NORTH CAROLINA LAW REVIEW

Volume 51 | Number 1 Article 8

11-1-1972

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CORPORATE LIQUIDITY, RESERVES, AND THE ACCUMULATED EARNINGS TAX.

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INTRODUCTION

In determining the applicability of the accumulated earnings tax to a corporation that has permitted its earnings and profits to accumulate beyond the reasonable needs of the business, section 537 of the Internal Revenue Code specifies that reasonable needs shall include "the reasonably anticipated needs of the business."[1] Though the tax has been in existence since the Revenue Act of 1921,[2] this section was first placed in the Internal Revenue Code of 1954. Its purpose was to eliminate the requirement imposed by some examining revenue agents that there "be an *immediate* need for the funds in order to justify the retention of earnings."[3] It was contemplated that "this amendment will cover the

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[1]INT. REV. CODE OF 1954, § 537. Actually, the statutory scheme of § 531 imposes a tax on accumulated taxable income (27½% of the first $100,000 and 38½% of the excess) "of every corporation described in section 532." *Id.* § 531. "Accumulated taxable income" is defined in *id.* § 535, and a corporation made subject to the tax by § 532 is any corporation that is not a personal holding company (as defined in § 542), a foreign personal holding company (as defined in § 552), or a corporation that is exempt from taxation under Subchapter F (§§ 501-26) (an exempt organization) and that is "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed." *Id.* § 532(a). Reasonable needs of the business are relevant because § 535(c)(1) allows a credit, or deduction, in computing "accumulated taxable income" of "an amount equal to such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business," *id.* § 535(c)(1), and because "the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary." *Id.* § 533. In view of this obstacle, and in view of the holding of the Supreme Court in United States v. Donruss Co., 393 U.S. 297 (1969), that avoidance of the income tax with respect to shareholders need not be the sole purpose for the unreasonable accumulation nor the dominant, controlling or compelling motive but need only be one of the purposes of the accumulation for the tax to apply, defense of a corporation against assessment of the accumulated earnings tax often becomes a practical matter of proving the reasonable needs of its business.

[2]Revenue Act of 1921, ch. 136, § 220, 42 Stat. 247. The Revenue Act of 1918 placed the tax on the shareholders "as though members of a personal service company." United Business Corp. of America v. Commissioner, 62 F.2d 754, 756 (2d Cir. 1933), *cert. denied*, 290 U.S. 635 (1933) (defending the 1921 Act provision against accusations of unconstitutional vagueness and retroactivity).

[3]H.R. REP. No. 1337, 83d Cong., 2d Sess. 53 (1954) (emphasis added). The committee noted:

case where the taxpayer has specific and definite plans for . . . use in the business. It would not apply where the future plans are vague and indefinite, or where execution of the plans is postponed indefinitely."[4]

The tax regulations under section 537, proposed January 15, 1958, and adopted May 12, 1959, echo the Congressional committee reports:

> In order for a corporation to justify an accumulation of earnings and profits for reasonably anticipated future needs, there must be an *indication that the future needs of the business require such* accumulation, and the corporation must have specific, *definite,* and feasible *plans* for the use of such accumulation. Such an accumulation need not be used immediately, nor must the plans for its use be consummated *within a short period after the close of the taxable year,* provided that such accumulation will be used within a reasonable time depending on all the facts and circumstances relating to the future needs of the business. Where *the future needs of the business are uncertain or vague, where the plans for the future use of an accumulation* are not specific, definite, and feasible, or where the execution of such a plan is postponed indefinitely, an accumulation cannot be justified on the grounds of reasonably anticipated needs of the business.[5]

This article will examine certain administratively and judicially developed standards of reasonably anticipated business needs as they relate to the financial decisionmaking process of management in a closely held corporation,[6] and more specifically, whether these stan-

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"In some cases section 102 [now section 531] was applied even though the corporation had definite plans for expansion and the bona fides of the expansion program were not in question." *Id.*

[4] *Id.* The Senate committee's statement is identical. S. REP. No. 1622, 83d Cong., 2d Sess. 69 (1954).

[5] Treas. Reg. § 1.537-1(b)(1) (1959) (emphasis added).

[6] In the House version, the Internal Revenue Code of 1954 contained a provision which would have excepted from the accumulated earnings tax any corporation that submitted proof that its outstanding stock was owned by more than 1,500 persons and that not more than 10 percent of either the total combined voting power or the total value of all classes of its outstanding stock was directly or indirectly owned by any one individual at the close of the taxable year. H.R. REP. NO. 1337, 83d Cong., 2d Sess. 54, A172 (1954). This provision was eliminated in the Senate committee because "testimony . . . indicated that it would be very difficult for many corporations which are generally recognized to be publicly held to establish from its records that not more than 10 percent of its stock is held by an individual and members of his family" and, more cogently perhaps, because of "[t]he fact that this tax is not now in practice applied to publicly held corporations." S. REP. No. 1622, 83d Cong., 2d Sess. 68-69 (1954). This practice continues. *See generally* 7 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 39.54 (1967). In Golconda Mining Corp., 58 T.C. 139 (1972) the Tax Court concluded

> as a matter of law that the accumulated earnings tax can apply to publicly held corporations. [But this] should only occur where the fact of public ownership is neutralized by

dards reflect the realities of corporate financial needs and planning as they might exist if uninfluenced by tax motives.[7]

It is implicit in the contention that a tax system is a revenue-raising system that the business and economic decisions of taxpayers should be untainted by tax avoidance motives. Though, in the well-known words of Learned Hand, "there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible,"[8] taxpayers ideally ought not to have to resort to such arrangements when the exigencies of the marketplace would indicate a different course. However imperfect an economic system may be, the minimization of the effects of taxes on economic planning seems to be a worthwhile goal.[9]

It is explicit in the statutory scheme of the accumulated earnings tax that tax avoidance motives should have no relevance to earnings and profits that are retained for the reasonable needs of business. The general rule of section 532(a) and the section 535(c)(1) credit leave no doubt about that. Yet in a context that requires judicial and administrative determination of what are "reasonable" or "unreasonable" business needs, to what extent is it realistic to expect that considerations of such motives will be ignored? The primary contention of this article is that

> the manner in which the company has been managed. If the management group is dominated by a single large shareholder or a small group of large shareholders who exercise effective control over the dividend policy of the company or the company represents itself to prospective or existing shareholders as an investment company with the avowed policy of accumulating its investment income, public ownership of the company becomes a less important factor in determining whether earnings and profits have been accumulated for the proscribed purpose.

Id. at 158 (footnotes omitted).

[7]There is a gap, of course. *See* Treas. Reg. § 1.533-1(a)(2) (1959). It is theoretically possible that a corporation could accumulate earnings and profits for anticipated needs not meeting the INT. REV. CODE OF 1954, § 537 standards and nevertheless prove "by the preponderance of the evidence" that no tax avoidance motive existed, *e.g.*, that however unspecific indefinite or unreasonable its plans were, they were real plans genuinely based on corporate rather than stockholder interests. Though this possibility tends to obviate the test of reasonableness, reducing it to one of genuineness and credibility, in view of United States v. Donruss Co., 393 U.S. 297 (1969), it is an unlikely strategy of proof. *But see* T.C. Heyward & Co. v. United States, 18 Am. Fed. Tax R.2d 5775 (W.D.N.C. 1966).

[8]Commissioner v. Newman, 159 F.2d 848, 850-51 (2d Cir.) (in dissent on another point), *cert. denied*, 331 U.S. 859 (1947).

[9]The desire for economic neutrality in the tax structure is very much present in the arguments favoring a "comprehensive tax base" criticized in Bittker, *A "Comprehensive Tax Base" As a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967). Reference is made to the sources cited therein. Professor Bittker's criticism has to do principally with the impossibility of practical achievement, but perhaps that has little to do with its desirability.

the regulatory scheme in respect to "reasonably anticipated needs of the business" demonstrates an improper reference to suspected tax avoidance motives that is a basic and perhaps irremediable defect in the accumulated earnings tax structure.

