible loss of this customer. Teeple ultimately accrued a substantial surplus which was neither used nor required in the business because the principal customer remained with Teeple. The Service argued that the possible damage to the business was too remote since the contingency had not yet occurred at the time of litigation. The court disagreed and, while conceding that the money was not currently needed in the business, nevertheless held that the dependency of the business upon the good will and continued patronage of one customer over which the taxpayer had no control justified the accumulation. An additional factor of importance was the growing competition in Teeple’s industry which constituted an ever present danger and existing threat to its business.\footnote{81}

\footnote{v. Commissioner, 373 F.2d 87, 90 (5th Cir.), cert. denied, 389 U.S. 842 (1967).}  
\footnote{78 Id. at 92.}  
\footnote{79 L.R. Teeple Co. v. Commissioner, 47 B.T.A. 270 (1942).}  
\footnote{An allied concept which can justify accumulating earnings and profits is the implementation of corporate plans to battle competition. However, a business slump due to increased competition may be insufficient to justify an accrual of corporate earnings if no definite plans are made for diversification or for intensifying sales efforts. Henry Van Hummell, Inc. v. Commissioner, 23 T.C.M. (CCH) 1765, 1777 (1964), aff’d, 364 F.2d 746 (10th Cir. 1966). An accrual of earnings due to anticipated competition must arise from an impending threat in the market place. L.R. Teeple Co. v. Commissioner, 47 B.T.A. 270 (1942).}  
\footnote{80 47 B.T.A. 270 (1942).}  
\footnote{81 Id. at 299. The court also pointed out that since there were increasing numbers of competitors in locations better suited to supply Teeple’s primary customer, Teeple faced the possible necessity of moving its plant to meet the requirements of its principal customer.}
3. Fear of Loss of Business

A reasonable fear of lost business can also justify the retention of corporate earnings and profits. In *Alma Piston Co. v. Commissioner*,\(^{\text{82}}\) for example, savings for future product diversification was held to be a reasonable business need. In *Alma*, the Tax Court found that expansion was justified when Alma's primary auto clutch buyer decided to convert to automatic transmissions. The court's rationale was that the taxpayer had valid reasons to fear a loss of business which would require an extensive modernization program.\(^{\text{83}}\) The court considered the following factors relevant in deciding whether the taxpayer had sufficiently documented its plans: 1) evidence of actual implementation of the plans; 2) the corporation's active pursuit of alternatives to proposed plans where delay in actual implementation was caused by practical difficulties; and 3) the corporation's history of continuous expansion.\(^{\text{84}}\)

4. Funding Self-Insurance Programs

Corporate financing of self-insurance is a permissible ground for retaining earnings and profits. The Tax Court in *General Smelting Co. v. Commissioner*\(^{\text{85}}\) held that the payment of premiums on insurance securing debts owed to a corporate fulfills a reasonable business need. In *General Smelting*, the corporation extended approximately $146,000 in personal loans to its then president. After retirement, the president experienced financial difficulties. He settled his outstanding debt to the corporation by assigning to it certain life insurance policies. The Service argued that the payments by the corporation showed that: 1) General Smelting did not need all of its earned surplus for use in its business; 2) the investment in these insurance policies were unrelated and unnecessary to the operation of Smelting's business; and 3) the investment provided evidence of the purpose prohibited by section 531. The court disagreed, holding that the taxpayer exercised sound business judgment in making the insur-

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\(^{\text{82}}\) 35 T.C.M. (CCH) 464 (1976).

\(^{\text{83}}\) The court analogized this program to business expansion allowed by regulation 1.537-1(b)(1),(2). See text accompanying notes 43-51 supra.

\(^{\text{84}}\) 35 T.C.M. (CCH), 464, 476 (1976).

\(^{\text{85}}\) 4 T.C. 313 (1944), acq. 1945 C.B. 3.
ance policy investments.  

Maintaining liquid reserves to protect against uninsured losses is also an allowable accumulation. When areas of substantial risk of loss are involved, a corporation is allowed to retain reasonable amounts of earnings to fund reserve accounts. In \textit{Inter-County Title Co. v. United States}, for example, a title insurance company was allowed to maintain liquid reserves to protect against uninsured losses. Inter-County Title Company conducted its business operations for thirty years without competition. Within an eight year period, however, four other title companies began operating in Inter-County's area. The court held that the company's accumulation was essential in order to maintain necessary deposits with financial institutions and to insure the continued referral of business. In order to meet this new competition, Inter-County engaged in new and risky business practices which exposed the company to substantial risk. In determining reasonable reserves for losses, the \textit{Inter-County} court said that a business must look not merely at the taxpayer's past loss experience, but also at pending claims and losses being suffered by similar companies.

