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Accumulating Surplus for Business Needs

Fred D. Kidder*

The improper accumulation of surplus by a corporation will expose its annual accumulated taxable income to the accumulated earnings tax. The tax is computed at a rate of twenty-seven and one-half per cent on accumulated taxable income up to 100,000 dollars and thirty-eight and one-half per cent on the accumulated taxable income in excess of 100,000 dollars.

The purpose proscribed by the statute is a subjective intent to form or use a corporation to avoid the payment of income tax. The

* The author requests that this article be read in conjunction with that of Mr. Robert G. Skinner which appears at 17 W. RES. L. REV. 737 (1966).

1 INT. REV. CODE OF 1954, §§ 531-37 [hereinafter cited as CODE §§].

2 CODE § 531.

3 CODE § 532(a).


5 The regulations state that, in this regard, the Commissioner will consider dealings between the corporation and its shareholders such as withdrawals for personal loans, the expenditure of corporate funds for the personal benefit of the shareholders, or the investment by the corporation of undistributed earnings in assets having no reasonable...
statutes, regulations, and decisions contain numerous guidelines for the solution of the "formed or availed of" issue. Nearly every case involving the problem of an unreasonable accumulation of earnings will require an objective consideration of the reasonable needs of the business. It is the purpose of this article to explore some of the problems which commonly arise during such a consideration.

Although there have been statements to the effect that the accumulated earnings tax will be imposed where the proscribed purpose is present, even though all of the earnings and profits of the corporation are required for the reasonable needs of the business, such statements do not seem to reflect a proper analysis of the sections of the Internal Revenue Code that deal with the imposition of the tax on the unreasonable accumulation of earnings. The better statement of the law on this point appears to be that so long as the reasonable needs of the business require the accumulation of the earnings and profits of the corporation, no accumulated earnings tax will be imposed on the earnings and profits for the tax year. Thus, where it can be established that the accumulation of the corporation's earnings and profits was for the reasonable needs of the business, this should allow the following practical conclusions: (1) There was no purpose to avoid the income tax with respect to the


8 It is not the purpose of this paper to explore, in separate detail, the limited question of whether a corporation has been formed or availed of for the proscribed purpose. See Sullivan, Prohibited Purpose for Accumulation of Earnings, 17 W. Res. L. Rev. 712 (1966).


9 Conversely, there are decisions to the effect that an accumulation of earnings and profits beyond the reasonable needs of the business may exist where the proscribed purpose is not present. See, e.g., Bremerton Sun Publishing Co., 44 T.C. 566 (1965).

10 The determination of accumulated taxable income upon which the accumulated earnings tax is imposed involves various adjustments to the taxable income of the corporation in order to arrive at the corporation's accumulated taxable income. One such adjustment is the deduction for the accumulated earnings credit which is the amount of the earnings and profits that is being retained for the reasonable needs of the business. This credit is not less than the amount by which $100,000 exceeds the accumulated earnings and profits at the close of the preceding taxable year. Code §§ 535(a), (c). See Freedom Newspapers, Inc., P-H 1965 Tax Ct. Rep. & Mem. Dec. (34 P-H Tax Ct. Mem.) § 65248 (Sept. 15, 1965). See also text accompanying notes 1-9 supra.
corporation's shareholders; and (2) There is no accumulated taxable income in the year under consideration.\(^{11}\)

## I. THE BALANCE SHEET

### A. Demonstration of Financial Liquidity

The corporation's balance sheet for *federal income tax purposes* is probably the best place to begin an analysis of questions concerning unreasonable accumulation of earnings and profits.\(^{12}\) The accumulated earnings and profits reflect the end result of the operations of the business. An analysis of the retained or accumulated earnings and profits of the corporation is not meaningful apart from a consideration of the nature of the accumulation. The corporation must be in a sufficiently liquid financial position during the tax years in issue in order to allow the conclusion that the corporation had ample funds for its needs and thus should have made a distribution of a dividend to its shareholders.\(^{13}\) The Tax Court has stated this proposition as follows: "The question is primarily one of determining whether the taxpayer has enough liquid assets (not surplus) to meet estimated needs, including demands for working capital, plant expansion, and all reasonable contingencies."\(^{14}\)