Courts and the Business Judgment of Corporations

The Tax Court consistently has professed its faith in the business judgment of corporations and its unwillingness to substitute its judgment for that of corporate directors in the determination of the reasonableness of corporate accumulations.[10] As summarized by the Eighth Circuit in *Bride v. Commissioner,*[11] the Tax Court has expressed

> its full recognition that Section 102(a), now 532(a), does not empower the court to substitute its judgment for the judgment of the corporate officers in the matter of whether or not corporate dividends should be declared.
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> . . . The Tax Court has settled in numerous decisions approved on review, that determination of reasonable needs of its business is in the first place a task for the officers and directors of a corporation; that the court would be hesitant to attribute a sinister or ulterior motive to them [and] that the law contemplates that any business may grow and may finance its proper expansion and plow its earnings back into the business for immediate use and Section 102 is not based on the contemplation that a business should remain static.[12]

Further evidence of courts' professed liberal attitude toward business planning is the rule that a corporation does not have to specify on its books surplus reserves intended to cover reasonably anticipated needs of the business.[13] On the other hand, and consistent with the

[10] Dill Mfg. Co., 39 B.T.A. 1023, 1031, *not acquiesced in,* 1939-2 CUM. BULL. 47. The *Dill* case cited Klug & Smith Co., 18 B.T.A. 966, *acquiesced in,* IX-2 CUM. BULL. 33 (1930) (on the reasonableness of executive salaries). This case was decided under § 104 of the Revenue Act of 1932, which provided that "the fact . . . that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax." Revenue Act of 1932, ch. 209, § 104(b), 47 Stat. 169. The Revenue Act of 1938 initiated the provision that this fact "shall be *determinative* of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary." Revenue Act of 1938, ch. 289, § 102(c), 52 Stat. 447 (emphasis added). This language remains substantially unchanged to the present day.

[11] 224 F.2d 39 (8th Cir. 1955).

[12] *Id.* at 42.

[13] Smoot Sand & Gravel Corp. v. Commissioner, 241 F.2d 197, 207 (4th Cir. 1957): "The Statute imposes no such evidentiary requirement, nor is the mere book entry conclusive . . . that

"specific, definite, and feasible" requirements of the section 537 regulations,[14] courts are generally in agreement that "some objective evidence is still necessary to demonstrate that the taxpayer actually intends to carry out its spending program within a reasonable period of time."[15] Particularly in the one-man, closely held corporation in which the person "who obviously determined the policy and made the decisions for the company is the sole stockholder of the company,"[16] the Tax Court has not felt compelled to give much weight to a decision to accumulate reserves for anticipated needs of the business "unless it is supported by more tangible evidence . . . ."[17]

It is now appropriate to examine business planning as it confronts a "reasonable" business manager. Presumably, it is the reasonable business manager who, tax avoidance motives being absent, will not accumulate earnings and profits beyond the reasonably anticipated needs of the business. Like his cousin, "the reasonable man of ordinary prudence,"[18] he is "guided upon those considerations which ordinarily regulate the conduct of human affairs."[19]

Reasonableness in Practice

For this reasonable business manager the following types of problems might appear. These problems will be examined later in light of judicial and administrative views of what a "reasonably anticipated" business need is.[20]

Corporation A manufactures widgets by the age-old, tried-and-true, standardized method of widget making. The company foresees that it could sell more widgets since its market is limited only by its manufacturing capacity. In order to increase the capacity, Corporation A expects to build a new plant in 1973. Blueprints have been

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the reserve is for a reasonably anticipated business need."

[14]*See* text accompanying note 5 *supra.*

[15]Oklahoma Press Publishing Co. v. United States, 437 F.2d 1275, 1277 (10th Cir. 1971). *See also* Henry Van Hummell, Inc. v. Commissioner, 364 F.2d 746 (10th Cir. 1966), *cert. denied,* 386 U.S. 956 (1967).

[16]Walter C. McMinn, Jr., 31 P-H Tax Ct. Mem. 1003, 1021 (1962).

[17]*Id.* at 1022.

[18]Note that the tax regulations speak of "the amount that *a prudent businessman* would consider appropriate for the present business purposes and for the reasonably anticipated future needs of the business." Treas. Reg. § 1.537-1(a) (1959) (emphasis added).

[19]Blyth v. Birmingham Waterworks Co., 11 Ex. 781, 784, 156 Eng. Rep. 1047, 1049 (1856).

[20]*See* text accompanying notes 52-117 *infra.*

drawn, bids have been taken, the contract has been let, and construction will begin January 1. Is it reasonable for Corporation A to hold its accumulating 1972 earnings against the anticipated payment of the costs of construction and new machinery, rather than paying them out as dividends to its stockholders?[21]

Corporation B is engaged in the manufacture of munitions, which involves a high risk of explosion or fire. Is it reasonable (and if so, to what extent is it reasonable) that Corporation B set up a reserve against anticipated losses from fire or explosion?[22]

As a variation on the problem of Corporation B, Corporation C is faced with a substantial risk that is conventionally uninsurable—the risk of losing a major customer or client, for example.[23] Does the business reasonably need to accumulate funds to cover fixed operating costs if this contingency becomes a reality? If so, what fixed operating costs should be covered?

Corporation D operates a bus line in the District of Columbia. Its diesel-powered buses are substantial sources of air pollution. Not only is the enterprise faced with a variety of civil nuisance actions seeking both damages and injunctive relief, it also anticipates that the franchising authority will require prompt replacement of its bus fleet with pollution-free vehicles when those vehicles become available.[24] Gasoline-powered buses that produce lower levels of harmful emissions are currently available, and the company has accumulated sufficient funds to pay for them. However, management is aware that steam-powered buses which produce *no* harmful emissions are being developed, and

[21] Each of the corporations in these hypothetical examples uses the calendar year as its taxable year. The Internal Revenue Service has occasionally argued that funds used to pay dividends from a closely held corporation will still be available for the reasonable needs of the business in the form of subsequent contributions to capital. The courts have had little trouble rejecting this. *See, e.g.*, Smoot Sand & Gravel Corp. v. Commissioner, 241 F.2d 197, 205-06 (4th Cir. 1957); Faber Cement Block Co., 50 T.C. 37 (1968), *acquiesced in*, 1968-2 CUM. BULL. 2.

[22] Obviously, the cost and availability of insurance coverage through Lloyd's of London or elsewhere will bear upon the decision here. Conventional coverage on plant and equipment may be available at "reasonable" cost, but what about protection against business-interruption losses? Fortunately, this discussion is concerned not with the correctness of decisions, but with their "reasonableness," and the cost of available coverage may not correlate precisely with the reasonableness of a reserve. *See* Harry A. Koch Co. v. Vinal, 228 F. Supp. 782, 785 (D. Neb. 1964).

[23] *See, e.g.*, Ted Bates & Co., 34 P-H Tax Ct. Mem. 1476 (1965).

[24] *See, e.g.*, *In re* Greater Washington Alliance to Stop Pollution, Inc., 1 ENVIR. L. REP. 10055 (Aug. 21, 1969) (petition before Washington Metropolitan Area Transit Comm'n). This complaint alleged, however, that bus exhaust emissions could be adequately controlled by *present* technology.

tests of their operating efficiency are presently being conducted. No one now knows if these buses will be commercially viable. Should Corporation D be allowed to postpone replacement of its bus fleet until the testing of the pollution-free vehicles is completed?

Corporation E is a manufacturer of widgets and like Corporation A uses the age-old, tried-and-true widget-making method. All of its widget-making machines now in use were purchased new in the period 1950-1953, and they have been depreciated over an estimated useful life of twenty years using the straight line method. The company has set aside funds (equal to its accumulated depreciation plus an amount estimated to reflect the effect of inflation on replacement costs) to replace these machines as they wear out. However, as some of the machines become fully depreciated (there is no salvage value) in 1970, 1971, and 1972, the company maintains them in service rather than replacing them immediately. Though the machines are becoming gradually less efficient, the company anticipates that a new widget-making machine may become available in 1973, 1974, or shortly thereafter. No one knows with certainty that the new machine will really work, but if it does, it will revolutionize the industry to such an extent that those who haven't the funds to buy it will be forced out of the business. Is management reasonable in postponing its reinvestment? What if, at the same time, Corporation E (like Corporation A) is buying more of the old-type machines in order to increase its capacity?

The experienced business manager will undoubtedly be familiar with some variation of these five situations, and the experienced tax adviser will recognize at least the first three. In the language of the business manager and perhaps the tax adviser,[25] all of these problems involve the maintenance of liquidity. In what situations is it reasonable to continue to maintain liquidity in the face of the alternative uses of funds—immediate investment or perhaps the payment of dividends to stockholders?

ECONOMIC AND FINANCIAL THEORY

Incentives to Liquidity

In *The General Theory of Employment, Interest and Money,* Lord

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[25]*See* Ziegler, *The "New" Accumulated Earnings Tax: A Survey of Recent Developments,* 22 TAX L. REV. 77, 83-87 (1966).

Keynes identifies four "psychological and business incentives to liquidity."[26] the first of these is "the Income-motive," or "holding cash to bridge the interval between the receipt of income and its disbursement."[27] Lord Keynes advises that "the strength of this motive in incuding a decision to hold a given aggregate of cash will chiefly depend on the amount of the income and the normal length of the interval between its receipt and its disbursement."[28]

The second is holding cash "to bridge the interval between the time of incurring business costs and that of the receipt of the sales proceeds."[29] Lord Keynes calls this the "Business-motive," but students of business finance, and tax practitioners who have read the *Bardahl* cases,[30] will recognize this cash as necessary working capital.[31]

The third incentive is "the Precautionary-motive," which is intended "to provide for contingencies requiring sudden expenditure *and for unforeseen opportunities of advantageous purchases* . . . ."[32] This sounds very much like a motive that may be involved in each of the five hypothetical situations described previously, except that Company A's liquidity preference, involving as it does a need to expend fixed amounts at predictable points in time, may seem to some to fit better in the working capital category of business motives.[33] Lord Keynes observes:

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[26]*See* J.M. KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY 194-209 (MacMillan & Co. ed. 1965).

