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Planning to Avoid the Accumulated Earnings Tax: Some Advice for Oil and Gas Corporations

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PLANNING TO AVOID THE ACCUMULATED EARNINGS TAX: SOME ADVICE FOR OIL AND GAS CORPORATIONS

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Many closely held corporations in the oil and gas industry may be vulnerable to the accumulated earnings tax. This article outlines the basic provisions of the accumulated earnings tax and offers some practical advice on how oil- and gas-related corporations can successfully avoid this potential tax trap.

The accumulated earnings tax is a penalty tax on any corporation in any industry which avoids the income tax on dividends paid to shareholders by accumulating earnings and profits inside the corporation instead of distributing them as dividends.[1] The underlying theory behind this provision is that without the tax, shareholders may be tempted to avoid the resulting double taxation on dividends. In *Helvering*, the Supreme Court stated that the purpose of the accumulated earnings tax "is to compel the company to distribute any profits not needed for the conduct of its business so that, when so distributed, individual stockholders will become liable" for taxes on the dividends received.[2]

The accumulated earnings tax may be imposed on any corporation, foreign, domestic, public or closely-held, other than a domestic or foreign personal holding company.[3] S Corpo-

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1 Sec. 532(a).

2 Helvering, Commissioner v. Chicago Stock Yards Co., 318 U.S. 693, 699, 30 A.F.T.R. 1091, 1094 (1943).

3 Sec. 532(b).

rations are not subject to the tax since an S Corporation is deemed to distribute all earnings and profits currently.[4] Therefore, any closely held oil- and gas-producing corporation that has not yet elected S Corporation status should be careful to avoid this potential tax trap.

Although in theory most corporations may be held liable for the accumulated earnings tax, the IRS has paid special attention to certain types of corporations. The Service carefully scrutinizes closely-held corporations, including corporations in the oil and gas industry since, as a result of the concentration of ownership in a small group of shareholders, there is a greater chance of the shareholders exercising control over corporate dividend policy than in the publicly held corporation. As a general rule, publicly held corporations need not worry about the penalty tax because management's independence and the wide diffusion of stock ownership prevents a single group from exercising control over dividend policy. Nevertheless, publicly held corporations are not immune from Section 531, as evidenced in the holding in *Trico Products Corp.*[5] In *Trico*, six shareholders controlled about two-thirds of the voting stock and the Court determined that the accumulations were motivated by the individual interests of this group.

The accumulated earnings tax is levied at the rate of 28 percent of accumulated taxable income.[6] Accumulated taxable income, defined in Section 535(a), is calculated by subtracting from the corporation's taxable income (as adjusted under Section 535(b)):(1) the dividends paid deduction and (2) the accumulated earnings credit. Adjustments to taxable income under Section 535(b) include the following:

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4 Sec. 1366.

5 Trico Products Corp. v. Commissioner, 137 F. 2d 424 (2d Cir. 1943), *cert. denied*, 320 U.S. 799 (1946).

6 Sec. 531.

ADDITIONS TO TAXABLE INCOME:

(1) Net operating loss deduction.

(2) Capital loss carryforward deduction.

(3) Capital loss carryback deduction.

(4) Special dividends received deduction prescribed in Section 241 and following (except Section 248).

DEDUCTIONS FROM TAXABLE INCOME:

(1) Federal income taxes.

(2) Income, war profits, and excess profit taxes of foreign countries and possessions of the United States.

(3) Charitable contributions disallowed because of the 10% limitation.

(4) Disallowed capital losses.

(5) Net capital gain for the taxable year reduced by the taxes attributable to such net capital gain.

From the adjusted taxable income, the dividends paid are deducted. This includes: (1) dividends paid during the tax year (Section 561); (2) dividends paid within two and a half months after the close of the tax year (Section 563); and (3) consent dividends (Section 565). In addition, the accumulated earnings credit is deducted from adjusted taxable income in computing accumulated taxable income. The allowance of the accumulated earnings credit insures that a corporation is not required to distribute earnings and profits which are needed in the business.

The minimum accumulated earnings credit for most corporations is equal to $250,000 less the accumulated earnings and profits at the close of the preceding taxable year.[7] Service corporations in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or

7 Sec. 535(c)(2).

consulting are however permitted to accumulate only a minimum of $150,000.[8] The maximum credit for all corporations is an amount of earnings and profits retained for the reasonable needs of the business minus the adjustment to taxable income for the net capital gain. As a result, as long as the earnings and profits accumulated are retained for the reasonable needs of the business, there will be no accumulated earnings tax. Therefore, the key issue to be resolved in most accumulated earnings tax cases is a determination of the "reasonable needs of the business" in particular fact situations.[9]

EXAMPLE 1:

X Corporation had accumulated earnings and profits as of December 31, 1988, of $200,000. During 1989, X had adjusted taxable income of $100,000. It is determined that the reasonable needs of the corporation justify a current accumulation of $120,000. X Corporation's accumulated earnings credit is the greater of the reasonable needs of the business or the statutory credit. The credit is therefore $120,000, calculated as follows:

Earnings and profits retained for the reasonable needs of the business	$120,000
Statutory minimum credit	$250,000
Accumulated earnings and profits as of December 31, 1988	$200,000
Minimum credit	$50,000

(See Exhibit C which is a worksheet that can be used to calculate the accumulated earnings credit)

As a result, X corporation would have no accumulated taxable income since the credit of $120,000 would be allowed

8 *Id.*

9 See, John P. Scripps Newspapers v. Commissioner, 44 T.C. 453 (1965).

as a deduction from its adjusted taxable income of $100,000 and thus no accumulated earnings tax.

