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Federal Income Tax - Application of Accumulated Earnings Tax

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Recent Decisions

FEDERAL INCOME TAX—APPLICATION OF ACCUMULATED EARNINGS TAX —In a case of first impression the Tax Court has refused to rule on whether compensation determined to be unreasonable via section 162 of the Internal Revenue Code should be subject to the accumulated earnings tax.

Dielectric Materials Co. v. Commissioner, 57 T.C. 587 (1972).

BACKGROUND OF THE CASE

Section 162 of the Internal Revenue Code[1] (Code) entitles a corporation to deduct a reasonable amount for compensation paid for personal services.[2] Although there has been some dispute as to the legislative purpose behind section 162,[3] it seems clear that the section was intended to limit the compensation of employees who are also stockholders to only that compensation which is reasonable in light of the circumstances.[4] To the extent that earnings can be distributed by a corporation to its shareholders without incurring a corporate tax on these earnings, an overall tax benefit will result. Since corporate earn-

1. Unless specified otherwise, all references are to the Internal Revenue Code of 1954.

2. INT. REV. CODE OF 1954, § 162, which states:
(a) In General—There shall be allowed all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business including—
(1) a reasonable allowance for salaries or other compensation for personal services actually rendered . . . .

3. *See* Griswold, *New Light on "A Reasonable Allowance for Salaries,"* 59 HARV. L. REV. 286 (1945). The author writes:
There is in fact a clear basis for showing that the purpose of Congress in adding the 'reasonable allowance for salaries' clause was to enlarge the preceding language of the section, and to permit the deduction of an allowance for salaries although no salaries were in fact paid. This additional material makes it plain that the manner of introducing the clause in question with the word 'including' was intentional, and that the clause furnishes no basis whatever for the assumption by the Treasury of a visitatorial power over salary payments through the medium of a disallowance of the deduction of payments actually made.
Id. at 287.

4. *See* Alvarez, *The Deductibility of Reasonable Compensation in the Close Corporation*, 11 SAN. CLAR. LWY. 20 n.4 (1970), *citing* Revenue Act of 1916, Reg. 33 (revised), Art. 138, which provides:
Salaries of officers or employees who are stockholders will be subject to close analysis, and if they are found to be out of proportion to the volume of business transacted, or excessive when compared with the salaries of like officers or employees of other corporations doing a similar kind or volume of business, the amount so paid in excess of reasonable compensation for the services will not be deductible from gross income, but will be treated as a distribution of profits.

ings are taxed at 48 per cent above $25,000 of taxable income,[5] each dollar paid to a shareholder-employee which is deductible as compensation will usually result in an overall tax savings of 48 cents.[6] The only alternative available for distributions of earnings to a shareholder is a dividend which is not deductible by the corporation.[7]

In order for compensation to be deductible two tests must be met: (1) the compensation must in fact be payment purely for services;[8] and (2) the amount of payment must be reasonable in light of the services performed.[9] The presence of these two elements has been the central issue in a myriad of cases.

Since Dielectric's formation in 1946, Hans D. Isenberg had been its principal shareholder owning 950 of a total of 1,000 shares. The remaining 50 shares were owned by Isenberg's wife. In addition to being majority stockholder, Isenberg was president-treasurer of Dielectric during the entire taxable year in 1966. The Tax Court's findings of fact established that Isenberg served as chief engineer of Dielectric from its inception and throughout 1966. He is the holder of a number of engineering degrees and with respect to the technological endeavors of Dielectric, he was the only employee capable of discharging these duties. Isenberg's technical skills were well known throughout the trade and substantially and continually enhanced Dielectric's reputation.

The court found that during 1966 Isenberg spent 45 to 50 hours per week at the Dielectric plant. Although he took a three week vacation and spent eleven weeks at his summer home, some of this time was also spent on Dielectric's business.

In 1953, Dielectric's board of directors decided to pay Isenberg, as compensation for services, 5 per cent of the net sales of Dielectric in addition to his previously established annual salary of $40,000. Through 1966 Isenberg's rate of compensation had not been altered. Since 1961 and up to and including the taxable year 1966, Isenberg, as majority stockholder, had not been paid any dividends.

5. INT. REV. CODE OF 1954, § 11.

6. *See* Alvarez, *The Deductibility of Reasonable Compensation in the Close Corporation*, 11 SAN. CLAR. LWY. 20, 21 (1970).