[27]*Id.* at 195.

[28]*Id.*

[29]*Id.*

[30]Bardahl Int'l Corp., 35 P-H Tax Ct. Mem. 1051 (1966); Bardahl Mfg. Corp., 34 P-H Tax Ct. Mem. 1123 (1965).

[31]That "the strength of this demand will chiefly depend on the value of current output (and hence on current income) and on the number of hands through which it passes," J.M. KEYNES, *supra* note 26, at 195-96, is not quite the way the Tax Court has described necessary working capital, but one should remember that Lord Keynes was speaking in macro-economic terms, and the Tax Court seldom, if ever, ought to do so. Lord Keynes' previously quoted observation in respect to the income motive may seem more familiar to *Bardahl* readers.

[32]J.M. KEYNES, *supra* note 26 at 196 (emphasis added).

[33]While the accounting profession defines "working capital" as "the excess of current assets over current liabilities," COMM. ON ACCOUNTING PROCEDURE, AM. INSTITUTE OF ACCOUNTANTS, ACCOUNTING RESEARCH BULL. NO. 43 at 21 (1953), the tax regulations speak in terms of "necessary working capital" (Treas. Reg. § 1.537-2(b)(4) (1959)) which, as defined by the Tax Court, is "an amount sufficient to cover its reasonably anticipated costs of operation for a single operating cycle." Bardahl Mfg. Corp., 34 P-H Tax Ct. Mem. 1123, 1130 (1965). It is more precise to refer to the former as net liquid assets and reserve the term "working capital" to describe operating cash needs *as distinguished* from other reasonably anticipated and extraordinary needs of the business, including expansion needs.

> The strength of all three types of motives will partly depend on the cheapness and the reliability of methods of obtaining cash, when it is required, by some form of temporary borrowing . . . For there is no necessity to hold idle cash to bridge over intervals if it can be obtained without difficulty at the moment when it is actually required. Their strength will also depend on what we may term the relative cost of holding cash. If cash can only be held by foregoing the purchase of a profitable asset, this increases the cost and thus weakens the motive towards holding a given amount of cash.[34]

The fourth incentive, the "Speculative-motive," is perhaps of less concern in the context of "reasonableness." If the corporate business manager is thought to have some fiduciary responsibility to the shareholder-investors, the reasonable manager ought not hold corporate funds for "speculative" purposes. Though, as Lord Keynes admits, "the amount of cash which an individual decides to hold to satisfy the transactions-motive [the first two motives together] and the precautionary motive is not entirely independent of what he is holding to satisfy the speculative-motive,"[35] the various business needs identified in the five described situations are speculative only to the degree that the term describes any uncertainty. The classification of these business needs as "precautionary," rather than "speculative," at once identifies them as "reasonable."[36]

But how do these economic forces operate in the financial decision-making process of a corporate business? While one familiar with the risks of the accumulated earnings tax may find the discussions of dividend policy in standard texts on financial management a little naive or unenlightening,[37] they do provide appropriate indications of financial

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[34] J.M. KEYNES, *supra* note 26, at 196.

[35] *Id.* at 199. "Speculative" was not used by Keynes in a pejorative sense.

[36] Other economists have, quite naturally, used different terms. For example, Professor Tobin identifies funds held for the first two motives as "transactions" and funds held for precautionary and speculative motives as "investment balances." *See* Tobin, *Liquidity Preference as Behavior Toward Risk*, 25 REV. OF ECON. STUDIES 65, 65-86 (1958). This article was limited to the study of preferences for different types of monetary assets. For some of Professor Tobin's thoughts on the holding of liquid (monetary) assets versus investment in capital goods see Tobin, *A Dynamic Aggregative Model*, 63 J. POL. ECON. 103, 103-15 (1955).

[37] For example, H. BIERMAN & S. SMIDT, THE CAPITAL BUDGETING DECISION (2d ed. 1966) [hereinafter cited as BIERMAN & SMIDT] makes no mention of the accumulated earnings tax, while P. HUNT, C. WILLIAMSON & G. DONALDSON, BASIC BUSINESS FINANCE (3d ed. 1966) recognizes the existence of "a considerable body of specialized knowledge about how [the accumulated earnings tax] must be regarded" but does not explore the subject "because of the narrow range of

management's training and thinking in respect to earnings retention.

Though funds generated by the retention of earnings are occasionally thought to be free of cost, as opposed to the interest or dividend cost of newly-raised outside capital, it is almost universally recognized that such funds do have a cost which "must be measured by the opportunities forgone in using them in one way instead of other possible ways."[38] Since the choice is between retaining funds in the corporation or distributing them to the shareholders "this cost should be measured by comparing the benefits they would derive from having the funds distributed."[39]

It is generally recognized that "the large majority of businesses consistently reinvest a substantial fraction of current earnings."[40] However, at least one text argues that there is no advantage to the shareholders from retention because the shareholder will have to pay taxes on any ultimate distribution anyway and because it cannot be assumed "that the addition of a dollar to retained earnings will be reflected by an increase of a dollar in the market price of equity."[41] To ignore the tax effect on the shareholder of distribution or retention is of course to ignore all of the theoretically attractive corporate-shareholder tax planning devices which have made the accumulated earnings tax appear necessary, but it does seem valid that management should

> view the investment in a particular business as one of several investment opportunities open to the stockholder. If the stockholder had free access funds could be withdrawn and used wherever they could be more profitably invested. [Therefore] every investment, including reinvested earnings, viewed in this way has its opportunity cost, that is the benefit [to the shareholders] forgone by not investing elsewhere.[42]

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companies to which in fact it might be applied." *Id.* at 284; *see* note 6 *supra*. J. WESTON, MANAGERIAL FINANCE (1962) states that the Internal Revenue Code of 1954 shifted the burden of proof so that "earnings retention is justified unless the Bureau of Internal Revenue can prove otherwise" and that this "salutary change" "reduces somewhat the uncertainty with regard to the propriety of earnings retention." *Id.* at 372.

[38] BIERMAN & SMIDT 153.

[39] *Id.* These authors comment that it is not only investment in long-lived assets that may benefit the shareholders but that benefits may also be derived from, among other things, simply adding "to the financial liquidity of the corporation by increasing the amount of cash on hand." *Id.* at 154.

[40] P. HUNT, C. WILLIAMSON & G. DONALDSON, *supra* note 37, at 290.

[41] *Id.*

[42] *Id.* at 452-3.

Opportunity Cost

The benefit to shareholders forgone by not investing elsewhere may be expressed in terms of anticipated investment return. Ignoring the tax costs of distributions, a rough rule might be that the corporation should accumulate earnings when it can anticipate a return from investment in the business greater than shareholders could receive elsewhere.

Assume, for example, that a corporation has one million dollars in invested capital which earns 120,000 dollars a year—a twelve percent return. Management has under consideration four projects, each costing 25,000 dollars: project A which will earn fifteen percent; project B which will earn thirteen percent; project C which will earn ten percent; and project D which will earn nine percent. The corporation can raise new capital sufficient for any or all projects, either through the issuance of bonds or new common stock, at a cost of eight percent.

If one ignores peripheral considerations, it is apparent that management should reasonably undertake all of these projects; all are beneficial to the present shareholders since the anticipated return (nine percent plus) exceeds the opportunity cost, or the cost of raising the necessary new capital (eight percent).[43] It is equally apparent, however, that total earnings on invested capital (the old plus the new) will be reduced from the present twelve percent if projects C and D are undertaken. If the new capital is to be additional equity, it is unlikely that management will find these latter projects attractive, particularly if the corporation's stock is publicly traded and market price is responsive to reported earnings per share.

Suppose the source of "new" capital is last year's earnings, which could be devoted to these projects rather than distributed to the shareholders as dividends. If tax considerations are ignored, the opportunity cost will remain the same if it is assumed that the eight percent market cost of new capital will equal the return that the shareholders might obtain if they invested the funds outside the corporation. All four projects retain their attractiveness and perhaps are even enhanced by the ready accessibility of this capital source.[44] In this context the payment of a 25,000 dollar dividend could be described as project E, which offers

[43]The example, thus far, parallels that in *id.* at 459.

[44]Among the non-tax factors that this example ignores is the effect of dividend payments, as distinct from earnings, on the market price of the stock. If the opportunity cost is calculated correctly this is reduced to a psychological element which is probably incapable of measurement.

a "return" of eight percent to the shareholders. While it is less attractive than any of the projects considered heretofore, it is a more reasonable use of funds than a project F that would return only seven percent.