Some guidance as to what constitutes the reasonable needs of the business is provided in Section 537 and the Regulations thereunder. Under Section 537(a), the term "reasonable needs of the business" includes the reasonably anticipated needs of the business, the Section 303 redemption needs of the business, and the excess business holdings redemption needs of the business.

The reasonably anticipated needs of the business include not only amounts with respect to the immediate business purpose, but also amounts that are appropriate for the future needs of the business.[10] The corporation must have specific, definite, and feasible plans for the use of the accumulation. Nevertheless, the 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. All that is necessary is that such accumulations be used within a reasonable time depending upon all the facts and circumstances.[11] Reasonably anticipated needs would not cover plans that are uncertain or vague nor situations where execution of the plans is postponed indefinitely.[12] In *Magic Mart*, the Tax Court held that the time between the initiation of plans for expansion and completion some 10 years thereafter was a reasonable time under the circumstances and stated "we do not think the time element is controlling."[13]

One of the most asserted grounds for accumulating earnings and profits is for the expansion of the business or the replacement of productive assets. The Regulations list this as an indicator that earnings and profits are being accumu-

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10 Regs. Sec. 1.537-1(b)(1).

11 *Id.*

12 *Id.*

13 Magic Mart, Inc. v. Commissioner, 51 T.C. 775, 797 (1969).

lated for the reasonable needs of the business.[14] In order for the corporation to ensure that plans for expansion or replacement will constitute reasonable needs, the plans should be reflected in specific contracts, book entries, or corporate minutes. Such documentation should take place during the period of accumulation to support the taxpayer's position that the plans for expansion or replacement were a real consideration and not simply an afterthought in an attempt to justify a challenged accumulation. Naturally, a partial or complete execution of the expansion or replacement in the taxable year or soon thereafter is fairly convincing that the accumulation is reasonable. Likewise, a strong history of expansion or active investigation of the expansion or replacement and preparation for its execution may be sufficient.

EXAMPLE 2:

Assume that in 1985, the boards of directors of A Corp. and B Corp. both decided to accumulate $2,000,000 for the purpose of constructing new corporate headquarters. A Corp. takes no steps to initiate the construction and four years pass. On the other hand, B Corp. appoints a committee to select a site in 1985 and that same year, the committee chooses a site. In 1986, B Corp. purchases the site. In 1987, an architect is retained to draw up plans for the new corporate headquarters. In 1988, bids are requested and submitted for the construction of the headquarters. Clearly, B Corp. is in a better position to justify the accumulation than that of A Corp.

Nevertheless, A's chances of prevailing are worth discussing. In *Motor Fuel Carriers, Inc.*, the Fifth Circuit Court of Appeals noted that ". . . plans for expansion were not set forth in the minutes or other documentary material with precision or detail. Nevertheless, the requirement of 'specific, definite, and feasible' plans does not demand that the taxpayers produce meticulously drawn, formal blueprints for

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14 Regs. Sec. 1.537-2(b)(1).

action. . . ."[15] The Court noted that the plans must be a real consideration and not an afterthought to justify a challenged accumulation. Thus, in the example above, if A Corp. could prove the sincerity of its reasons for accumulating, A could prevail. In *Motor Fuel Carriers, Inc.*, the Court held that Motor Fuel Carriers was justified in its accumulation where the corporation documented in its minutes both an intent to expand, as well as forecasting almost the exact cost of the proposed expansion which was ultimately carried out.

Even the fact that funds are not used as planned for expansion or replacement does not of itself make the accumulation unreasonable. In *Sterling Distributors, Inc.*, the Fifth Circuit held that the reasonableness of accumulations is determined by conditions as they exist in the year involved and not by subsequent events except as they shed light on facts existing during the tax year.[16] In *Sterling*, at the end of the tax year in question, the taxpayer had a bona fide business plan and need for expanding its beer distributorship facilities. In a subsequent year, the plan was abandoned. The Court held that this abandonment did not, per se, show an unreasonable accumulation. It should be noted however, that in years subsequent to the abandonment, a corporation may be highly vulnerable to the accumulated earnings tax unless reasonable grounds for future accumulations of earnings and profits can be supported.

The Regulations point out that another ground for accumulating earnings and profits for the reasonable needs of the business is to provide necessary working capital for the business.[17] The Tax Court, the U.S. Court of Claims, and the U.S. Court of Appeals have all used an operating cycle

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15 Motor Fuel Carriers, Inc. v. Commissioner, 559 F. 2d 1348, 1354 (CA-5), 77-2 U.S.T.C. Par. 9661 at 88,232 (1977).