If the assets of the corporation are not liquid, even though substantial accumulated earnings and profits appear on the balance sheet, the corporation should be able to demonstrate that its accumulated earnings and profits are being utilized for the reasonable needs of the business. A simple example may help to demonstrate this point. Assume a calendar year corporation with a December 31, 1965 balance sheet as follows:\(^{15}\)

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\(^{11}\) Since there is no accumulated taxable income, there can be no accumulated earnings tax. See John P. Scripps Newspapers, 44 T.C. 453 (1965).


\(^{15}\) The example is perhaps somewhat unrealistic from a business point of view.
XYZ CORPORATION
Balance Sheet
December 31, 1965

ASSETS

<table>
<thead>
<tr>
<th>Current Assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$1,000</td>
</tr>
<tr>
<td>Other Current Assets</td>
<td>$49,000</td>
</tr>
<tr>
<td>Total Current Assets</td>
<td>$50,000</td>
</tr>
<tr>
<td>Fixed Assets</td>
<td></td>
</tr>
<tr>
<td>Plant &amp; Equipment</td>
<td>$300,000</td>
</tr>
<tr>
<td>Total Assets</td>
<td>$350,000</td>
</tr>
</tbody>
</table>

LIABILITIES

| Current Liabilities            | $50,000       |

NET WORTH

| Capital Stock                  | $10,000       |
| 1965 Net Earnings              | $25,000       |
| Accumulated Earnings           | $265,000      |
| Total Net Worth                | $300,000      |
| Total Liabilities and Net Worth| $350,000      |

In this example, there are 290,000 dollars of accumulated earnings and profits. When the asset side of the balance sheet is examined in conjunction with existing liabilities, it becomes difficult to conclude that the corporation is exposed to the accumulated earnings tax for 1965. This does not mean that XYZ Corporation may not have future problems involving the unreasonable accumulation of earnings and profits, nor that XYZ Corporation did not have such a problem in some previous year. The example does demonstrate, however, that once the size of the accumulated earnings and profits for federal income tax purposes has been determined, the unreasonable-accumulation-of-earnings analysis must be primarily concerned with the asset side of the balance sheet to determine the size and utilization of the liquid assets together with a consideration of the current obligations of the corporation.

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16 It should be noted that all of the earnings and profits of a corporation that have not been divided or distributed to its shareholders constitute an accumulation of earnings and profits. Reg. § 1.535-3(b)(1)(ii) (1959).

17 The only source from which dividends can be paid.

18 The analysis of whether the accumulated earnings tax should be imposed for the tax year under review.
B. Assets Likely to Encourage the Penalty

At some stage in an Internal Revenue audit proceeding involving the issue of unreasonable accumulation of earnings, a corporation's financial condition at the end of various years will become the subject of analysis. This analysis generally will involve the use of comparative balance sheets of the corporation which either have been specially prepared for the case or are a collection of the balance sheets that were prepared as a part of the various federal income tax returns of the corporation. The balance sheets may constitute the first impression of the case for the examining agent or other person who may be asked to review the problem. The existence of certain assets of the corporation, as reflected in the balance sheet, may suggest to an examining agent that the possibility of an unreasonable accumulation of earnings should be further explored. Assets that fall within this category include: (1) an apparent excess of cash not needed for operations; (2) an excess investment in bonds, certificates of deposits, savings accounts, and related substitutes for ready cash; (3) investments in stocks or securities which do not constitute control of at least eighty per cent of one or more corporations conducting active businesses; (4) notes receivable representing loans to shareholders; and (5) investments in assets that primarily benefit or accommodate the shareholders rather than the business and which have no reasonable connection with the conduct of the business.