It is beyond the intention of this article to describe with precision the measurement of opportunity costs.[45] It is sufficient to observe that, however described, the consideration of opportunity costs is a reasonable and routine aspect of business financial management. Such measurements have a distinct relevance to considerations of the reasonably anticipated needs of a business.

The analysis is at its most sophisticated when opportunity cost is put in terms of the present value of money.[46] If present value is thought of as being simply the value of a distribution of earnings to the shareholders versus investment in the business, it is easily equated with opportunity cost. However, if it includes the value of increased flexibility in planning which may result from having liquid funds readily available for unforeseen opportunities, the equation becomes more complicated.

Assume, for example, that a corporation has 100,000 dollars in liquid funds available from last year's earnings. Faced with spending the funds on a fixed asset that will earn nine percent per year or distributing the funds to shareholders to whom the present value is six percent (the return on investments outside the business), the preceding analysis would obviously dictate retention of the earnings and investment in the fixed asset. But suppose the corporation knows that if it holds the 100,000 dollars in a liquid and idle state for five years (with no return) it would then be able to invest the funds in a fixed asset that would return thirteen percent per year.

By analyzing these alternatives over a twenty year period they may be compared in terms of present value. At the end of the twentieth year the nine percent immediate investment will have earned 180,000 dollars, whereas the investment postponed five years but returning thirteen percent will have earned 195,000 dollars. Since the 180,000 dollars will be returned faster, its present value (using the six percent factor) will be 103,229.10 dollars, versus 94,247.50 dollars from the postponed 195,000 dollar return.[47] This would seem to dictate immediate investment, but

[45]For detailed descriptions *see* BIERMAN & SMIDT and the works cited therein.

[46]*See* BIERMAN & SMIDT 60-73. For a discussion of the classification, or rating, of investment opportunities by means of calculation of the present value of anticipated yields *see id.* at 74-105.

[47]*See* BIERMAN & SMIDT 386-403 for tables on which these computations of present value are based.

if the 100,000 dollars can be maintained in an interest bearing liquid form over the first five years, e.g., a savings account yielding three percent, an additional 15,000 dollars will be earned with a present value of 12,637.20 dollars. The investment of the 100,000 dollars in this form for five years at three percent and then for fifteen years at thirteen percent has a present value of 106,884.70 dollars as compared to the 103,229.10 dollar present value of the immediate nine percent return fixed asset investment. Thus, without considering the uncertainties involved in either choice, the holding of the funds in a liquid state and postponing the investment becomes more reasonable and attractive than the immediate investment. In addition, while the computation loses some authority when the return on either alternative is estimated rather than certain, it is quite possible in this manner to compute in terms of present value the cost of postponing the fixed asset investment for one or more years and then determine that the nine percent return is feasible and the thirteen percent return is not.[48] While this type of analysis is familiar to the experienced corporate financial planner, it is notably absent from the approach of taxing authorities to the retention of liquid reserves.

As noted previously, neither the possibility (or probability) that a better use of the liquid funds will appear nor the possibility that the thirteen percent investment opportunity will become available earlier than the predicted five years is capable of precise valuation. Nevertheless, these possibilities have real value in corporate financial planning and will increase the reasonableness of holding retained earnings in a liquid form.[49]

REASONABLE ANTICIPATION AND THE TAXING AUTHORITIES

With these considerations in mind one can examine specific situations in which judicial and administrative views of reasonable anticipation may have differed sharply from the analysis deemed appropriate in corporate financial management. The five hypothetical problems posed earlier in this article provide a framework.

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[48]It is, quite simply, the difference in present value of a 9% return and a 3% return for the period. For the first year it is $5,660.40.

[49]*See* BIERMAN & SMIDT 61. On uncertainty *see id.* at 196-217.

Specific, Definite and Feasible . . . and Immediate?

Corporation A's need to pay for its new widget plant is clearly a reasonably anticipated need. The tax regulations state that one proper ground for the reasonable accumulation of earnings and profits is "to provide for bona fide expansion of business or replacement of plant"[50] (if supported by sufficient facts and if the general requirements of sections 1.537-1 and 1.537-3 are satisfied). Clearly these requirements are met. Since the blueprints have been drawn, bids have been taken, and the contract let, the plans are undoubtedly "specific, definite, and feasible," and the facts at the close of the taxable year could hardly demonstrate a clearer need.[51] Moreover, the reported cases demonstrate that even less specificity may be allowed. The plans here are comparable to those for plant expansion in *Faber Cement Block Co.*[52] There the "plans for expansion were not set forth in the minutes or other documentary material with precision or in detail,"[53] but the Tax Court was apparently impressed because the plans were "accomplished within a reasonable time after the years in question at a cost closely in line with the amount originally estimated."[54] The court stated that the requirement that there be " 'specific, definite and feasible' plans does not demand that the taxpayer produce meticulously drawn, formal blueprints for action."[55] However, in *Smoot Sand & Gravel Corp. v. Commissioner,*[56] the Fourth Circuit noted that "formal entries upon the books do not alone substantiate such needs, nor is justification for such reserves to be found merely in subsequently declared intentions. *The intention claimed must be manifested by some contemporaneous course of conduct directed toward the claimed purpose.*"[57] Likewise, the "testimony of the corporation president that an architect had made several rough sketches of the proposed building" was insufficient for the Tenth Circuit when the company was unsure of the type of building to be con-

[50]Treas. Reg. § 1.537-2(b)(1) (1959).

[51]*See* Treas. Reg. § 1.537-1(b)(2) (1959).

[52]50 T.C. 317 (1968), *acquiesced in,* 1968-2 CUM. BULL. 2.

[53]*Id.* at 332.

[54]*Id.* at 333.

[55]*Id.* at 332, *citing* John P. Scripps Newspapers, 44 T.C. 453, 469 (1965) *and* Sterling Distrib., Inc. v. United States, 313 F.2d 803, 807 (5th Cir. 1963).

[56]241 F.2d 197 (4th Cir. 1957).

[57]*Id.* at 202 (emphasis added).

[58]Oklahoma Press Publishing Co. v. United States, 437 F.2d 1275, 1278 (10th Cir. 1971) (refusing to sustain trial court's finding because it was clearly erroneous).

structed.[58] In *F. E. Watkins Motor Co.*,[59] the corporation had specific cost estimates for its planned expenditures which were deemed by the Tax Court to be sufficient.

Corporation A's reasonably anticipated needs would have been reasonable needs of its business even before the addition of section 537 to the Code, although the section may have been necessary for a favorable result in *Faber Cement,* since its plans did not come to fruition in the immediately following taxable year. Paying for a plant to be built in the immediately following taxable year would undoubtedly pass the "immediacy test" as it was being applied prior to the Internal Revenue Code of 1954.[60] What has often bothered courts in this area, however, is needs which admittedly are reasonably anticipated but which are not justified by specific and definite spending plans. Particularly in respect to the expansion of a business into unrelated areas, which is specifically authorized by the tax regulations,[61] courts have thought that "the need for tangible evidence of corporate action directed toward fulfillment of the proposed project is probably most acute . . . since plans of this type can be easily fabricated and postponed for indefinite periods."[62] Such suspicion may often be justified, but it may also distort the effect of the accumulated earnings tax, as will be seen when the expansion plans of Corporations D and E are examined.

Self-Insurance: Specific and Definite?

Corporation B is a self-insurer against losses from fire and explosion and presumably other casualty losses as well. General, or "all-risk" casualty insurance is so easily available that it might often seem unnecessary and even unreasonable for a corporation to take this risk upon itself when it can use the risk-spreading device of purchased insurance to minimize its exposure.[63] Yet courts have recognized that the contin-

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[59]31 T.C. 288 (1958), *acquiesced in,* 1959-1 CUM. BULL. 5.

[60]*See* text accompanying note 3 *supra.*

[61]Treas. Reg. § 1.537-3(a) (1959).

[62]Oklahoma Press Publishing Co. v. United States, 437 F.2d 1275, 1278 (10th Cir. 1971). In addition, *see* Barrow Mfg. Co. v. Commissioner, 294 F.2d 79, 80-81 (5th Cir. 1961) (affirming Tax Court finding that plan was vague and indefinite, both as to type of plant to be built and time of implementation; land bought in 1950 but no further steps through 1959); American Metal Prods. Corp. v. Commissioner, 287 F.2d 860 (8th Cir. 1961).