7. *See generally* INT. REV. CODE OF 1954, § 316.

8. Treas. Reg. § 1.162-7 (b)(1) (1954), provides:
Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible.

9. *Id.* § (b)(3), which reads:
In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances.

In *Dielectric Materials Co. v. Commissioner*,[10] the Commissioner relied on section 162 in asserting a tax deficiency in Dielectric Material Company's 1966 tax return.

Since the findings of fact apparently established the unquestionable value of Isenberg to Dielectric, the court found it necessary only to inferentially deal with the test of whether the compensation paid to Isenberg was in fact payment purely for services.[11] Rather, the court chose to deal with the correlated test of whether or not the amount of the compensation in question represented a reasonable allowance for such services.[12]

Over the years, courts have considered a substantial number of different factors in dealing with this type of factual issue.[13] Thus, the *Dielectric* court had a variety of choices in determining the reasonableness of compensation in relation to services rendered.

The court pointed out that the burden of proving the reasonableness of compensation is on the taxpayer.[14] In the case of a closed corporation, the courts become suspicious if the employee to whom the salary was paid is in control of the corporate employer's affairs. Under such circumstances the corporate taxpayer is subject to close scrutiny.[15] The Commissioner's determination regarding what constitutes a reasonable compensation carries with it a clear presumption of correctness which can be rebutted by the taxpayer's showing of error in the Commissioner's determination.[16] Where a taxpayer's evidence is so equivocal or tenuous as not to afford a satisfactory basis for determining the value of the services rendered or the reasonableness of the compensation, the court may hold that the taxpayer has failed to sustain this burden.[17]

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10. 57 T.C. 587 (1972).
11. Treas. Reg. § 1.162-7(b)(1) (1954).
12. *Id.* § (b)(3).
13. *See* Mayson Mfg. Co. v. Commissioner, 178 F.2d 115 (6th Cir. 1949). Some of the "traditional" factors considered in *Mayson* were:
> . . . [T]he employee's qualifications; the nature, extent and scope of the employee's work; the size and complexities of the business; a comparison of salaries paid with the gross income and the net income; the prevailing general economic conditions; comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable positions in comparable concerns; the salary policy of the taxpayer as to all employees; and in the case of small corporations with a limited number of officers the amount of compensation paid to the particular employee in previous years.

Id. at 119.
14. *See* Botany Mills v. United States, 278 U.S. 282, 293 (1929); Anthony Mennuto v. Commissioner, 56 T.C. 910, 921 (1971).
15. *See* Darco Realty Corp. v. Commissioner, 301 F.2d 190, 191 (2d Cir. 1962); Nowland v. Commissioner, 244 F.2d 450, 455 (4th Cir. 1957).
16. *See* Miles-Conley Co. v. Commissioner, 173 F.2d 958, 960 (4th Cir. 1949).
17. *See* Mahler v. Commissioner, 119 F.2d 869, 870 (2d Cir. 1941).

The Court's Decision

Dielectric failed to rebut the presumption in favor of the Commissioner's finding, and the court found that the corporation had in fact paid Isenberg unreasonable compensation.[18] The court, however, was unclear as to precisely why Dielectric failed in its appeal. Instead, the court attributed its decision to a number of indistinct reasons, each of which individually would not be determinative of the issue.[19] The court cited *R.H. Oswald v. Commissioner*,[20] for the rationale that it is within the Tax Court's province to reject long established compensation arrangements which do not represent a free bargain between the corporation and the shareholder-employee. Against this rationale, Isenberg's 13 year unchanged compensation agreement was not considered significant by the court because during the entire period of the agreement Isenberg owned 95 per cent of the stock and was for all practical purposes the sole distributee of the earnings, whether labeled dividends or compensation.

On the other hand, the court did consider it meaningful that Dielectric did not pay any dividends during the taxable years 1962 through 1966, despite the existence of substantial earnings. Importance was placed on the fact that Isenberg was away from Dielectric's business for fourteen weeks during the 1966 taxable year. Despite his absence, 1966 was the most profitable year for Isenberg under his percentage compensation agreement.