C. Choice of the Tax Year

One or more of the above items may appear in the balance sheet of a corporation which, for many reasons, probably could not be charged with the accumulated earnings tax. On the other hand, many of these items either would not appear in the balance sheet or would appear as a much smaller amount, if a different fiscal year-end had been utilized in the preparation of the balance sheet. The initial choice of the tax year of the corporation may have a direct bearing on the corporation's exposure to an assertion of the accumulated earnings tax. Frequently, the selection of the corporation's tax year is made so that the books may be closed at a time when the inventories and the accounts receivable are at minimum levels

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19 With the examining agent, conference staff, or the appellate division.
20 Reg. § 1.537-3(b) (1959). See text accompanying notes 35-37 infra.
21 And necessarily its year-end for balance sheet purposes.
and the cash balance is most favorable. Although taking these factors into consideration may result in the presentation of a good financial statement for creditors, banks, and shareholders, a balance sheet prepared at such a time might create a harmful first impression in an examining agent who will be viewing a balance sheet position of high liquidity. However, if the tax year of the corporations ends at a time when the needs of the business are at a peak, the balance sheet should reflect a more favorable position for the taxpayer since any substantial amount of cash needed to finance peak business requirements will be reflected in the balance sheet, not as cash, but as a part of other business asset items.

II. CORPORATE STRUCTURE PLANNING

Careful planning of the corporate finance structure may postpone substantially the time when the accumulated earnings tax will be imposed on the operations. Opportunities for such planning exist at the time of initial incorporation and at each time new financing occurs. At the time of incorporation, if the shareholders, by way of equity investment, provide all the funds needed to construct the plant, buy the necessary equipment, purchase the raw materials, and provide cash for adequate working capital, then cash subsequently generated by the earnings and profits of the corporation will probably be available for dividend distribution to the shareholders at a relatively early date. This will normally be true unless the corporation expands its operations, acquires additional facilities, or diversifies its operations in an acceptable manner. On the other hand, the prospective owners of a business, either because of appropriate planning or economic necessity, may start the corporation with the assistance of substantial creditor financing thus providing business with "leverage." Leverage is present in the corporate structure itself. See KOHLER, A DICTIONARY FOR ACCOUNTANTS 291 (2d ed. 1957), wherein the author speaks of capital leverage as follows:

Capital leverage, referring to the distribution of income among the equities, is large when most of the capital is in the form of fixed commitments, such as bonded debt and preferred stock, and only a small proportion is in the form of...
financing structure where, for example, the corporation finances a large portion of its real estate by using a purchase money mortgage, buys its machinery and equipment on credit, factors its inventory, discounts its receivables, borrows short-term funds for general corporate purposes, obtains working capital through long-term notes or debentures, or raises cash through the use of redeemable or sinking-fund, preferred stock. In each situation, the corporation, in one way or another, has created payment obligations by the use of leverage, and cash will be needed either immediately or prospectively to discharge the obligations so incurred.

The posture of the statute, the regulations, and the case law in this area strongly suggest the conclusion that the corporation with the greatest leverage in its financial structure will reap the benefit of a longer moratorium from attack under section 531 of the Internal Revenue Code. In a leverage situation, the corporation’s funds will be needed to reduce the obligations that created the “leverage.”

III. Testing Reasonable Business Needs

Although it is very difficult to classify into separate types or groups the accumulated earnings tax cases involving the issue of the reasonable needs of the business, two broad classifications may be helpful in the analysis of some of the cases in this area. These classifications are: (1) those cases in which there has been a diversion of funds to an asset which to the Commissioner appears on its face to be an “unrelated investment”; and (2) those cases in which there has been an apparent accumulation of a large amount of cash or its equivalent without any diversion to an unrelated investment. It must be recognized that these two classifications overlap in many respects, and in all likelihood no single case can be characterized as falling entirely within one of the two categories.

of common stock which receives all income after costs and fixed commitments, such as bond interest, are met; under such conditions, small fluctuations in net income tend to produce large variations in earnings per share of common stock. *Ibid.*

27 Where a substantial portion of the corporation’s earnings and profits is committed to the servicing of debt, there exists reasonable business justification for utilizing the earnings and profits for the debt servicing.