[63]Note that the tax regulations provide that business expenses deductible from gross income as ordinary and necessary include "insurance premiums against fire, storm, theft, accident or other similar losses in the case of a business." Treas. Reg. § 1.162-1(a) (1958).

gency of such a loss is a reasonably anticipated need of the business.[64] Apparently, the amount of such losses to be anticipated is the full amount necessary to meet the need, even though historically the current earnings of the corporation may have been sufficient to cover any losses.[65]

The availability and cost of appropriate insurance coverage should have a direct bearing on the reasonableness of becoming a self-insurer. If the fire or casualty risk is low, conventional coverage will be available at reasonable cost. Following the opportunity cost analysis used previously, if Corporation B can obtain appropriate coverage at a cost of less than sixty dollars per thousand dollars in value, it would be more profitable for it to purchase that coverage. In other words, it would not be reasonable for Corporation B to set up a reserve for self-insurance "returning" (by means of premium cost saved) less than six percent if that percentage represents the present value of the necessary reserve amounts to the shareholders.[66] To the extent that the corporation can predict that its losses will be lower than the actuarial norm it will save money by becoming a self-insurer, but any savings would result whether or not the corporation recognizes the need to accumulate earnings and

[64]*See, e.g.*, Smoot Sand & Gravel Corp. v. Commissioner, 241 F.2d 197, 203 (4th Cir. 1957): "There can be no doubt that reserves for such contingencies are proper. While saving the premiums it would otherwise have had to pay, the petitioner assumed *a direct liability in an undetermined amount*, and the reserve was *an estimate of this contingent liability*." (Emphasis added.)

[65]*Id.* In this case the taxpayer had argued that the reserves set up on its books were actually insufficient in amounts, but the court determined that they were binding in the absence of actuarial evidence to support its contention because they represented "what petitioner [had] currently conceived to be its potential liability in these areas." *Id.*

In Halby Chem. Co. v. United States, 180 Ct. Cl. 584 (1967), the corporations involved "manufactured one or more products containing ingredients of a volatile nature, subject to possible fire or explosion or both." *Id.* at 602. While the corporations carried some fire insurance, management reasoned; (a) that this was insufficient to cover the full cost of new and improved machinery (because of inflation and other factors) that would be purchased if the machinery currently in use was destroyed; (b) that available business interruption insurance could not sufficiently cover potential losses; and (c) that the corporations were self-insurers in respect to damage claims that could result from a fire or explosion. The Court of Claims apparently accepted these as proper purposes for the accumulation of earnings. No estimates of the amounts necessary to meet any or all of these contingencies are provided in the opinion, and in fact the courts seldom concern themselves with amounts in their discussions of accumulations for self-insurance purposes.

[66]This assumes, contrary to reality, that the reserved funds are serving the single purpose of providing protection from casualty losses. As we have seen, such funds usually will not be held purely as cash but may be invested in relatively low-return but relatively risk-free liquid or "quick" assets. In reality the liquid reserve is available for a myriad of needs, few of which are likely to occur simultaneously.

liquidity in order to meet anticipated losses. (A loss experience more favorable than the norm might indicate that the reserve should reasonably be lower than that of the corporation with normal experience.[67]) Thus the reasonableness of becoming a self-insurer is in direct proportion to the degree to which the corporation's loss experience is below the norm. Reasonableness will increase substantially as the risk of loss becomes actuarially greater; and as the risk approaches the uninsurable category, by reason of cost or otherwise, the role of self-insurer becomes not only reasonable but necessary.[68]

What is most remarkable is the failure of courts to apply the "specific, definite, and feasible" requirements of the tax regulations to these contingencies. While these requirements have been potent barriers in other areas, particularly in respect to business expansion, definiteness with respect to amounts needed is annoyingly lacking in the self-insurance cases.[69] Computations, when made, seem haphazard. In *Magic Mart, Inc.*,[70] the taxpayer had experienced flood losses (primarily damage to its inventory) valued at 16,596 dollars in 1957 and 6,966 dollars in 1963, including its average gross markup on sales of twenty-nine to thirty-five percent. Without explaining the method used to arrive at the result, which was that suggested by the Commissioner of Internal Revenue, the Tax Court determined that eleven thousand dollars was a

[67]The computation of the appropriate self-insurance reserve for accumulated earnings tax purposes might be similar to that used in computing a bad debt reserve, *i.e.* by computing the ratio of the average losses over the past six years to the replacement value of assets that are exposed to the risk of this kind of loss and applying that ratio to the total replacement value of these assets at the end of the year. *Cf.* Black Motor Co., 41 B.T.A. 300 (1940). A (non-deductible) adjustment could be made each year, adding the losses for the year and subtracting the amount of the reserve at the beginning of the year. Such a formula is probably no worse than the *Bardahl* formula.

[68]For example, if Corporation B's investment is solely in plant and machinery worth $100,000 on which it earns $5,000 annually, it *must* be a self-insurer if the cost of insurance is $50 per $1,000 value or more. *See, e.g.*, Magic Mart, Inc., 51 T.C. 775, 783-84 (1969) (prohibitive premiums), *acquiesced in result only*, 1969-2 CUM. BULL. xxiv; Millane Nurseries & Tree Experts, Inc., 11 P-H Tax Ct. Mem. 1683 (1942) (coverage impossible to obtain). *See also* California Motor Transport Co., 12 P-H Tax Ct. Mem. 605 (1943). Of these three cases, only *Magic Mart* mentions any amounts as proper reserves.

[69]In Coastal Casting Service, Inc. v. Phinney, 26 Am. Fed. Tax R.2d 70-5862, 70-2 U.S. Tax Cas. 84,831 (S.D. Tex. 1970) the court found the taxpayer's need to be self-insured against products liability claims "too speculative to fall within the classification of a concrete, specific need requiring an accumulation." *Id.* at 70-5863, 70-2 U.S. Tax Cas. at 84,833. In Oyster Shell Prods. Corp. v. Commissioner, 313 F.2d 449 (2d Cir. 1963), the Second Circuit affirmed the Tax Court's rejection of he taxpayer's claimed flood damage risk as "so remote as to be a negligible risk" and "conjured up." *Id.* at 453.

[70]51 T.C. 775 (1969), *acquiesced in result only*, 1969-2 CUM. BULL. xxiv.

reasonable amount of earnings and profits to retain for this contingency in the years 1958-62.[71] Perhaps the method used by the taxpayer in *Bradford-Robinson Printing Co. v. United States*[72] is more sound, if less liberal: in providing for a "key man" insurance fund, the corporation made annual transfers to the fund "of the amounts which would be decided by insurance companies for the insured's [*sic*] decided upon,"[73] and the district court found this proper. Since the temptation to fabricate or at least to overestimate needs in this area would seem as great as in the area of business expansion, some sort of cost-benefit analysis similar to that described here would be useful.

Uninsurable Contingencies: Irresistible Temptation?

William C. Atwater & Co.[74] is an authority frequently cited for the proposition that contingencies in general are reasonable needs of business.[75] *Atwater,* however, involved the contingency of paying a judgment that was on appeal, and the corporation had had to deposit a 375,000 dollar bond in order to free its attached bank accounts.[76] Thus the liability was both specific and definite in amount. Nevertheless, the case has been used by the Tax Court to support the reasonableness of a need when the liability has been contingent only as to amount,[77] and perhaps only in *Perfection Foods, Inc.,*[78] has it recognized a contingency as a

[71]*Id.* at 784. The court is equally vague on how it arrived at the amount ($200,000) it considered necessary for business expansion. *Id.* at 784-87. It used the *Bardahl* formula to arrive at working capital needs. *Id.* at 782-83.

[72]1 Am. Fed. Tax R.2d 1278 (D. Colo. 1957).

[73]*Id.* at 1280.

[74]10 T.C. 218 (1948), *acquiesced in,* 1948-1 CUM. BULL. 1.

[75]Cited in the following accumulated earnings tax cases: Bardahl Mfg. Corp., 34 P-H Tax Ct. Mem. 1123 (1965); Bremerton Sun Publishing Co., 44 T.C. 566 (1965); John P. Scripps Newspapers, 44 T.C. 453 (1965); Perfection Foods, Inc., 34 P-H Tax Ct. Mem. 68 (1965); Henry Van Hummell, Inc., 33 P-H Tax Ct. Mem. 1942 (1964); J. Gordon Turnbull, 41 T.C. 358 (1963); Jerome E. Casey, 26 P-H Tax Ct. Mem. 865 (1957), *rev'd,* 267 F.2d 26 (2d Cir. 1959); and in Rev. Rul. 70-301, 1970-1 CUM. BULL. 139.

[76]10 T.C. at 240. The taxpayer had also been advised that it could not legally pay dividends under the laws of its state of incorporation. *Id.* at 251.

[77]Bremerton Sun Publishing Co., 44 T.C. 566, 585-86 (1965); John P. Scripps Newspapers, 44 T.C. 453, 471 (1965). These cases concerned obligations under unqualified profit-sharing and retirement plans. Congress has provided standards of reasonableness in respect to the funding of such plans in the provisions relating to the deductibility of contributions to qualified plans contained in INT. REV. CODE OF 1954, § 404.