There is currently only one reported accumulated earnings tax case dealing with "key-man" insurance. In \textit{Bradford-Robinson}

\begin{itemize}
\item \textsuperscript{66} The court stated that:
while the loans were not made for business purposes, we think it was clearly a business purpose for petitioner to salvage as much as possible out of the loans where they became bad and this it was endeavoring to do when it took the assignment of the insurance policies... and made payment on them in subsequent years... to protect them and keep them in force. \textit{Id.} at 324.
\item \textsuperscript{67} Wm. C. Atwater & Co., Inc. v. Commissioner, 10 T.C. 218 (1948), \textit{acq.} 1948-1 C.B. 1.
\item \textsuperscript{68} 75-2 U.S.T.C. \textsuperscript{7} 9845, at 88,702 (E.D. Cal. 1975).
\item \textsuperscript{69} \textit{Id.} at 88,705. These business practices included: issuing title policies insuring against known defects on the strength of guarantees from customers, using automatic subordination clauses, using holding agreements and allowing good customers to start construction prior to recordation of construction loans, thereby knowingly risking liability for all mechanics' liens. \textit{Id.}
\item \textsuperscript{70} \textit{Id.} at 88,706.
\item \textsuperscript{71} When a corporation provides key-man insurance, it assumes financial responsibility for insurance policies on the lives of its most important employees. Key-man insurance often serves as a draw to qualified executives. In some cases, these employees may be shareholder-owners. \textit{See} \textit{The Emeloid Co. v.}
\end{itemize}
Printing Co. v. United States, the taxpayer, rather than purchase a policy from a commercial insurance company, set up a fund to provide insurance to key members of the company and to establish a special self-insurance fund. Due to prior experience, the directors considered the self-insurance more advantageous than commercial insurance. The court stated that the desirability of the insurance plan was not the issue. Rather the court focused on inferences that could be drawn about the purpose of the retention from the creation of the fund and the carrying out of its functions. The court decided that the taxpayer did not set up the fund in order to avoid taxes. Instead, there was a genuine business need for the self-funded program.

5. Labor Problems

Fear of labor strikes and impending unrest among employees are also permissible grounds for retaining earnings. Under such circumstances, courts are reluctant to substitute their business judgment for that of corporate management. In Dielectric Commissioner, 189 F.2d 230 (3d Cir. 1957).

Id. at 67,633.
Id.
The court considered the history of the company and its conservative policies regarding financial matters. The court recognized that there must be room for honest differences of opinion in business. As long as the officers did not form their opinion in order to prevent the imposition of income tax on the shareholders, the court will recognize the right of management to exercise their judgment. Id. at 67,634.

The Emeloid Co. v. Commissioner, 189 F.2d 230 (3d Cir. 1957) is often cited for the proposition that maintaining key-man insurance is justified when the taxpayer shows that such insurance provides the continuity of management and corporate policy. In Emeloid, the issue arose under the World War II excess profits tax. Despite a different statute and potentially different policy considerations the general judicial acceptance of key-man insurance in Emeloid appears to establish the proposition that a reasonable amount of key-man insurance is a reasonable need of any business.

In Goldstein, Tax Aspects of Corporate Business Use of Life Insurance, 18 Tax L. Rev. 133, 204 (1963), the author contends that if a reasonable amount of key-man insurance is a reasonable need of the business, then the retention of earnings in the form of cash surrender values will not be indicative of the prohibited purpose and such earnings would, in any event, qualify for the accumulated earnings credit.

Materials Co. v. Commissioner, a strike in foreign copper mines occurred and, at the close of the year, the prospect of a domestic strike with uncertain consequences loomed. Dielectric's principal business was the manufacture and marketing of insulated electrical wire and cable, for which it required substantial copper supplies. The court allowed the accumulation, reasoning that the potential effect of such economic turmoil on Dielectric's business could be disastrous to the availability of supplies, the ability to satisfy customers, and the prices of both purchases and sales.

6. Funding Retirement and Bonus Plans

Corporate directors may set aside funds to establish a reserve to meet increasing contingent liabilities arising from profit-sharing and retirement plans. In Bremerton Sun Publishing Co. v. Commissioner, the taxpayer established profit-sharing and increment agreements for its key employees. Bremerton's executive committee passed a resolution to set up reserve accounts to provide for the corporation's liability under these agreements. In determining the amount of the reserve, they reviewed current profits and considered the historical growth of the newspaper, including its increased circulation and its unbroken history of substantial net earnings after taxes. Despite the paper's current profitability, the court allowed the accumulation. It reasoned that the company's liability was contingent only as to the amount, not as to its existence. The court further stated that no management group would ignore the existence of such a liability, and the setting aside of a reserve out of such accumulated surplus was entirely proper.