The court's refusal to attribute Dielectric's unusually successful year to Isenberg's efforts was based upon a series of war cases where enormous profits were suddenly made as a result of market conditions

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18. While the court disagreed with the Commissioner, it apparently did find that Dielectric failed to prove the Commissioner's finding was clearly wrong, since the court upheld the finding. The court stated:

> The long and the short of the situation is that we agree with neither petitioner nor respondent. On the basis of the entire record herein and our evaluation of the testimony, we hold that, of the $142,234 paid to Isenberg by petitioner in 1966, $110,000 constituted reasonable compensation for services rendered.

57 T.C. at 592.

19. Two examples of the court's vague reasoning are:

> Although not determinative, the fact that Isenberg's compensation arrangement had been established some 13 years before the taxable year in issue and had remained unchanged throughout the intervening period should not be completely ignored . . . although not determinative, fortuitous occurrences not related to the actual services performed by an employee may appropriately be considered in determining the reasonableness of the employee's compensation.

Id. at 591.

20. 185 F.2d 6 (7th Cir. 1950).

rather than the services of the corporation's employees.[21] The court stated that there was no evidence to justify the increase in compensation to Isenberg. His duties and responsibilities during the taxable year in question remained the same as in prior years. Thus, the court concluded that Dielectric's brighter financial situation for the taxable year of 1966 was not the result of any new and specific actions of Isenberg.

The court's decision as to the unreasonableness of Isenberg's compensation resulted in the perplexing problem of how to treat that portion of compensation which was determined to be unreasonable. The aforementioned facts precipitated consideration of the accumulated earnings tax, treated in sections 531 through 537 of the Code.[22]

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21. *See* Huchkins Tool & Die, Inc. v. Commissioner, 289 F.2d 549 (7th Cir. 1961) (held that the increase in profits was due to the Korean War rather than an increase in the duties and responsibilities of the executives or in the value of their services); Burford-Toothaker Tractor Co. v. Commissioner, 192 F.2d 633 (5th Cir. 1951).

22. INT. REV. CODE OF 1954, § 531. Imposition of Accumulated Earnings Tax.
In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of—
(1) 27½ per cent of the accumulated taxable income not in excess of $100,000 plus
(2) 38½ per cent of the accumulated taxable income in excess of $100,000.

Id. § 532. Corporations Subject to Accumulated Earnings Tax.
(a) General Rule.—The accumulated earnings tax imposed by section 531 shall apply to every corporation . . . 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. § 533. Evidence of Purpose to Avoid Income Tax.
(a) Unreasonable Accumulation Determination of Purpose.—For purposes of section 532, the fact 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. § 534. Burden of Proof.
(a) General Rule.—In any proceeding before the Tax Court involving a notice of deficiency based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, the burden of proof with respect to such allegation shall—
(1) if notification has not been sent in accordance with subsection (b), be on the Secretary or his delegate, or
(2) if the taxpayer has submitted the statement described in subsection (c), be on the Secretary or his delegate with respect to the grounds set forth in such statement in accordance with the provisions of such subsection.
(b) Notification by Secretary.—Before mailing the notice of deficiency referred to in subsection (a) the Secretary or his delegate may send by certified mail or registered mail a notification informing the taxpayer that the proposed notice of deficiency includes an amount with respect to the accumulated earnings tax imposed by section 531 . . . .
(c) Statement by Taxpayer.—Within such time (but not less than 30 days) after the mailing of the notification described in subsection (b) as the Secretary or his delegate may prescribe by regulations, the taxpayer may submit a statement of the grounds together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business.

The Accumulated Earnings Tax

Briefly, section 531 imposes the accumulated earnings tax; section 532 provides that every corporation formed or availed of for "the purpose" of avoiding the income tax of its shareholders by permitting earnings and profits to accumulate instead of being divided or distributed shall be subject to the tax; section 533 provides that the fact that earnings and profits are permitted to accumulate beyond the reasonable needs of the business shall be determinative of "the purpose" unless the corporation by a preponderance of the evidence shall prove to the contrary; section 534 deals with the burden of proof; section 535 defines "accumulated taxable income" upon which the tax under section 531 is based; and section 537 provides that the term "reasonable needs of the business" includes the reasonably anticipated needs of the business.[23]

The accumulated earnings tax of section 531 has its origins in the Revenue Act of 1913,[24] which provided that if a corporation was "formed or fraudulently availed of" for the purpose of escaping the individual income tax by permitting gains and profits to accumulate in the corporation, each shareholder's ratable share of the corporate income was taxable to him whether distributed or not.[25]

