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Miscellaneous Procedural Problems

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MISCELLANEOUS PROCEDURAL PROBLEMS

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The hypothetical corporation has now advanced to success. The above articles have viewed the taxpayers as being the abused party. There are two sides to be considered, however. The government is not always unreasonable.

The problem is human greed. The corporation need not be formed. However, when the corporate form, with its attendant advantages, is utilized, certain rules necessarily follow. Because lawyers create the corporation, in a sense they also create the facts. Therefore, it is a necessary rule that the government can look through the corporation, can regard it or not regard it more or less at its convenience. The corporation should be created for some nontax reason—to limit liability—and then determine the tax consequences.

One price the corporation pays for being a separate taxpayer is that any rewards must be shared with the government. Having been talked into the glories of corporate life, the client now finds that he is paying another tax when he takes his reward out of the business. He may own the entire business or a share of it. His desire is to escape all tax liabilities, or to employ a capital gains treatment.

In the past, the price of using the corporate form was that its earnings would be taxed first to the corporation unless distributed to the stockholders for taxation in their hands. Under the former rule, if the corporate earnings were distributed, the corporation would be taxed, resulting in less earnings retained in the business. That was quite burdensome and had a tendency to interfere with the relationship between new businesses and established businesses.

Todays treatment does not unreasonably burden that relationship. However, there is a possibility of a return to the prior situation, though such treatment is counter to the taxpayer's desires. The natural enthusiasm of the owner, who is the individual taxpayer, is to get his money out, either with no tax as a return of his investment or at capital gains rates. The enthusiasm of the government is the opposite. This is part of the problem of the conflict between the antitrust laws and the tax laws, the latter tending to force consolidation and bigness and the former basically designed for the opposite.

Currently, there are a number of provisions under three headings designed to protect the revenue from the natural desire of the individual taxpayer not to pay any more tax than he has to – personal holding companies, collapsible corporations, and accumulated earnings taxes. This article will address itself to the accumulated earnings tax.

The lawyer, representing the successful corporation, must be aware of the personal holding company tax. This provision has been characterized as the incorporated pocketbook. The statute is arbitrary, and applies where there are five or fewer individuals owning, by attribution or otherwise, 50 percent of the equity in the business. That is the basic rule. Frequently, the shareholders prefer not to have strangers holding shares in the corporation. However, even if there is only one real party in interest he may escape liability under certain circumstances. Certain business activities of the corporation may exempt him from the tax. If its business is to hold the investments of this individual or to exploit his services the corporation is a personal holding company. An attorney must understand these rules. This technical provision effectively forces the distribution. If the corporation falls within the provisions, it must distribute the earnings or pay the tax.

The collapsible corporation has similar problems. The personal holding company is relatively simple to identify and, while the rules over reach in rare instances, they do not have the occasional unintended reach of the collapsible corporation rules. The basic collapsible corporation is illustrated by a taxpayer organizing a corporation for the purpose of building in values with the intention to collapse the corporation by liquidation—or the equivalent by a sale to another party—before it becomes successful. The sweep of the rules is broad.

A recent case involved actual failure of the venture.[1] The corporation created a new product, but there was no demand for it. The physical assets were sold and resulted in a profit. The profits were not on the business for which the corporation was organized yet the issue of intent to collapse was raised. Such a tax demonstrates the volatile nature of this area. The lawyer must therefore be leery of a quick sale or liquidation of the business by his client. Unawareness may result in the imposition of additional taxes.

Even more volatile are accumulated earnings tax questions. The basic situation occurs when a corporation is formed for the purpose of insulating individual high-bracket taxpayers from paying tax on earnings which would otherwise be subject to taxation. In *Donruss*[2] the issue was whether saving taxes had to be the primary purpose of the corporation. The argument was that it demands a primary purpose, not an incidental one. Lawyers indulge the presumption that everyone knows the law and the legal ramifications of their actions—an unrealistic presumption. The taxpayer knows that he is saving taxes. This was a point of conflict between the Justices when the question reached the Supreme Court of the United States. The majority held that saving taxes did not have to be the dominant purpose, or even particularly significant, but that there must have been "some" purpose to save taxes. The minority said that there is always "some" purpose, and that the majority's ruling would be too inclusive.

At this time, the future impact of *Donruss* is unclear. The majority, in its answer to the minority, in the last paragraph of Justice Marshall's opinion left open the possibility of proving that saving taxes are not a significant portion of the corporate purpose.