28 The cases dealing with the unrelated investment problem are concerned with the question of the reasonable needs of the business, as are the cases that consider an apparent accumulation of a large amount of cash. The classification is suggested only as a guide in the analysis of the cases, and no attempt is made here to consider the cases dealing with stock redemptions under the accumulated earnings tax.
A. Diversion of Funds to an Unrelated Investment

In the "unrelated investment" area, the conclusion that funds of the corporation have been diverted to investments unrelated to the business may suggest, at first glance, that a section 531 violation has been established against the corporation.\textsuperscript{20} Admittedly, a finding (or a concession by the taxpayer) that an unrelated investment of the corporation's assets exists can be harmful to the taxpayer's case; however, this fact should not be taken as determinative. An opposite answer would mean, for example, that in every case in which a corporation has loaned funds to its shareholders an assessment of the accumulated earnings tax would result. This is not the result of the cases.\textsuperscript{30}

The unrelated investment problem should be subdivided into two categories. The first includes those cases in which the unrelated investment of the corporation occurs in the year in which the accumulated earnings tax is being asserted. The second includes those cases in which the unrelated investment of the corporation occurred in one or more of the years prior to the year in which the accumulated earnings tax is being asserted.

Where an unrelated investment has been made in the year in which the accumulated earnings tax is being asserted, the corporation will have to establish that such an investment was temporary and that the reasonably anticipated needs of the business will require the use of such invested funds. If this cannot be established, the corporation will have a difficult time otherwise answering the argument of the Commissioner that, to the extent of the unrelated investment, current earnings and profits were not needed in the business and should have been distributed.\textsuperscript{31}

Where the investment occurred in a year prior to the year in which the accumulated earnings tax is being asserted, a different situation arises. In such case there has been no diversion of the current earnings and profits of the corporation. In this type of situation, to the extent that the corporation previously invested its


\textsuperscript{31} To the extent that the Commissioner can establish that a particular investment in assets is to be classified as "unrelated," he can argue that the corporation itself has determined that such investment-amount is not needed in the business and, to that extent, should have been distributed. There are, however, many situations where, despite the admitted reasonable needs of the business, funds may have been diverted to a use which may be classified as an unrelated investment.
funds in assets unrelated to its business, these unrelated investments should be classified as a liquid asset — the equivalent of cash. The case should then proceed to the further determination of whether the corporation's cash and its equivalents are reasonably needed in the business.

It should be noted that what may appear to be an unrelated investment may, in fact, be an investment in a second business of the corporation. As the corporation expands its main business, it may also want to consider diversification. The decision to diversify and the actual process of diversification may extend over a period of time. A direct diversification by engaging in the new business will often not create any particular problem. Where the new business, however, is one that consists of such activities as the lending of funds, a problem may arise as to whether such an activity is a separate business or is merely a method of selecting an investment portfolio for the corporation. In a recent case, the Tax Court noted that a corporation may have more than one business and that if its loan activities reach the magnitude of constituting a separate business, the funds of the corporation devoted to the separate business will not be considered a mere liquid investment used to retain the corporation's earnings and profits.

Not every investment by a corporation in the stock of another corporation is to be classified as an unrelated investment. In many cases it may be necessary to the conduct of a business to invest funds of the corporation in the stock of a supplier or a customer. Such investments are recognized as permissible and will not subject the corporation to a penalty tax.