16 Sterling Distributors, Inc. v. United States, 313 F. 2d 803 (5th Cir. 1963), 11 A.F.T.R. 2d 767 (1963).

17 Regs. Sec. 1.537-2(b)(4).

approach to determine the amount of needed working capital. Working capital needed is the amount necessary to finance the normal operations of the business during its operating cycle.

The *Bardahl* decisions are probably the most famous Tax Court decisions in the accumulated earnings tax area.[18,19] In *Bardahl*, the Tax Court recognized a computational approach to determine a corporation's liquidity relative to the reasonable needs of the business. Under *Bardahl*, a corporation is allowed to accumulate enough working capital to cover its reasonable business needs. The result of the *Bardahl* decisions is that a corporation need only justify its accumulation of earnings and profits to the extent of working capital, not necessarily to the extent of earnings and profits. The *Bardahl* decisions recognize the impracticality in pressuring a corporation to pay a dividend if it is does not have sufficient working capital to do so. Under *Bardahl*, earnings and profits are considered available for dividend distribution only to the extent that working capital exceeds the reasonable needs of the business.

The first step in the *Bardahl* computation is to ascertain the amount of working capital available to the corporation at the close of the taxable year. Working capital retained to provide for a single operating cycle is deemed to be accumulated for the reasonable needs of the business. Working capital is computed by subtracting the corporation's current liabilities from its current assets. The courts have generally attached the same meaning to current assets and current liabilities as under generally accepted accounting principles. Under generally accepted accounting principles, current assets are normally stated in the balance sheet at historical cost rather than current fair market value. However, the Supreme Court, in *Ivan Allen*, has held that if a portion of the cur-

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18 Bardahl Mfg. Corp. v. United States, 24 T.C.M. 1030 (1965).

19 Bardahl Int'l Corp. v. United States, 25 T.C.M. 935 (1966).

rent assets includes marketable securities, the fair market value of such securities should be used to compute working capital.[20] The *Ivan Allen* holding has the practical and detrimental effect of increasing working capital where a corporation's marketable securities have appreciated in value. Thus the corporation's reasonable business needs would have to be measured against working capital as increased by the appreciation of the securities. In addition, if the marketable securities have declined in value, such decline may offer a potential benefit to the corporation in measuring working capital against reasonable needs of the business.[21]

Under *Bardahl*, working capital needed is an amount sufficient to cover a corporation's reasonably anticipated costs of operating for a single operating cycle. In *Bardahl Int'l*, the Court stated that "In this approach to determining the reasonable needs of petitioner's business we are trying to determine . . . how long petitioner's cash will be tied up in inventory and receivables on the assumption that petitioner needs at least enough cash or cash equivalents to cover its cash requirements during that period of time if it had no receipts."[22] The calculation consists of first adding together two cycles: (1) the inventory cycle, calculated by dividing peak (or average) inventory by annual cost of goods sold and (2) the receivable cycle, calculated by dividing peak (or average) accounts receivable by total sales for the year. From this sum is subtracted the credit cycle, calculated by dividing peak (or average) accounts payable by annual purchases. The Court used this result, the single operating cycle expressed as part of the year, to multiply times the adjusted operating expenses for the full year to determine the reasonably anticipated costs of operating for a single operating cycle. This it held to be the working capital needs of the business. In determining ad-

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20 Ivan Allen Company v. United States, 422 U.S. 617, 36 A.F.T.R. 2d 75-5200 (S. Ct., 1975).

21 *Id.*

22 Bardahl Int'l Corp. v. United States, 25 T.C.M. 946 (1966).

justed operating expenses under *Bardahl*, the Court did not use depreciation or federal income taxes. Exhibit A is a worksheet which can be used in computing a corporation's working capital needs in accordance with the operating cycle formula used by the Tax Court in *Bardahl Int'l.*

In determining working capital needs, either the current or subsequent year's costs may be used in the calculation, provided that the taxpayer makes a consistent choice where several years are at issue.[23] In addition, either peak cycles or average cycles can be used. However, if the corporations business is seasonal, the courts generally hold that the peak cycle should be used.[24]

The issue as to whether or not the *Bardahl* formula is applicable to a service business is unsettled. Although a service business has working capital requirements, the variable missing in a service business is inventory. The purchase of inventory in a manufacturing business begins the operating cycle. What specific activity would begin the operating cycle of a service business thereby replacing the inventory cycle? Some courts have applied the *Bardahl* formula to a service business by simply ignoring the inventory cycle,[25] or by ignoring the inventory cycle and adjusting the operating cycle under *Bardahl* (by adding 60 days of professional payroll to working capital needs as a reasonable operating reserve).[26] Other courts have specifically rejected the use of the *Bardahl* computation as applied to a service business.[27]

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23 Empire Steel Castings, Inc. v. Commissioner, 33 T.C.M. 155 (1974).