Another significant area of controversy that continues to develop is the determination of unreasonable accumulated earnings. The rule requiring stockholders to include all of the corporation's earnings on their individual returns or have the corporation pay a second tax is no longer applied. The corporation may keep a reasonable amount of earnings for internal expansion. However, certain questions must be answered. What amount is necessary to run the business? What amount will the tax allow the corporation to retain in the business for future operations and capital improvements?

Working capital must be defined before the above questions may be answered. Working capital is an accounting concept, somewhat refined in this case for tax purposes. An early case in the development of this concept introduced the concepts of operating cycle, peak operating cycle, average operating cycle, and so forth.[3] Mr. Libin's paper for the New York University Tax Institute discusses the relationship between operating a business and liquid assets. The second volume was published in the summer of 1972, and beginning at page 1143 updates the discussion of a year ago.

The government has followed this operating cycle theory and has acquiesced in numerous cases. The Service has been quite reasonable, even recognizing the need for extra funds when there is a strike in the industry.[4]

There is a caveat to this opinion. The Commissioner took the position, where excessive compensation had been paid to one of the stockholder-officers which resulted in a preference dividend, that the constructive dividend was inapplicable in calculating an adequate distribution. The issue is unresolved because the Court decided the case on other grounds. This illustrates that the Service is still aggressive in pursuing an unreasonable accumulation of earnings.

In contrast to that aggressive position, there is the special situation referred to in *Rev. Rul.* 72-345. The corporation had a short taxable year because of a tax-free reorganization. The rule in calculating the unreasonable accumulation of earnings is that the corporation receives credits for amounts paid out two and one-half months after the close of the taxable year. In this case, the amount was paid within the two and one-half months, but there had been a whole tax year within the two and one-half calendar months. The question was whether the distribution was too late to be credited on the earlier year's accumulation of earnings. The ruling was favorable and indicates that the Internal Revenue Service is occasionally quite realistic.

An obvious problem is the relationship between unreasonable accumulation of earnings and Phase I and Phase II of wage and price control, which includes restrictions on dividend payments. The accumulated earnings tax purpose is to force the pay-out. The national policy on wage and price control is to limit raising dividends thereby slowing inflation. It is significant that the dividend guidelines are administered by the Internal Revenue Service. Fortunately, the two sections of the Service were able to agree that certain actions had to be taken.

The developments were fairly rapid. During the freeze in the fall of 1971, the Service issued a ruling that accumulated earnings tax would be waived if the corporation followed the freeze guidelines. Rather promptly after the freeze in *Rev. Rul.* 72-11, the I.R.S. joined the dividend payout tax section of the Service with the restricted dividends section of the Service and its guideline pronouncements. The pronouncement was that for tax purposes the

the corporation would be excused for not distributing any dividend in excess of the guideline amount—the highest amount paid in the last three years of 25 percent of current year earnings. Due to questions raised by the tax bar, the Service in *Announcement* 72-42, I.R.B. 1972-14, 27 restated *Rev. Rul.* 72-11. Therefore, *Rev. Rul.* 72-11 is phrased differently in the Cumulative Bulletin from the statement that appeared in the Internal Revenue Bulletin. The restated ruling is that the corporation must pay as much as it can, or the excess will be taxed. The corporation will not be excused for not paying an amount in excess of the guideline amount unless it pays as much as possible under the guideline.

In *Rev. Proc.* 72-42 the question of excess payments was raised. Generally, the guideline enforcement section condemned those corporations making excess payments. Nor could the corporation escape liability by not distributing the rest. The two branches of the Service came to a compromise whereby the stockholder can pay the excess back but, nevertheless, it is taxable income to him and becomes a capital contribution back to the corporation. This has an overtone of the old undistributed earnings tax under which if the corporation retains its earnings, the earnings retained in or contributed back to the corporation would necessarily be reduced by the "second" tax.

A current topic of interest to the tax attorney is the procedure to be followed when the client's accumulated earnings are taxed. Most attorneys, except in rare instances, do not wish to advise their client to pay the penalty upon the filing of the return. The tax bar rejected the self-assessment system in this instance. This attitude resulted in later tax payments, which included interest. When is the tax due for the purpose of calculating interest and penalties, if they apply? The Service naturally took the position that it was a part of the self-assessment system—that the tax was due with the regular return and that interest ran from the due date of the return. The taxpayers favored the theory that the tax was due at the later date and, therefore, interest and penalties ran from that time. The latter prevailed in the District Court,[5] affirmed by the Ninth Circuit. The government also lost this point in the Sixth Circuit and in the Court of Claims. After having lost in two circuits and the Court of Claims, the Service issued *Rev. Rul.* 72-324, which agrees that penalties and interest run from the day of demand or, indeed, ten days after demand. This concession was occasioned by courts' refusals to accept the reasoning of the Service.