The business of a corporation may encompass more than activities that were conducted previously and will ordinarily include any line of business that the corporation may undertake. Often a corporation will conduct a part of its business through a controlled subsidiary. Where a corporation owns eighty per cent of the voting stock of a second corporation which is not a mere holding or investment company, the business of the second corporation will be con-

33 Reg. § 1.537-2 (b) (5) (1959).
34 Reg. § 1.537-3 (a) (1959).
35 Where the accumulated earnings tax is concerned, the business of a corporation may include the active business being conducted by another corporation. See Reg. § 1.537-3 (b) (1965).
considered that of the controlling parent corporation. 36 Where a parent corporation controls less than eighty per cent of the voting stock of a subsidiary, the regulations provide that the question of whether the funds of the parent corporation are being employed in the conduct of its own business will depend upon the particular circumstances of the case. 37

Perhaps the most difficult question confronting a corporation which encounters the problem of an unrelated investment concerns the use of its funds for loans to its shareholders. The Commissioner has taken the position that the loaning of funds by a corporation to its shareholders will in itself indicate that funds of the corporation are being accumulated beyond the reasonable needs of the business. 38 It would appear quite difficult to justify a loan by the corporation to its shareholders in many cases. However, the courts have not imposed the accumulated earnings tax merely upon the basis of a finding that such a loan exists. 39 Such loans should be classified as a part of the corporation's liquid assets in the over-all determination of whether the accumulation was for the reasonable needs of the business. 40 From a planning standpoint, loans of this type should be avoided whenever possible.

Where a corporation has diverted funds to a so-called unrelated investment, and the justification therefor is that the investment was only temporary, the subsequent facts should confirm the temporary


37 Reg. § 1.537-3(b) (1959). For example, the acquisition of a business enterprise through the purchase of a portion of the stock of another company with the expectation of eventually acquiring the business should qualify the investment in the stock as being employed in the business, and it should not be an unrelated investment. Reg. § 1.537-2(b)(2) (1959); cf. Omar Real Estate Corp., P-H 1965 TAX CT. REP. & MEM. DEC. (34 P-H Tax Ct. Mem.) § 65189 (July 13, 1965).


39 The Tax Court has been very impressed by the absence of any shareholder loan. See Bremerton Sun Publishing Co., 44 T.C. 566 (1965). In Freedom Newspapers, Inc., P-H 1965 TAX CT. REP. & MEM. DEC. (34 P-H Tax Ct. Mem.) § 65248 (Sept. 15, 1965), the court emphasized the absence of any shareholder loan at the same time as it noted that the corporation had not distributed any dividends to its shareholders in the year under review.


For these reasons, we conclude that the note may properly be considered a current asset for our purposes as of December 31, 1957. Indeed, had the circumstances been other than they were, the existence of such an outstanding loan to the principal shareholder, without security or interest, might be strong evidence of the purpose proscribed by the statute. Id. at 10.
nature of the investment if the corporation is to succeed in this argument. For example, where the corporation has a definite plan for plant expansion, the appearance on the balance sheet of one or more temporary, unrelated investments is to be expected. When the plant is constructed, these investments should be liquidated for the intended use. Any investment that is unrelated to the business generally is valued at its present fair market value when the availability of funds for use in the business is being considered.

B. Accumulation of Funds Without Diversion to Unrelated Interests

Cases in which a corporation is being charged with an unreasonable accumulation of earnings and profits, and in which there is no unrelated investment of assets, involve a definition or ascertainment of the current and reasonably anticipated needs of the business and a comparison of these needs with the corporation's accumulated earnings and profits. Again, this comparison is not meaningful apart from a consideration of the nature of the accumulated earnings and profits.