24 See, Kingsbury Investments, Inc. v. Commissioner, 28 T.C.M. 1082 (1969); Magic Mart, Inc. v. Commissioner, 51 T.C. 775 (1969).

25 W.L. Mead, Inc. v. Commissioner, 34 T.C.M. 924 (1975).

26 Simons—Eastern Co. v. United States, 354 F. Supp. 1003 (D.C. Ga.), 73-1 U.S.T.C. Par. 9279 (1973).

27 Cheyenne Newspapers, Inc. v. Commissioner, 32 T.C.M. 234 (1973); Myron's Ballroom v. United States, 382 F. Supp. 582 (D.C. Cal. 1974) *rev'd on other grounds*, 548 F. 2d 331 (9th Cir. 1977).

Although the *Bardahl* formula is widely used by the Courts and suggested to be used for most taxpayers by IRS examiners,[28] it was never intended to be rigidly applied in all cases.[29] The *Bardahl* formula has been designed by the courts as a mere yardstick in measuring management's judgment. It should be used to determine whether management's decision to retain earnings and profits was motivated entirely by the needs of the business or was influenced by the desire to avoid a second tax on the corporate earnings at the stockholder level. The formula has the advantage of leaving room for consideration of many variables which may be applicable to the particular corporate situation."[30] The search for the proper method must always take into account the needs of the particular business as they existed during the particular year. Such needs are to be determined on a case by case basis.[31] Therefore, departure from *Bardahl* has both been applied and anticipated by the courts.

In *Apollo*, the First Circuit utilized a working capital needs computation different from *Bardahl*.[32] In *Bardahl*, cost of goods sold plus operating expenses were considered in calculating working capital needs for both the inventory and accounts receivable cycles (see lines 2 and 4 of Exhibit A). *Apollo* did not consider operating expenses in calculating working capital needs for the inventory cycle. As a result, the First Circuit's formula resulted in a considerably smaller amount for working capital needs than the Tax Court's formula. Although the Section 531 Audit Guidelines observe that

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28 4233 Internal Revenue Manual—Audit, Chapter 600, Tax Audit Guidelines, *Audit Techniques—Accumulated Earnings Tax*, at 638.

29 See, Apollo Industries, Inc. v. Commissioner, 44 T.C. 1 (1965), *rem'd.* 358 F. 2d 867 (1st Cir. 1966); Cheyenne Newspapers, Inc. v. Commissioner, 32 T.C.M. 234 (1973); Magic Mart, Inc. v. Commissioner, 51 T.C. 775 (1969).

30 Bardahl Int'l Corp. v. United States, 25 T.C.M. 944 (1966).

31 See, Dixie, Inc. v. Commissioner, 277 F. 2d 526 (CA-2), 60-1 U.S.T.C. Par. 9419 (1960).

32 Apollo Industries, Inc. v. Commissioner, 44 T.C. 1 (1965), rem'd 358 F.2d 867 (CA-1, 1966).

the *Apollo* formula may have application to nonmanufacturing businesses,[33] no other Court has actually applied the *Apollo* formula.

Once working capital needs are calculated, they should be compared to the working capital available to the corporation. If the working capital needs exceed available working capital, the result is a shortage of working capital, and there is no unreasonable accumulation (assuming there were no unrelated investments). On the other hand, if the working capital available exceeds working capital needs, it is necessary to ascertain the other reasonable needs of the business before determining whether the corporation has accumulations beyond its reasonable needs.[34]

In *Bardahl Mfg.*,[35] the Tax Court used working capital to determine if the accumulation of earnings and profits was beyond Bardahl Mfg.'s reasonable needs. The crucial factor is not the monetary size of the accumulated earnings and profits but the liquidity position of the taxpayer and the relationship of this liquidity position to current and anticipated needs of the business.[36] Thus, justification of accumulated earnings is only required to the extent of working capital. In the *Bardahl Mfg.* analysis, unrelated investments are considered an additional component of working capital.

Many courts have utilized this liquidity analysis to determine the reasonableness of the accumulated surplus. Exhibit B presents the formula utilized by the Tax Court in *Bardahl Mfg.* in determining the unreasonable accumulation. Line 3 of the worksheet entitled "Needs of the Business" includes not only working capital needs (line 3(a)), and expansion or replacement of productive assets needs (lines 3(b) and (c)),

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33 4233 Internal Revenue Manual—Audit, Chapter 600, Tax Audit Guidelines, *Audit Techniques—Accumulated Earnings Tax*, at 638.

34 Bardahl Int'l Corp. v. United States, note 19 *supra*.

35 Bardahl Mfg. Corp. v. United States, note 18 *supra*.

36 Empire Steel Castings, Inc. v. Commissioner, note 23 *supra*.

but other reasonable and reasonably anticipated needs of the business. Other reasonably anticipated needs of the business (line 3(d)), include the additional grounds for accumulation set forth in Treas. Reg. Sec. 1.537-2(b):

> "To acquire a business enterprise through purchasing stock or assets; . . . To provide for the retirement of bona fide indebtedness created in connection with the trade or business, such as the establishment of a sinking fund for the purpose of retiring bonds issued by the corporation in accordance with contract obligations incurred on issue; . . . To provide for investments or loans to suppliers or customers if necessary in order to maintain the business of the corporation; . . . To provide for the payment of reasonably anticipated product liability losses . . ."