[78]34 P-H Tax Ct. Mem. 68 (1965).

reasonable need of the business but found that "[p]etitioner has failed to establish the reasonableness of the amount of surplus accumulated" because the evidence introduced" was in vague and general terms which we find to be unconvincing."[79]

In *Smoot Sand & Gravel Corp. v. Commissioner*,[80] the Fourth Circuit defined a contingency as "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."[81] The definition is fair enough, but if the tax regulation requirements of specific, definite, and feasible are generally applicable they should be applied here as well. Some computation of the amounts needed would be appropriate.

In *Ted Bates & Company, Inc.*,[82] the Tax Court dealt with a taxpayer facing, in perhaps its most acute form, the type of conventionally uninsurable risk attributed to Corporation C in the hypotheticals previously given—the problem of continuing in business if a major client or customer goes elsewhere. The corporation, an advertising agency, had twelve to nineteen clients in the period 1957-61, and of these, the five largest accounted for 73.1 percent to 77.3 percent of its revenue and the two largest accounted for 41.6 percent to 44.0 percent.[83] It had a fixed annual rental obligation of 829,000 dollars, paid its employees (other than officers) from 3,709,078.26 dollars in 1957 to 7,260,648.60 dollars in 1962 in salaries, and contributed from 603,450.57 dollars to 1,718,012.60 dollars to employee benefit plans.[84] The Tax Court found that the corporation's need to continue to pay rent and salaries (and apparently, to make profit-sharing plan contributions as well) in the event of the loss of a major client was a reasonably anticipated need, and it computed the amount of the reserve needed for this contingency to be 2,000,000 dollars in 1957 and 1958, and 2,300,000 dollars in 1959, 1960, and 1961.[85]

[79]*Id.* at 73. The contingency was the carrying of peak period accounts receivable. About six months later, in Bardahl Mfg. Co., 34 P-H Tax Ct. Mem. 1123 (1965), the Tax Court considered this need as a part of the working capital need and established its own formula for computing the amount reasonably needed.

[80]241 F.2d 197 (4th Cir. 1957).

[81]*Id.* at 206.

[82]34 P-H Tax Ct. Mem. 1476 (1965). *See also* L.R. Teeple Co., 47 B.T.A. 270, 278-79 (1942), *acquiesced in*, 1942-2 CUM. BULL. 18.

[83]34 P-H Tax Ct. Mem. at 1483.

[84]*Id.* at 1481-82.

[85]*Id.* at 1492.

The method used in making this computation is mysterious. Rounding off the figures for 1957, the total of these obligations for that year as determined by the Tax Court is something in excess of 5,000,000 dollars. Forty percent of that, approximately the percentage represented by the two largest clients, is 2,000,000 dollars. But by 1959 the total of these obligations is over 6,000,000 dollars, and forty percent of that is 2,400,000 dollars, not 2,300,000 dollars. By 1962 the total is more than 8,000,000 dollars, and forty percent of that is 3,200,000 dollars.[86]

In addition, the Tax Court made two errors in reviewing the needs of the corporation—errors which are both logically inconsistent with the stated purpose of the contingent reserve just described and contradictory to each other. First, the court stated that a reserve for deductible expenses is "invalid as a matter of law"[87] and refused to allow the corporation any reserve for expenses in promoting new business. Yet in the event of the loss of one or more major clients this type of expense would be as reasonable and necessary as the continuance of salary and rental payments. Salary and rental payments are, of course, also deductible expenses, and they were included in computing the contingency reserve.

Second, as a part of the corporation's expenses that would continue even though major clients were lost, the court included contributions to a profit-sharing plan.[88] The plan is not described in the opinion, but it would seem that, like future income taxes,[89] no reserve is needed since by definition such contributions are normally made out of current earnings.

The *Ted Bates* decision has been examined in some detail since it demonstrates some of the weaknesses and failures of analysis in this area. Few business managers would argue that the needs of this advertising agency for reserve funds were not both legitimate and reasonable,

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[86] If the Tax Court had found that the reasonable needs of the business *exceeded* the accumulated earnings of the corporation, the amount needed for this purpose would be unimportant, at least to the extent of the excess over the accumulations. But since the Tax Court found that there were excess accumulations in three of the five years involved (1958, 1959 and 1961), the precise amount needed becomes crucial, both to the taxpayer and to the government, in computing the credit that the taxpayer is entitled to under INT. REV. CODE OF 1954, § 535(c)(1). 34 P-H Tax Ct. Mem. at 1493-94.

[87] *Id.* at 1492, *citing* Smoot Sand & Gravel Corp. v. Commissioner, 274 F.2d 495, 502 (4th Cir. 1960) in respect to depreciation and depletion expenses. Perhaps the weakness is one of advocacy, as apparently the taxpayer treated these expenses separately from its needs in the event of a *loss* of clients.

[88] *Id.* at 1482, 1491.

[89] *See* Bardahl Mfg. Co., 34 P-H Tax Ct. Mem. 1123, 1142 (1965).

yet reasonable men could differ substantially about the specific amounts necessary. But if reasonableness of the need is conceded, how are the uncertainties inherent in this kind of need reconciled with the expressed Congressional intent that the taxpayer have "specific and definite plans for . . . use [of the accumulated funds] in the business" and that those plans be neither "vague and indefinite" nor "postponed indefinitely"?[90] The Tax Court's solution has been mostly to ignore this expression of intent as inapplicable and thereby to create what might be thought to be a substantial loophole in the coverage of the accumulated earnings tax.[91] The Congressional intent may be irreconcilable, but it is hard to conceive any argument that would make it inapplicable.

Technologically Postponed Replacement

The need of Corporation D, with its air-polluting diesel-powered buses, is, in our environmentally conscious era, undoubtedly a reasonably anticipated need.[92] The threat of legal action, both from civil nuis-

[90]H.R. REP. No. 1337, 83d Cong., 2d Sess. 53 (1954). In Inland Oil & Chem. Corp. v. United States, 338 F. Supp. 1330 (D. Md. 1972), the corporation's plans were, alternatively, to use accumulated funds to finance accounts receivable which would result if a program of business diversification and expansion were undertaken or to purchase a new plant location in order to relieve dangerous crowding in its existing plant. The first alternative was chosen, but the "directors did not have in mind at that time a specific amount by which accounts receivable would increase . . . but they knew it would be substantial." *Id.* at 1333. Quoting Electric Regulator Co. v. Commissioner, 336 F.2d 339 (2d Cir. 1964), the court found these needs reasonable, even in the absence of specific figures. 338 F. Supp. at 1335. But the court rejected an estimated $100,000 need for trailers and other equipment in the expanded business when "no evidence was offered with respect to rates of depreciation, rentals or purchase arrangements, contemplated or actual," *id.* at 1333, and rejected any need to be a self-insurer though evidence was offered in respect to the latter. *Id.* at 1335 n.10. The court's liberality in respect to the needs to finance receivables might be explained by the fact that the corporation's investment in cash and Treasury Bills dropped from $360,000 to $10,000 in the five years subsequent to the year at issue.

[91]On the other hand, the Treasury has been consistent in its opposition to reserves for contingencies that are incapable of precise measurement. The tax regulations approve contingent grounds for accumulation only by way of a negative exception. ("Retention of earnings and profits to provide against unrealistic hazards" as an indication of accumulations is beyond the reasonable needs of the business. Treas. Reg. § 1.537-2(c)(5) (1969).) It is apparent in the cases dealing with contingencies cited previously that the Commissioner of Internal Revenue has frequently argued vagueness and indefiniteness in attacking reserves in this area. In Rev. Rul. 70-301, 1970-1 CUM. BULL. 138, the *Atwater* case is cited as support for accumulating to meet a contingent liability, but one that is specific and definite in amount (a proposed assessment of the accumulated earnings tax for the prior year). *But cf.* Rev. Rul. 72-306, 1972 INT. REV. BULL. No. 25, at 8.