In an apparent attempt to provide an objective analysis of the current needs of the business, some courts have held that a corporation should be permitted to accumulate sufficient earnings to meet operating expenses for one year. This rule, however, is no more than a guide in this area. One recent case considered the fact that a taxpayer's surplus was less than two-thirds of its an-

42 Even here, at the time of the later plant expansion, the corporation might find it wise temporarily to use the unrelated investment as collateral for a loan to obtain the funds to build part or all of the plant, thereby postponing the impact of the federal income tax on any gain on the investment that may exist. The pledging of securities to guarantee a line of credit is a recognized procedure. Ted Bates & Co., P-H 1965 Tax Ct. Rep. & Mem. Dec. (34 P-H Tax Ct. Mem.) §65251 (Sept. 17, 1965).
44 A large accumulation of earnings and profits is not, per se, grounds for the imposition of the accumulated earnings tax. Electric Regulator Corp. v. Commissioner, 336 F.2d 339 (2d Cir. 1964); John P. Scripps Newspapers, 44 T.C. 453 (1965). See HOLZMAN, THE TAX ON ACCUMULATED EARNINGS 17 (1956).
annual operating costs to be favorable to the taxpayer. In another case, the surplus was in the neighborhood of three-fourths of the annual operating costs and the court likewise found in favor of the taxpayer. It does seem highly desirable, however, to have some objective standard by which a corporation can judge the degree of its possible exposure to the accumulated earnings tax. Perhaps the most significant step in this area was taken by the Tax Court in Bardahl Mfg. Corp. There the court applied a "cash" cycle or single operating cycle concept, viewing the reasonable needs of the business as including the right of the corporation to retain sufficient cash to finance one operating or cash cycle.

The current needs of the business also may include the need to accumulate for (1) substantial hazards resulting from the nature of the business; (2) recurring situations that result in substantial work stoppages such as annual labor union contracts; (3) the extreme cyclical nature of the business; (4) self-insurance; (5) unresolved, pending litigation or claims against the corporation; or (6) immediate activity in the industry should an opportunity for an advantageous purchase of machinery or materials arise where the usual cost for such items is high. Naturally, mere arguments that these factors could exist will not suffice; however, in many cases one or more of these factors may actually exist despite the possibility that little publicity has been given to this fact in the corporate records, since the item is so common to the normal demand of the particular business.

In addition to accumulation of earnings to meet the current needs of the business, there may be additional accumulation for the reasonably anticipated needs. A taxpayer need not incur indebtedness in order to expand, and he is permitted to accumulate cash for that purpose. The Tax Court, however, has stated that a taxpayer's plans in connection with a proposed acquisition or program of expansion must be definite and certain before these plans will be considered

51 The cash cycle objective analysis concept as well as a critical analysis of Bardahl are discussed in Skinner, Reasonable Needs of the Business, 17 W. RES. L. REV. 737 (1966).
52 CODE § 537.
as reasonably anticipated needs of the business.\textsuperscript{54} The specificity of these plans must be judged in the light of the particular problems common to the taxpayer's business.\textsuperscript{55}

IV. CONCLUSION

As case law develops, it is hoped that, because of the costly impact of the accumulated earnings tax, objective standards may emerge to provide a guide to corporations in the difficult area of reasonable business need. The corporate income tax imposed by section 11 and the accumulated earnings tax imposed by section 531 present a three-tier system. Where the accumulated earnings tax is asserted and there is no adjustment to the corporation's taxable income in computing the accumulated taxable income, except for the federal income tax under section 11, the overall effective tax rate of the corporation, that is, the normal tax, the surtax, and the accumulated earnings tax, may be expressed as follows:

<table>
<thead>
<tr>
<th>Taxable Income Brackets</th>
<th>Effective Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 - $25,000</td>
<td>43.45%</td>
</tr>
<tr>
<td>$25,000 - $180,000</td>
<td>62.30%</td>
</tr>
<tr>
<td>over $180,000</td>
<td>68.02%</td>
</tr>
</tbody>
</table>

In addition to exposure to these high rates of corporate tax, the earnings and profits of the corporation for a particular year after payment of the accumulated earnings tax are not sheltered in any way. When distributed, these earnings and profits are taxable as dividends to the shareholders and also retain their character as accumulated earnings and profits when a subsequent year is examined on the issue of unreasonable accumulation of earnings and profits.

\textsuperscript{54} \textit{Ibid.}