The Regulation expressly states that this list of grounds is nonexclusive. In addition, Section 537(a) provides that reasonable needs of the business include the section 303 redemption needs and the excess business holdings redemption needs.

As mentioned above, a ground for accumulating surplus based on reasonable needs is to invest in a new business enterprise through acquiring the stock or the assets of another business. There does not appear to be any restriction on the type of business that the corporation may enter.[37] Abandoning the old business and entering a new one should not have adverse consequences for accumulated earnings purposes, as long as the accumulations are necessary for the acquisition of the new business.[38] As a practical matter, if a corporation is planning on purchasing another line of business, it is essential to ensure that the corporate charter allows for such expansion. Otherwise, accumulations for this purpose would be denied under the Regulations for lack of feasibility.[39]

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37 Regs. Sec. 1.537-3(a).

38 JJJ Corp. v. United States; 576 F. 2d 327 (Ct.Cl.) 42 A.F.T.R. 2d 78-5024 (1978).

39 See, Regs. Sec. 1.537-1(b)(1).

Although a corporation can enter any line of business, the business acquired can not be a personal holding company or an investment company.[40] The company acquired must be engaged in the active conduct of a trade or business.[41] If this is not the case, the investment will be classified as an unrelated investment for purposes of measuring working capital against reasonable business needs.[42] The Regulations also provide that an accumulation to provide for such an investment is an improper ground for accumulating earnings and profits.[43]

The Regulations also outline the level of activity required to constitute an active trade or business.[44] The holding for investment purposes of stock, securities, land, or other property, including casual sales of such property does not constitute an active business.[45] A corporation not in the active business of owning real estate, but desirous of purchasing real estate to shelter its active income must be extremely careful that such an acquisition is not classified as an unrelated investment. For example, if a corporation purchases an apartment complex and engages a management company as an independent contractor to operate the complex, the corporation's level of activity in the project would not rise to the "active conduct of a trade or business" level. Therefore, the investment will be classified as an unrelated investment.[46] If real estate is purchased, the corporation should manage and

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40 Regs. Sec. 1.537-3(b).

41 *Id.*

42 See, Bardahl Mfg. Corp. v. United States, 24 T.C.M. 1030 (1965); Faber Cement Block Co., Inc. v. Commissioner, 50 T.C. 317 (1968); Nemours Corp. v. Commissioner, 325 F. 2d 559 (CA-3, 1963).

43 Regs. Sec. 1.537-2(c)(4).

44 Regs. Sec. 1.355-3(b).

45 Regs. Sec. 1.355-3(b)(2)(iv).

46 See, Atlantic Commerce & Shipping Co. v. Commissioner, 32 T.C.M. 473 (1973), *aff'd* 500 F. 2d 937 (2d Cir. 1974).

operate the property itself by employing personnel necessary to manage and operate the property.

The determination as to whether a taxpayer has entered a "new business" or acquired an "unrelated investment" depends on the magnitude of the taxpayer's interest and the extent of the taxpayer's participation in the operation and management of the activity. A passive investment such as a net-leased property or ownership of mineral rights will more likely than not be classified as an "unrelated investment."[47] An investment by a corporation in a limited partnership, which would be treated as an interest in a passive activity under Section 469(h)(2), will be classified as an unrelated investment and therefore not a permissible ground for accumulation.

If the acquisition is in the form of a stock purchase, the business of the investor company will be deemed to include in substance the investee's business, where at least 80 percent of the voting stock of the investee is owned by the investor.[48] If the investor purchases less than 80 percent of the investee's voting stock, the determination of whether the investor's business includes the investee's business depends upon the particular circumstances of the case.[49] In the event that the investor's business is determined not to include the investee's business, such investment would be classified as an unrelated investment.

Accumulations of earnings and profits for purposes of investing in unrelated assets are considered beyond reasonable business needs and are added to working capital in computing accumulations beyond the reasonable needs of the business.[50] Other possible improper grounds for accumulations under the Regulation include the following:

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47 See, Cataphote Corp. of Miss. v. United States, 535 F. 2d 1225 (Ct. Cl. 1976).

48 Regs. Sec. 1.537-3(b).

49 *Id.*

50 Regs. Sec. 1.537-2(c).

"(1) Loans to shareholders, or the expenditures of funds of the corporation for the personal benefit of the shareholders;

(2) Loans having no reasonable relation to the conduct of the business made to relatives, or friends, of shareholders or to other persons;

(3) Loans to another corporation, the business of which is not that of the taxpayer corporation, if the capital stock of such other corporation is owned, directly or indirectly, by the shareholder or shareholders of the taxpayer corporation and such shareholder or shareholders are in control of both corporations; . . .

(5) Retention of earnings and profits to provide against unrealistic hazards."