[92]The relevance of pollution-control needs of manufacturing businesses is perhaps best illustrated in the attitude of the Securities and Exchange Commission. On July 19, 1971, the Commission announced its interpretation that the disclosure requirements of the federal securities laws

ance suits seeking injunctive relief and from its franchising authority, makes the need to replace its buses most specific, and it is clear that it can definitely compute the costs of the currently available gasoline-powered replacement vehicles by obtaining price quotes or bids. But should Corporation D purchase the gasoline-powered buses, or should it postpone its commitment to a new bus fleet, perhaps indefinitely, and see if the steam-powered, pollution-free vehicles will become available? Since it is assumed in this hypothetical that operating costs will not be affected by the decision to replace now or to postpone replacement, it is more reasonable, from management's point of view, to postpone dealing with its pollution problem until a complete solution is available. The risk of too early replacement in these circumstances is great. If the corporation were to replace the fleet immediately and the steam-powered pollution-free buses became available, it might be necessary to finance a second replacement with its reserves already expended. Sound and reasonable financial planning would dictate holding the reserve at least until the commercial viability of steam-powered buses is proved or disproved.[93]

Yet if the corporation presents these facts as a defense against assessment of the accumulated earnings tax, the response undoubtedly would be that its plans are perhaps specific, perhaps even definite, but certainly at this point in time not feasible. Authority for this position is *KOMA, Inc. v. Commissioner*,[94] in which the taxpayer had estimates of the costs of facilities for broadcasting FM and television as early as 1940. In affirming the Tax Court's rejection of this as grounds for the accumulation of earnings the Tenth Circuit observed: "At the time . . . television was in an experimental stage; no equipment was on the market; no coaxial cable was availble prior to 1950; no one knew or could tell with a reasonable degree of certainty the cost of such a station, if and when it could be constructed, or whether it would be commercially feasible."[95]

"call for disclosure, if material, when compliance with statutory requirements with respect to environmental quality, e.g., various air, water and other anti-pollution laws, may necessitate significant capital outlays, may materially affect the earnings power of the business, or cause material changes in registrant's business done or intended to be done." SEC Securities Act Release No. 9252 (July 19, 1971).

[93] *See* Goldstein & Ford, *The Management of Air Quality: Legal Structures and Official Behavior*, 21 BUFFALO L. REV. 1, 40 (1971).

[94] 189 F.2d 390 (10th Cir. 1951).

[95] *Id.* at 396. The holding is complicated by the fact that "while the corporations contend that

If this is the reasoning to be followed (the case was decided prior to the elimination of the immediacy test but the result is entirely consistent with the tax regulations adopted under section 537),[96] it is in direct contradiction to what would be reasonable absent the accumulated earnings tax.

Delayed Replacement and Depreciation

The contradiction becomes even more apparent when the attitude of the taxing authorities towards reserves for replacement of operating assets is examined. It has already been demonstrated in previous illustrations that under appropriate circumstances reasonable financial planning will dictate the postponement of investment when the present value of the anticipated return from the postponed investment is greater than the present value of the return from an alternative investment made immediately. This is directly applicable to Corporation E's decision to maintain its old widget-making machines in service rather than replacing them as they become fully depreciated. If, for example, Corporation E is enjoying a nine percent return on its investment in the old machines (and could expect a similar return if it invested its accumulated replacement reserves in new machines of the same type), it can afford to wait up to five years to invest the funds if the return from the same funds then invested in the new machines will return thirteen percent. The advantage of waiting will be diminished by the cost of increased repair and maintenance of the old machines, but the cost of waiting, as has been demonstrated, is capable of reasonable calculation and estimation. The reasonableness of that cost will depend on management's prediction of the advantage to be gained from the new machines and its confidence in the accuracy of its own prediction. Management will be aware, however, that it is often willingness to accept the risks imposed by such uncertainties that makes one business more successful than its competitors.

Further, if the corporation is in the happy position of having funds available in excess of what is being accumulated to replace its old machines, it is entirely reasonable to use these funds to invest in additional

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it was necessary to set aside these reserves for their reasonable needs in the reasonable foreseeable future, they were loaning their earnings to [the major shareholder] and his other enterprises instead of declaring dividends." *Id. But cf.* Havens & Martin v. United States, 65-1 U.S. Tax Cas. 95,503 (E.D. Va. 1965).

[96] *See* text accompanying note 5 *supra*.

machines of the old type rather than using them to pay dividends, provided the present value of the anticipated return from the increased capacity exceeds the present value of a dividend to the shareholders.[97] So long as the latter is not influenced by the shareholders' own tax considerations, the investment is entirely reasonable and does not contradict the plan to ultimately replace the old machines.

Taxing authorities' considerations of reserves for replacement are, however, devastating to this type of reasoning. First of all, since depreciation is "a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) . . . of property used in the trade or business,"[98] it might be thought that the accumulated depreciation (in respect to unretired and unreplaced depreciable property) of the corporation is some measure of the amount reasonably necessary to replace such property. But in *Smoot Sand & Gravel Corp. v. Commissioner*[99] the court flatly rejected the idea, since "[s]urplus has already been reduced by annual charges to depreciation expense [and] allowing them again would give the taxpayer double deductions."[100] The court was "cognizant of the fact that replacement of taxpayer's wasting assets will ultimately become necessary," and that for this purpose cash or other liquid assets must be available.[101] But it concluded: "Replacement of assets which are fully depreciated . . . requires available cash but does not require a second appropriation of surplus. It is only when rehabilitation plans involve replacement of old equipment with equipment costing more than the original, or when additional equipment is required, that appropriation of surplus is justified."[102]

This analysis is confusing since the same opinion states that it is "liquid assets in excess of the immediate or reasonably foreseeable business needs of the corporation" that will indicate that imposition of the accumulated earnings tax is appropriate.[103] Since the depreciation allowance may cause liquidity to increase faster than surplus is accumulated,[104] this puts the corporation in an awkward position.

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[97]*See* text accompanying notes 49-50 *supra.*

[98]INT. REV. CODE OF 1954, § 167(a).

[99]274 F.2d 495 (4th Cir. 1960).

[100]*Id.* at 502./

[101]*Id.*

[102]*Id.* at 503.

[103]*Id.* at 501.

[104]As every fan of real estate tax shelters knows, the depreciation deduction is a non-cash item. Assume, for example a corporation with assets at the opening of its taxable year with assets

Relying on *Smoot Sand & Gravel*, the Fifth Circuit in *Battelstein Investment Co. v. United States*[105] rather summarily rejected a tax-

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consisting solely of depreciable property with a book value (after prior year's depreciation) of $200,000. It has no liabilities except for shareholder's equity consisting of paid-in capital of $10,000 and accumulated surplus of $190,000. Following the *Smoot Sand & Gravel* analysis, it is safe at this point from the accumulated earnings tax since all its surplus "has been translated into . . . assets related to its business." *Id.* at 501.

If during the year this corporation has a cash income of $20,000 before its depreciation deduction and that deduction equals $20,000 so that there is no taxable income, its balance sheet will look like this:

Assets		Liabilities	
Liquid (Cash)	$20,000	Shareholder's Equity	
Fixed (Depreciable Assets after		Paid-In Capital	$10,000
Depreciation	$180,000	Accumulated Surplus	$190,000
	$200,000		$200,000

Thus, while there has been no addition to surplus, the corporation now has $20,000 with which either to meet reasonably anticipated needs or to pay dividends.

Similarly, if the corporation has the same cash income before depreciation but a depreciation deduction of $30,000, and thus an operating loss of $10,000, its closing balance sheet will look like this:

Assets		Liabilities	
Liquid (Cash)	$20,000	Shareholder's Equity	
Fixed (Depreciable Assets after		Paid-In Capital	$10,000
Depreciation)	$170,000	Accumulated Surplus	$180,000
	$190,000		$190,000

Thus, even in a loss year the corporation is increasing its liquidity, and its ability to pay dividends if the funds generated by the depreciation deduction are not needed for replacement or other purposes.

Of course, in neither of these two situations will the corporation be subject to the accumulated earnings tax for the year under discussion since the tax is assessed only against accumulated taxable income for the year (INT. REV. CODE OF 1954, §§ 531, 535, 563) and there is no taxable income. But what if the cash income is $20,000 and the depreciation deduction is only $10,000? The closing balance sheet will look like this:

Assets		Liabilities	
Liquid (Cash)	$20,000	Shareholder's Equity	
Fixed (Depreciable Assets after		Paid-In Capital	$10,000
Depreciation)	$190,000	Accumulated Surplus	$200,000
	$210,000		$210,000

The corporation will have to justify retention of $20,000 in liquid assets if it pays no dividend. If it invests $10,000 of its cash in additional fixed assets before the close of the year, should it still be subject to the assessment of the accumulated earnings tax?

[105]442 F.2d 87 (5th Cir. 1971).

payer's argument which at least by implication equated the depreciation reserve with its replacement needs. While admitting that "[o]ne difficulty we have is that of understanding,"[106] the court found that there was no error of law in the trial court's finding that the taxpayer had failed to prove that replacement needs justified its accumulations.[107] The court also relied on Revenue Ruling 67-64,108 which held that

> although the reserve for depreciation itself may be considered and given appropriate weight as a part of the facts and circumstances in considering the reasonable needs of the business, the concept that a noncash deduction for depreciation based on historic costs requires the setting aside for an indefinite period a cash fund adjusted for economic fluctuations in order to provide for total replacement of plant assets is not within the meaning of the term "reasonable needs of the business."[109]

The Treasury cited no authority for its ruling other than the regulations and the legislative history of section 537,[110] and the implication of *Smoot Sand & Gravel* is to the contrary.[111]

In contrast, the accounting profession, which has been faced with the problem of properly accounting for replacement needs, especially since the inflationary period immediately after World War II, recognized in 1947 that

> business management has the responsibility of providing for replacement of plant and machinery . . . There is no doubt that in considering depreciation in connection with product costs, prices, and business policies, management must take into consideration the probability that plant and machinery will have to be replaced at costs much greater

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[106] *Id.* at 89.