An unresolved question is the treatment of assets which have appreciated in value, but have not been sold or exchanged. Will the Service, in calculating accumulated earnings and profits or undistributed earnings, which are a function of accumulated earnings and profits, add to the accumulated earnings any unrealized appreciation? This calculation might apply to any asset. It has its most frequent and obvious impact in the case of temporary cash investments. The calculation may force the corporation to sell, and realize a gain, in order to get the cash to make a distribution or, possibly, force the corporation to distribute the assets in kind.

The leading case on accumulated earnings and profits is *National Grocery,*[6] which concerned the problem of differences between balance sheet and market values. The taxpayer argued that while the corporation had earnings, the unrealized loss on securities more than offset the current year earnings. The Supreme Court, while considering the value of the assets, refused to allow the corporation to offset unrealized loss against current year earnings.

Inflation frequently creates a gain. A question exists as to the method of calculating accumulated earnings and profits from prior years which the Service says makes it unnecessary to accumulate any more. The Tax Court as well as the Tenth Circuit[7] includes the appreciation and takes these assets at current market value. The Tax Court in *Golconder,*[8] reasserted its position in the face of a case in the District Court of Maryland.[9] The gain was one hundred million dollars. The Court held that the accumulated earnings tax was not designed to force liquidation of investments.

The Court distinguished the *Fenco*[10] decision, which reached an opposite result. This distinguishing appealed to the *Ivan Allen* Court.[11] Quite simply, the ruling was that the Service could not force realization of gain. Since that case the Tax Court, as indicated, held that the Service may force realization. The *Allen* holding would force taxpayers into an annual valuation of not only the marketable securities, but of all the assets of the corporation to determine if there is an unreasonable accumulation of values, some of which should be distributed.

The *Allen* valuation ties in with *Wetter Manufacturing,* in which the corporation distributed property instead of selling it, realizing the gain and adding it to earnings. What is the credit in figuring what the corporation has distributed? The Regulations state quite clearly that the credit is basis to the distributing corporation. The taxpayer stated that he was entitled to fair market value, that basis is a theoretical concept, and that the stockholders received dollars or dollars' worth. The Court held the Regulation invalid by examining the legislative history and its impact. The 1939 Code stated specifically that the amount of the credit was basis to the distributing corporation. Since the 1954 Code did not address this situation, the I.R.S. sought to establish credit as the basis to the distributing corporation. The rationale for the decision may be that if the Service must allow credit for fair market value in calculating the amount distributed, it should have that figure available to it in calculating the amount available for distribution.

Even though the area is unsettled, the corporation can formulate a plan for its operation. The calculation of undistributed earnings applies to undistributed earnings year by year. In figuring the amount that should be distributed for the year 1972, the corporation must determine the amount held at the beginning of the year, accumulated in prior years. This amount is approximately equal to accumulated earnings and profits, referred to above.

Liquidity is of the utmost importance. For example, if the balance sheet shows an accumulation in prior years of thousands or millions of dollars and yet the cash on hand is negligible, the corporation could not make a meaningful distribution. For this reason, liquidity is important. If in fact all of these prior earnings have been recycled into the business in the form of plant, equipment, inventory or accounts receivable, the action of the corporation will not be characterized as unreasonable. Excess liquidity is seldom a problem, if the corporation can establish need for the cash. Courts have allowed, on a case by case basis that take into consideration the individual business, corporations to hold a large amount of cash.

The unreasonable accumulation principle does not forbid the flow of earnings into the business. However, a professional corporation with no cash designated for distribution while earnings have been invested in an unrelated type of activity will not be allowed. Nor will earnings distributed in the form of loans to the stockholders or some of the other constructive dividend situations that are referred to in the unrelated activities case pass unchallenged. Liquidity requirements need not be retained as cash for the corporation could justify allocating the cash to temporary cash. However, the problem may be compounded by an investing gain. Yet investing gain may offer other advantages.

Depreciation is also a factor to be considered. The idea of funding the depreciation account is based upon a conceptual mistake, engendered by Justice Brandeis, that depreciation supplies the money to make the replacement. Depreciation, in reality, spreads cost and does not affect cash on hand. It is a noncash item that adds to the cash flow. Few corporations fund depreciation, because it is a book figure. Otherwise, there would be a doubling effect the depreciation charges are taken in figuring the earnings through the years. It would be difficult to justify the cash, in addition to the prior depreciation taken.