In *Bardahl Mfg.*, loans unrelated to the taxpayer's business and two real estate investments were all considered unrelated assets and added to working capital to determine the amount of accumulation beyond the reasonable needs of the business. The Tax Court stated that the real estate activities "did not represent a genuine diversification of corporate activity but were in fact a diversion of corporate funds to a personal project of its principal stockholder which was wholly unrelated to its oil additive business."[51]

In the event that the liquidity analysis (Exhibit B) does not result in an accumulation beyond reasonable needs, the issue as to whether or not under Section 532 the corporation was "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders" is moot. If there are no accumulations beyond the reasonable needs, the corporation will receive a credit equal to the full amount of earnings accumulated during the taxable year.[52] As a result, the credit will reduce the tax base (accumulated taxable in-

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51 Bardahl Mfg. Corp. v. United States, 24 T.C.M. 1047 (1965).

52 See, Magic Mart, Inc. v. Commissioner, 51 T.C. 775 (1969).

come) to zero and there would be no accumulated earnings tax.[53] Exhibit C is a worksheet which can be used in calculating the accumulated earnings credit.

In the event that the liquidity analysis (Exhibit B) results in an accumulation beyond reasonable needs, except to the extent that the minimum credit applies, the corporation will not be given a credit under Section 535 for the unreasonable accumulation. In such cases, accumulated taxable income will be positive, thereby exposing the corporation to potential liability for the accumulated earnings tax. Liability for the tax will only attach when the corporation evidences the tax avoidance purpose. An unreasonable accumulation and the proscribed tax avoidance purpose are both necessary under Section 532 to trigger the tax. The determination as to whether the corporation's purpose in accumulating earnings and profits was to avoid income tax depends upon the particular circumstances of each case.[54]

In *JJJ Corp.*, the Court of Claims stated that "the corporate purpose or intent, measured by the purpose or intent of its board of directors and officers, is controlling in determining the lawfulness of the accumulation."[55] The Court held that the time period for measuring such intent is from the first day of the taxable year up to the date of filing the return. In computing the accumulated taxable income under Section 535(a), the dividends paid deduction under Section 561 is allowed as a deduction. Under Section 563, dividends paid after the close of the taxable year but before the due date of the tax return are considered as paid during the taxable year. Thus, the Court in *JJJ Corp.* reasoned that when a corporation with an unreasonable accumulation fails to pay a dividend and simply files its tax return, the intent of the cor-

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53 *Id.*

54 Regs. Sec. 1.533-1(a)(2).

55 JJJ Corp. v. United States, 576 F. 2d 327, 338 (Ct. Cl.), 42 A.F.T.R. 2d 78-5024, 78-5032 (1978).

porate officers up to the due date of the return is relevant to determining the corporate tax motives.

Where there has been an unreasonable accumulation, such accumulation is a significant factor indicating a purpose to avoid tax.[56] In fact, due to the inherent difficulty of proving a corporation's intent, Congress has provided in Section 533(a) that an unreasonable accumulation is determinative of the proscribed purpose unless the corporation proves otherwise by the preponderance of the evidence. Rebutting the Section 533(a) presumption is a difficult task under the Supreme Court's decision in *Donruss*.[57] In *Donruss*, the Supreme Court held that the proscribed purpose need only be one of the purposes for accumulating earnings and profits. It need not be the sole, controlling, or dominant purpose. Thus, a corporation cannot rebut the presumption of tax avoidance by proving the existence of alternative business purposes. The corporation will have to prove a complete lack of the proscribed purpose. In addition, where the presumption of tax avoidance purpose for accumulations is coupled with proof of "actual knowledge of the favorable tax consequences to the shareholders of such accumulations, it becomes imperative that the proof demonstrate reasonably definite grounds from which to infer the existence of a contrary purpose."[58]

In *Atlantic Properties*, the Tax Court held that a 25 percent shareholder's tax avoidance motive was enough to place liability for the accumulated earnings tax on the corporation in spite of the fact that the other shareholders had no tax avoidance purpose.[59] In *Atlantic Properties*, the corporation

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56 Vulcan Steam Forging Company, Inc. v. Commissioner, 35 T.C.M. 110 (1976).

57 United States v. Donruss Co., 384 F. 2d 292 (6th Cir. 1967), *rev'd and rem'd* 393 U.S. 297 (1969).

58 John B. Lambert & Associates v. United States, 212 Ct. Cl. 71, 85 (1976).

59 Atlantic Properties, Inc. v. Commissioner, 519 F. 2d 1233, 36 A.F.T.R. 2d 75-5562 (1975), *aff'g*, 62 T.C. 644 (1974).

was formed by issuing four equal blocks of stock and an 80 percent majority vote was required with respect to most corporate matters. The holders of 75 percent of the stock felt that dividends should be declared, but the holder of 25 percent disagreed and effectively, due to the 80 percent majority requirement, blocked any dividend from being paid. On appeal to the First Circuit, the Court stated, "We see no alternative to imposing liability on all the stockholders other than that of granting immunity to all stockholders of a closely-held corporation whenever one of them, with power of veto, chooses to use it for tax avoidance purposes."[60] Thus, where an individual can exercise control over corporate dividend policy, that individual's tax avoidance purpose may be imputed to the corporation.