A bonus fund set up for key employees may, however, be impermissible. For example, in Simons-Eastern Co. v. United States, the court ruled that a bonus plan was not a reasonable need. The court reasoned that it is imprudent for a company to

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98 Id.
100 Id.
101 A profit-sharing agreement guarantees a retirement benefit based on a percentage of net profits. An increment agreement, on the other hand, will pay a future benefit based on the increase or decrease in the value of the company throughout the time of employment.
continue to pay bonuses out of earned surplus, if, in fact, the
current business is not profitable.\textsuperscript{103} Traditionally, bonuses are
paid in profitable years and are normally paid out of current
profits alone. Additionally, the court stated that there must be
sufficient delineation of the reserves during the taxable year to
warrant the accumulation. Further, the court held that a general
or uncertain idea of possible future need is insufficient to justify
a retention.\textsuperscript{104}

7. Protection Against Miscellaneous Contingent Liabilities

Earnings and profits may be accumulated by companies in antici-
pation of certain other contingent liabilities. In evaluating
the propriety of such accruals, the Service and the courts focus
on the likelihood that the liability will occur.\textsuperscript{105} In \textit{Delhar, Inc. v. United States},\textsuperscript{106} a district court upheld a corporation’s reten-
tion of earnings to meet a contingent leasehold liability. In \textit{Del-
har}, actual litigation was threatened if certain leased premises
were not restored to their original condition. The court based its
decision on the probability that the money set aside would be
used to defend the corporation in litigation.

In a recent case,\textsuperscript{107} the Tax Court dealt with the creation of an
earnings reserve for various liabilities of a liquidating subsidiary.
Under the court’s first holding, the taxpayer-corporation could
retain earnings to pay reasonably anticipated federal taxes in-
curred by its subsidiary. The taxpayer also faced potential lia-
iblity over the condition of buildings it owned with another person.
The taxpayer was occupying the building and had refused to pay
rent to the co-owner until the co-owner repaired the deterior-
ated and dangerous areas. Litigation ensued between the par-
ties. The taxpayer knew that settlement of the suit would result
in an exchange of its one-half interest to the co-owner and that
the taxpayer would then be forced to move its business opera-
tions. The court held that since the parties agreed to this ex-
change arrangement in settling the suit, a need for future busi-

\textsuperscript{103} \textit{Id.} at 1010 n.5.
\textsuperscript{104} \textit{Id.} at 1009. Similarly, the court felt that even key employees could not
reasonably anticipate such payment and that failure to pay bonuses in a bad
year is not a real hazard or risk to this company. \textit{Id.} at 1010 n.5.
\textsuperscript{105} Alma Piston Co. v. Commissioner, 35 T.C.M. (CCH) 464 (1976).
\textsuperscript{106} 71-1 U.S.T.C. ¶ 9107 at 85,532 (S.D. Fla. 1970).
\textsuperscript{107} Estate of Kreisel, 37 T.C.M. (CCH) 264 (1978).
ness buildings was a real consideration on the part of the taxpayer. Accordingly, the accumulations to prepare for future construction costs were for reasonable business needs even though the taxpayer did not know the exact amount necessary to construct the building. 108

In *Marie’s Shoppe, Inc. v. Commissioner,* 109 the taxpayer faced the possible imposition of the accumulated earnings tax penalty. The Tax Court held that the taxpayer did not have to know the exact amount of the proposed tax in order to consider it a contingent liability. 110 The court stated, however, that a taxpayer cannot begin to accumulate for a possible liability until he or she becomes aware of its actual possibility; only then is it reasonable to anticipate the expense. 111

Revenue Ruling 70-301 112 supports the Tax Court finding in *Marie’s Shoppe.* The ruling provides that the amount of an accumulated earnings tax is a reasonable need of the business for taxable years in which it is a contingent liability. It follows that the associated or alternative expenses for legal and accounting advice would also be a reasonably anticipated need of the business for those years.

**CONCLUSION**

By attempting to force corporate distribution of profits, the accumulated earnings tax has a significant impact on corporate tax planners. Its harsh penalty provisions are, however, subject to numerous exceptions. These exceptions, based generally on reasonable business needs, are sufficiently flexible to permit earnings accumulations necessary to finance myriad business needs. The specific exemptions, and the cases construing them, are cast in technical terms. Corporate tax planners must, therefore, take great care in planning an accumulation; records must

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108 *Id.* at 274. In upholding the accumulation, the court emphasized that a corporation may accumulate earnings and profits for a contingent liability if “it’s reasonable for a prudent business firm to expect that such need might arise.”


110 *Id.* at 554. “While the amount of the proposed tax was unknown to petitioner at the time of the notification, we cannot say that it was unreasonable for petitioner to have made an allowance for payment of the tax.”

111 *Id.*

112 Rev. Rul. 70-301, 1970-1 C.B. 139.
be kept and plans must be concrete. If, however, the planner charts the proper course, the corporation will succeed in both avoiding the tax and accomplishing its business objective.

Renée Raimondi