A basic function of the accumulated earnings tax is to prevent shareholders of a corporation from allowing a surplus to accumulate and then return via a corporate liquidation. If this were permitted a tax-

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Id. § 535. Accumulated Taxable Income.
(a) Definition.—For purposes of this subtitle, the term "accumulated taxable income" means the taxable income, adjusted in the manner provided in subsection (b), minus . . . the accumulated earnings credit (as defined in subsection (c)).
(b) Adjustments to Taxable Income.—For purposes of subsection (a), taxable income shall be adjusted as follows:
(1) Taxes.—There shall be allowed as a deduction Federal income and excess profits taxes . . . accrued during the taxable year . . . .
. . .
(c) Accumulated Earnings Credit.—
(1) General Rule. For purposes of subsection (a), in the case of a corporation . . . the accumulated earnings credit is (A) 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 . . . .
(2) Minimum Credit.—The credit allowable under paragraph (1) shall in no case be less than the amount by which $100,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

Id. § 537. Reasonable Needs of the Business.
For purposes of this part, the term "reasonable needs of the business" includes the reasonably anticipated needs of the business.

23. Magic Mart Inc. v. Commissioner, 51 T.C. 755, 788-90 (1969).
24. Act of Oct. 3, 1913, ch. 16, § 2, 38 Stat. 166-67, *as amended* 26 U.S.C. § 531 (1954).
25. B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders 8-2 (3d ed. 1971) [hereinafter cited as Bittker & Eustice].

payer would receive capital gains treatment at liquidation and would escape paying taxes at ordinary rates on dividends.[26] As a practical matter the accumulated earnings tax is limited to the closely held corporation, since in a publicly held corporation the threat of stockholder pressure or legal action is present, thus eliminating total freedom of action by a single stockholder.[27]

Under section 532(a), the ultimate test regarding whether the tax should be imposed is based on the subjective motives of shareholders (the "subjective test"), *i.e.*, a corporation cannot be formed, or availed of, with the intention of avoiding tax on its shareholders by accumulation of earnings (the "avoidance purpose"). Section 533(a) creates a presumption that the avoidance purpose is present if earnings are, in fact, accumulated beyond the reasonable needs of the corporation's business (the "objective test").[28]

Recent decisions have tended to reduce the importance of the subjective test,[29] holding that the basic objective test is the single most important element in determining the presence of the prohibited purpose. The effect of these decisions is to minimize the usefulness of the subjective test as an argument for the corporation. The corporation, in a final effort to save itself, can contend that even if it did accumulate earnings beyond its reasonable business needs, it did not have the tax avoidance motive.[30]

Where business needs for the accumulation have been established, the government has ordinarily conceded or suffered defeat, despite the theoretical possibility that the accumulation was in fact motivated by a tax avoidance purpose rather than by business needs. Conversely, when an accumulation has been found to be unreasonable, taxpayers have rarely

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26. *See* McLean & Clark, *Additional "Reasonable Needs" Recognized—Code Sec. 537 Amended by the Tax Reform Act of 1969*, 1969 TAXES 45.

27. *See also* Golconda Mining Corp. v. Commissioner, 58 T.C. 139 (1972).

28. *See* Ziegler, *The "New" Accumulated Earnings Tax: A Survey of Recent Developments*, 22 TAX L. REV. 77, 78 (1966).

29. *See, e.g.*, United States v. Duke Laboratories, 337 F.2d 280 (2d Cir. 1967); Young Motor Co. v. Commissioner, 281 F.2d 488 (1st Cir. 1960).

30. *See* BITTKER & EUSTICE, *supra* note 25, at 8-11. The authors write:

> Many cases, however, have been presented and decided as though the accumulation necessarily stems *either* from a purpose to provide for the reasonable needs of the business *or* from a purpose to reduce shareholders' taxes. This false dichotomy probably arises from section 533(a), which provides that the fact that the earnings are permitted to accumulate beyond the reasonable needs of the business shall be 'determinative' of the purpose to avoid shareholder income taxes unless the corporation shall prove to the contrary by a preponderance of the evidence. By virtue of this provision, most of the cases have been won or lost on the battleground of reasonable business needs.

succeeded in rebutting the inference that tax avoidance was the motive for the accumulation.[31] The recent Supreme Court decision in *United States v. Donruss Co.*[32] makes this latter result almost a foregone conclusion.