The Regulations outline additional factors to be considered in the determination of a tax avoidance purpose. Factors considered are: "(i) Dealings between the corporation and its shareholders, such as withdrawals by the shareholders as personal loans or the expenditure of funds by the corporation for the personal benefit of the shareholders, (ii) the investment by the corporation of undistributed earnings in assets having no reasonable connection with the business of the corporation . . . and (iii) the extent to which the corporation has distributed its earnings and profits."[61] A corporation's attempt to rebut the statutory presumption of the tax avoidance purpose is even more difficult if any of the above factors stated in the Regulation are present.[62] However, the presence of these factors is not controlling. They are merely used as evidence to determine whether the accumulation was for the proscribed purpose. Despite the presence of all the factors in Treas. Reg. Sec. 1.533-1(a)(2), if the corporation can establish that tax avoidance was not a reason for accumulating surplus, the accumulated earnings tax will not apply.

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60 *Id.* at 1236, 36 A.F.T.R. 2d, at 75-5564.

61 Regs. Sec. 1.533-1(a)(2).

62 See, United States v. Donruss Co., 35 T.C.M. 110 (1976).

It must be kept in mind that the accumulation must be coupled with the intent to avoid shareholder taxes. Where a corporation accumulates for reasons other than the proscribed purpose such as "out of caprice, spite, miserliness, or stupidity, rather than sound business reasons," Section 531 will be inapplicable.[63] Likewise, an honest though mistaken belief that the accumulations were necessary for reasons other than the proscribed purpose may negate the requisite intent.[64] The Fourth Circuit has held that the mistaken belief must be reasonable;[65] however, unreasonable beliefs that the accumulations were necessary for purposes other than the proscribed purpose have been upheld.[66]

In addition to the presumption provided in Section 533(a) triggered by unreasonable accumulations, a similar presumption arises in the case of holding or investment companies. Under Section 533(b), the fact that a corporation is a mere holding or investment company (as defined in Treas. Reg. Sec. 1.533-1(c)) is *prima facie* evidence of the proscribed tax avoidance purpose. In such a case, the burden of proof is on the holding or investment company to prove absence of a tax avoidance purpose. Since the activities of a mere holding or investment company do not constitute a "business," it is impossible to establish any reasonable needs for such a business.[67] Congress has recognized this fact by providing for such companies a maximum accumulated earnings credit of $250,000 less the accumulated earnings and profits of the corporation at the close of the preceding taxable year.[68]

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63 Atlantic Properties, Inc. v. Commissioner, 62 T.C. 644, 659–660 (1974).

64 See, Casey v. Commissioner, 267 F. 2d 26 (2d Cir. 1959).

65 See, Smoot Sand & Gravel Corp. v. Commissioner, 274 F. 2d 495 (4th Cir. 1960).

66 See, T.C. Heyward & Co. v. United States, 18 A.F.T.R. 2d 5775 (W.D.N.C. 1966).

67 Lewis, 35-7th T.M., *Accumulated Earnings Tax*, at A-19.

68 Sec. 535(c)(3).

Considering the difficulty of rebutting the presumption that an unreasonable accumulation is determinative of the tax avoidance purpose, and the fact that the tax avoidance issue becomes relevant only when there is an unreasonable accumulation, most Section 531 cases are naturally won or lost on the issue of what constitutes the "reasonable needs of the business." As a general rule, where the taxpayer can establish that the accumulations were necessary to meet the reasonable needs of the business, the taxpayer normally wins. Where it is established that there has been an unreasonable accumulation, the taxpayer normally loses due to the difficulty in rebutting the Section 533(a) presumption.

Although planning to avoid the accumulated earnings tax should take second seat to that of planning to avoid the regular income tax under Section 11, corporations should not ignore the potential hazard of Section 531. Most importantly, a corporation should document any planned transactions to support its "reasonable needs" arguments. Such documentation includes the corporate minutes, architectural and engineering plans, cost projections, and any other correspondence to support the corporation's position. For instance, in the case of a proposed purchase of another business, such documentation would include financial statements of the investee corporation including an analysis thereof, correspondence between the investor and investee corporations, and any internal memorandums of the investor corporation regarding the proposed acquisition.

In assessing the corporation's potential exposure to the accumulated earnings tax, the corporation should consider the factors set forth in Treas. Reg. Sec. 1.533-1(a)(2). The existence of any factor favoring an assessment does not dispose of the issue. Factors favoring assessment are used solely for the purpose of providing evidence and the corporation must be prepared to defend its actions. For example, while loans to shareholders are a factor favoring assessment, they may be overlooked where there is a history of making these types

of loans, and the loans including interest thereon are paid in full. Conversely, the presence of factors inferring proper motive, although reducing the likelihood of impositition of the penalty tax, do not preclude an assessment.