[107] *Id.* at 88, 89.

[108] 1967-1 CUM. BULL. 150.

[109] *Id.* at 151.

[110] *See* text accompanying notes 4-5 *supra.*

[111] In addition, *see* Walter C. McMinn, Jr., 31 P-H Tax Ct. Mem. 1003, 1021 (1962): "We recognize that a reasonable reserve for replacement of depreciable plant and equipment, possibly even in excess of a cost depreciation reserve where prices have increased, may be a reasonable business need. But there is no evidence here to indicate that these two plants would have to be replaced anytime soon (they were still in use at the time of the trial) or that the available funds would not take care of this need."

In contrast, a replacement reserve was held to be reasonable in Oklahoma Press Publishing Co. v. United States, 437 F.2d 1275, 1279 (10th Cir. 1971) while a quite similar reserve was held to be not within the requirements of the tax regulations. *See* text accompanying note 62 *supra.*

than those of facilities now in use.[112]

The committee on accounting procedure of the American Institute of Certified Public Accountants expressed its belief that the problem should not be met by increasing depreciation charges against current income since "it would not increase the usefulness of reported corporate income figures if some companies charged depreciation on appraised values while others adhered to cost."[113] In reaffirming its opinion in 1948 the committee noted that

> [w]hen prices have risen appreciably since original investments in plant and facilities were made, a substantial portion of net income as currently reported must be reinvested in the business in order to maintain assets at the same level of productivity at the end of the year as at the beginning.
>
> Stockholders, employees, and the general public should be informed that *a business must be able to retain out of profits amounts sufficient to replace productive facilities at current prices if it is to stay in business.*[114]

The accounting profession's view is aimed primarily at the accurate reporting of financial positions on a comparable basis, and everyone is aware that accounting procedures for tax purposes will often differ from that for book or reporting purposes. Nevertheless, substantial weight should be given to what the accounting profession considers to be in conformity with generally accepted accounting principles when the question is one of reasonableness. But the difficulty in finding tax authority that specifically approves an accumulation out of earnings for the replacement of depreciating assets is surpassed only by the difficulty of imagining of an operating and continuing business that does not have this need.

CONCLUSION

It is not within the intention of this article to reach any final conclu-

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[112] COMM. ON ACCOUNTING PROCEDURE, AM. INSTITUTE OF ACCOUNTANTS, ACCOUNTING RESEARCH BULL. No. 33 at 267 (1947).

[113] *Id.* at 268.

[114] Letter from Samuel J. Broad to American Institute of Accountants, Oct. 14, 1948, in COMM. ON ACCOUNTING PROCEDURE, AM. INSTITUTE OF ACCOUNTANTS, ACCOUNTING RESEARCH BULL. No. 34, at 270(B) (1948) (emphasis added).

sions in respect to the validity of Treasury and court rulings on the specific types of anticipated needs of the business that have been described, nor is it within that intention to propose any specific measurements of reasonably anticipated needs. This article has achieved its intended purpose if it has demonstrated that the standards of taxing authorities do not reflect the realities of corporate financial thinking in respect to business needs and reserves, and that these standards are often inconsistent within themselves when they are applied to different types of anticipated needs.

The consequence is that the closely held corporation within the scope of the accumulated earnings tax[115] will find itself subject to limitations on the retention of earnings that are not applicable to publicly held corporations.[116] In recognizing this, the Second Circuit has commented:

> Courts, however, must not blind themselves to the realities in this age of rapid technological change. The product of today is frequently outmoded tomorrow. . . . Nor is it always possible for a company in advance to set aside a specific sum to achieve a specific goal. Comments made in the past to the effect that a definite plan actually followed through must be on the company's books and records before moneys assigned thereto become anticipated needs may have to be appropriately qualified in particular cases.
>
> If the Tax Court's views . . . were to be accepted, they would give to the Treasury virtually absolute power to stifle or encourage economic growth as it—not the corporate directors—decided how each company should handle its corporate and financial affairs.[117]

It may be an appropriate national policy to encourage the ownership of businesses among large groups of shareholders by special liberality towards the publicly held corporation in the accumulation of liquidity, but this is clearly not the purpose of the accumulated earnings tax. If this were its purpose, the structure of the tax would make it a remarkably ill-designed tool. Yet this is a substantial side effect of the tax and its enforcement in the courts, and it is probable that this side effect outweighs any effectiveness the tax may have in achieving its stated

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[115]*See* note 6 *supra.*

[116]Perhaps the only legal limitation on the retention of earnings by publicly held corporations is the risk of actions to compel dividends. *See* N.C. GEN. STAT. §§ 55-50(j)-(*l*) (1965); H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES 667-69 (1970).

[117]Electric Regulator Co. v. Commissioner, 336 F.2d 339, 345-46 (2d Cir. 1964); *see* Simons, *The Gathering Storm of Section 531 of Our Tax Laws,* 44 TAXES 528, 529 (1966); Ziegler, *supra* note 25, at 120-21.

purpose as a means of policing tax avoidance.

Two solutions suggest themselves. First, section 537 might be redrafted to encourage consideration of the real practices of businesses, whether publicly held or closely held, with respect to the retention of earnings.[118] It might be preferable to restructure the tax entirely so as to base its application on the reasonableness of the corporation's dividend policy in comparison with that of similarly situated public corporations.[119]

Second, the Treasury and the courts, with an eye to the teachings of financial planning experts, might devise objective computations and formulas which may be used as standards of reasonableness in respect to specific types of needs. The *Bardahl* formula in respect to working capital needs is precedent for this. However much the blind application of this formula by the Internal Revenue Service to every potential accumulated earnings may be criticized, its existence affords reliable protection to the corporation which possesses liquid assets that are within the limits of that formula.

Perhaps the most inviting solution is the repeal of the accumulated earnings tax altogether as having outlived its usefulness. Since it is entirely permissible under the statutes and regulations for a corporation

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[118]The Bible-Evins bill, S. 1615, 92d Cong., 1st Sess. (1972), H.R. 7692, 92d Cong., 1st Sess. (1972), is pending in Congress. Section 405 of this bill would reduce the accumulated earnings tax rate to a flat 22% and increase the minimum credit provided in §§ 535(c)(2)-(3) from $100,000 to $150,000. In addition, it would authorize the Secretary of the Treasury

> to prescribe by regulations a minimum credit (in lieu of the $150,000 amount . . .) of not more than $250,000 for any corporation which
>
> (A) is a small business concern (within the meaning of the Small Business Act), and
>
> (B) established a reasonable intention of future expansion which would require 197
>
> retaining earnings and profits for the taxable year in excess of $150,000.

It would also extend the possibility of shifting the burden of proof to the government in cases tried in the district court and the Court of Claims as well as in the Tax Court. Most importantly, the bill would add a new § 538, which would permit the payment of designated dividends in reduction of accumulated taxable income for years in which an accumulated tax liability has been determined, within 90 days after the determination. This latter provision would seem to eliminate imposition of the tax almost entirely (though not necessarily the tax risk of accumulating). But in respect to the $250,000 credit, is a "reasonable intention . . . which would require retaining earnings and profits" significantly different from a "reasonably anticipated need"?

[119]*See* Ziegler, *supra* note 25, at 122. Similarly, in Harry A. Koch Co. v. Vinal, 228 F. Supp. 782 (D. Neb. 1964), the court compared the taxpayer's ratio of current assets to current liabilities to that of another firm in the same business: "Comparison with the ratio of a respectable firm engaged in the same type of business is a quite effective method of determining what is a reasonable ratio for the kind of business with which we are dealing." *Id.* at 785.

to avoid "the income tax with respect to its shareholders"[120] by using unneeded earnings and profits to "acquire a business enterprise through purchasing stock or assets"[121] or by investing in "any line of business which it may [choose to] undertake,"[122] the tax is really only a trap for the unwary or unimaginative. In reality, with the exception of investments in marketable securities that are unrelated to the business, it is probable that corporate management will retain high liquidity in investments with little or no return only if it is believed necessary for the actual needs of the business. Thus conservative financial management is penalized and aggressive investment on thin reserves is rewarded.[123]

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[120] INT. REV. CODE of 1954, § 532(a).

[121] Treas. Reg. § 1.537-2(b)(2) (1959).

[122] Treas. Reg. § 1.537-3(a) (1959).

[123] For evidence that this has been the effect of the tax for some time *see* D. SMITH, EFFECTS OF TAXATION: CORPORATE FINANCIAL POLICY 194-99 (1952).