The availability of a self-insurance theory is unsettled. The corporation may claim that it has contingencies, known and unknown; and if it had paid the cash out in insurance premiums, the payments would have been deductible in computing income. The corporation did not choose to do that; the Service won't allow a deduction. Therefore, there is no doubling; the corporation desires to set aside funds to carry its own insurance risk. There may be a modest availability in this area.

It has been recommended that in many of these situations, particularly in the personal holding company, the solution is to give the money to charity. Also, with accumulated earnings, the corporation has an unlimited deduction in calculating accumulated earnings if it is donated to charity.

A successful corporation with accumulated earnings may spend it on all of the known and unknown expenses, yet, it still accumulates. At this time estate planning should become a major concern. The small close corporation has an infrequently recognized problem. A "key" man often exists. The more exploitation of the talents and abilities of one individual is the key to the success of the business, the greater problem there is when he dies. In effect, his death precipitates a replacement of the management. It is difficult to explain to the client that there is a very real possibility that such a business, so highly productive, will die with the key man, at least as far as future earnings are concerned. The property values will survive, but it is the going concern value that we must worry about. The replacement key man must have the same incentive as his predecessor-ownership. One solution is key man insurance. Much of the current discussion in estate planning involves the purchase of insurance in order to take care of this problem. Insurance may not solve the key man problem but the accumulated earnings tax might be one good reason for buying it.

There is debate over whether earnings could be accumulated for the purpose of a section 303 redemption. A simplified theory of the section 303 redemption is that if the government forces this closely held corporation—without any readily available market value and in the face of the death of the key man—to sell in order to raise the money to pay the tax, which may be quite significant—perhaps 30 or 40 percent or more of the value of the corporation—automatically, the price will be less because of the forced sale. Accordingly, the government will lose tax revenue. There are a number of approaches to that problem. One is the section 303 redemption. In the case of a sole stockholder, the estate with a basis in the stock now at fair market value, is allowed to redeem into the corporation enough stock to pay the tax and expenses of administration.

Under section 303 the corporation does not have to have the money; it can issue the estate a note and pay it back with future earnings. The note then could be used as collateral or discounted. Another alternative would be to borrow the funds from the beneficiaries.

The question is whether in the year of redemption—the year that you file the estate tax return—you can say that the section 303 redemption is a reasonable purpose for accumulated earnings. Stated differently, can you reduce the earnings accumulated for that year by the amount used for a section 303 redemption? The government asserts that it is not a reasonable purpose and at present they seem to have the stronger position.

In the 1969 Tax Reform Act, this problem was recognized. If the Service forces a sale, their share will be less. It is in their self-interest to grant a section 303 redemption and allow the corporation to credit the amount used on the accumulation of earnings.

The legislation recognized that earnings for the year of death or subsequent years could be used for a section 303 redemption. This includes subsequent years in which earnings are utilized to pay off a note issued in redemption and held by the estate or some distributee.

This raises the question of what the government regards as an unreasonable accumulation of earnings. The 1969 Act allows the use of earnings beginning with the year of death. There is a rational argument that earnings should be accumulated in prior years for this purpose. Would it be possible to have the corporation buy key man insurance—a legitimate business expenditure—that will justify an accumulation of earnings? Insurance, however, reduces liquidity to the extent that you have paid the money over to the insurance company. The insurance policy is as an asset, however.

The Code does not allow a deduction; there is no income. The government will prevail more often than it loses.

Although this premium has not been used to reduce earnings in any of the years prior to death, liquidity has been reduced. It is a legitimate thing to do, and it is a legitimate asset to hold. When the key man dies there are no earnings, but there is cash. The corporation suddenly has an accumulation of liquid assets that will have an impact on the year of death and future years' earnings that must be distributed. The result is the same as if substantial accumulations had been made in prior years.

A small corporation can accumulate one hundred thousand dollars in cash or other liquid assets with no questions asked. However, assume that there has been accumulation to the allowable limit to which insurance proceeds are added. This normally requires immediate distribution to avoid the surtax. The 1969 Act credit for the section 303 redemption takes over at this point. It seems possible that in the form of insurance premiums the section 303 redemption has been used in years ahead of death. To the extent insurance proceeds are used for such redemption, accumulated earnings problems are avoided for the year of death and thereafter.