As a matter of course, corporations with accumulations greater than the minimum accumulated earnings credit should calculate, using the *Bardahl* formula, reasonable needs of the business to determine if there has been an unreasonable accumulation. If there is an excess of working capital and the corporation believes its exposure to the accumulated earnings tax is high, the corporation should consider a dividend distribution under Section 563(a) to the extent of the unreasonable accumulation. The distribution will reduce its accumulated taxable income under Section 535(a) to zero and thus no tax will be assessed. In determining whether or not to distribute dividends under Section 563(a), the corporation must weigh the future probability of audit against the current effect of the dividend on its shareholders. Oil and gas corporations with substantial unreasonable accumulations should consider the acquisition of another business, the expansion of the current business, or possibly an election under Subchapter S. An S Corporation election will only provide protection from the tax in the future. It will not provide retroactive protection to the corporation in years during which the corporation was a regular corporation.

Naturally, if the corporation can eliminate accumulated taxable income, no tax will be assessed. For example, if the corporation expands its oil and gas operations, any loss derived from such expansion will reduce its taxable income.

Another method of reducing/eliminating taxable income is to pay higher salaries to corporate owner-employees. If this is decided, the risk of the compensation being classified as unreasonable should be addressed. If there is a determination that the compensation is unreasonable, the resulting constructive dividend, if determined not to be pro rata or pre-

ferential under Section 562(c), would not be allowed as a dividends-paid deduction in computing accumulated taxable income under Section 535.[69] As a result, the portion of the compensation deemed unreasonable would be taxed to the corporation at an effective rate of 62 percent assuming the highest marginal tax rates. (Regular tax 34 percent plus penalty tax 28 percent.)

Planning in the accumulated earnings tax area serves to reduce both the likelihood of audit and the likelihood of a deficiency assessment in the event of audit. Oil and gas corporations that clearly have no unreasonable accumulation need not be concerned about the tax. Oil and gas corporations that are concerned about their accumulations may be unreasonable, need to plan and prepare their defenses prior to audit. The presumption of tax avoidance under Section 533(a) whenever an unreasonable accumulation is present, together with a lack of defense may be fatal. Such circumstances could lead to a potential assessment by the IRS and an upholding of such assessment by the Courts, even where actual tax avoidance never existed at the corporate level.

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69 See, Dielectric Materials Co. v. Commissioner, 57 T.C. 587 (1972); Wm. J. Lemp Brewing Co., v. Commissioner, 18 T.C. 586, 600 (1952).

EXHIBIT A

WORKSHEET for computing a corporation's current operating needs (by applying operating cycle formula used by the Tax Court in *Bardahl Int'l Corp.*)

1. Operating expenses for full year including cost of goods sold		$ _____
Less: Depreciation included in line 1	$ _____	
Federal Income Taxes included in line 1	_____	
2. Operating expenses for year as adjusted		_____
3. Operating business cycle		
(a) Cost of goods sold	_____	
(b) Peak month inventory or Average inventory	_____	
(c) Divide line (b) by line (a)		_____
(d) Net sales for year	_____	
(e) Peak month accounts receivable or Average accounts receivable	_____	
(f) Divide line (e) by line (d)		_____
(g) Add lines (c) and (f)		_____
(h) Purchases	_____	
(i) Peak month accounts payable (or Average)	_____	
(j) Divide line (i) by line (h)		_____
(k) Subtract line (j) from line (g)— (Resulting figure gives operating cycle expressed as part of the year)		_____
4. Multiply line 2 by line 3(k)— Amount of working capital needs		$ _____

EXHIBIT B
Computation of Accumulation Beyond Reasonable Needs

1. (a) Current Assets		$ _____
(b) LESS: Current Liabilities		_____
2. Working Capital		_____
3. LESS: Needs of Business:		
(a) Working Capital needs	$ _____	
(b) Replacement needs	_____	
(c) Expansion needs	_____	
(d) Other needs	_____	
4. Total Needs of Business		_____
5. Working Capital Excess (Shortage) (line 2 minus line 4)		_____
6. Add: Unrelated Investments		_____
7. Accumulated Beyond Reasonable Needs (Add lines 5 and 6)		$ _____

EXHIBIT C
Accumulated Earnings Credit Worksheet

1. Earnings + Profits—End of Year	$ _____
2. Earnings + Profits—Beginning of Year	_____
3. Increase in Accumulated Earnings (line 1 minus line 2)	_____
4. LESS: Unreasonable Accumulations (line 7—Exhibit B)	_____
5. Earnings Retained for Reasonable Needs of Business	_____
6. LESS: Net Capital Gain (Sec. 535(b)(6))	_____
7. Allowable Credit Under Sec. 535(c)(1)	$ _____
8. Minimum Accumulated Earnings Credit	$250,000*
9. LESS: Earnings + Profits—Beginning of Year	_____
10. Allowable minimum credit under Sec. 535(c)(2)	$ _____
11. Accumulated earnings credit (Greater of line 7 or 10)	$ _____

*Under Section 535(c)(2)(B), this amount for certain service corporations would be $150,000.