In the hearings on the 1954 Code the accumulated earnings tax was strongly criticized,[33] on the basis that the determination by the Internal Revenue Service and the courts that a corporation had accumulated earnings beyond its reasonable business needs was a conclusion after the fact, thus necessarily having the "far-sightedness" which the corporation lacked before the fact.[34] The hearings resulted in a number of changes including the enactment of a provision enabling the burden of proof to be shifted from the corporation to the Commissioner.[35]

Section 534 places a duty on the secretary or his delegate to notify the corporate taxpayer of a tax deficiency with respect to the accumulated earnings tax.[36] The taxpayer then has a specified period of time (60 days, plus any extensions) to submit a statement of the grounds, "together with facts sufficient to show the basis thereof," upon which the corporation relies to establish that all or part of its earnings were not accumulated beyond the reasonable needs of its business. If the corporation submits such a statement or if the secretary does not send the notice, the burden of proof of the allegation shall be on the secretary "with respect to the grounds set forth in such statement."[37]

Section 534 has not been as valuable to corporations as had been expected. In many cases before the Tax Court the Internal Revenue Service has successfully claimed that the corporation's statement did not meet the requirements of the statute and thus did not shift the burden of proof.[38] Also, until recently the Tax Court has steadfastly refused to rule in advance of trial on the sufficiency of section 534 statements.[39]

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31. *Id.* at 8-11, 8-12.
32. 393 U.S. 297 (1969). The Court held:
It is not necessary that avoidance of shareholder's tax be the sole purpose for the unreasonable accumulation of earnings, it is sufficient if it is one of the purposes for the company's accumulation policy.
Id. at 298.
33. *Hearings on General Revenue Revision before House Comm. on Ways and Means*, 83d Cong., 1st Sess. 2120-54 (1950).
34. *Id.*; S. Rep. No. 1622, 83d Cong., 2d Sess. 68-70 (1953).
35. INT. REV. CODE OF 1954, § 534(a).
36. *Id.* § 534(b).
37. *Id.* § 534(a) (2).
38. *See, e.g.*, Shaw-Walker Co. v. Commissioner, 39 T.C. 293 (1962); I.A. Dress Co. v. Commissioner, 32 T.C. 93 (1959).
39. BITTKER & EUSTICE, *supra* note 25, at 8-29.

Finally, decisions of the Tax Court as to the degree of detail required in the statement have been unclear, thus giving no guidance to the attorney attempting to draft a section 534 statement.[40]

Since the trend of the courts is toward the application of the objective test of section 533(a), the concern of the corporate taxpayer is now centered on proving that any accumulation of earnings and profits was for reasonable business needs.

Turning to the problem of how the court dealt with that portion of Isenberg's compensation which it determined to be unreasonable, we find that the court's treatment of the issue is dicta.[41] The significance of the case, however, is the Commissioner's unprecedented assertion that unreasonable compensation should be subject to the accumulated earnings tax.

The Commissioner in his opening statement and brief argued that any compensation paid to Isenberg and found by the court to be excessive should be treated as a preferential dividend in view of the fact that Isenberg owned only 95 per cent of the stock of Dielectric. This position is grounded on section 562(c) which denies treatment as a dividend, for purposes of the dividends-paid deduction, any distribution which is not pro rata and without preference.[42]

The effect of this argument would be to impose the tax on the disallowed compensation. Insofar as the accumulated earnings tax is fundamentally a tax on undistributed income,[43] the amount determined as unreasonable must be added to any other amount (if any) which was unreasonably accumulated.[44] Though the Commissioner's argument is

40. *See* Ziegler, *The "New" Accumulated Earnings Tax: A Survey of Recent Developments*, 22 TAX L. REV. 77, 82 (1966).

41. The court stated:

> We reject respondent's assertion and do not decide the issues as to whether the amount of Isenberg's compensation determined to be excessive should be treated as a dividend and consequently whether it should be treated as a dividends-paid deduction.

57 T.C. at 598.

42. INT. REV. CODE OF 1954, § 562(c), Preferential Dividends.—

> The amount of any distribution shall not be considered as a dividend for purposes of computing the dividends paid deduction, unless such distribution is pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class except to the extent that the former is entitled (without reference to waivers of their rights by shareholders) to such preference.

43. BITTKER & EUSTICE, *supra* note 25, at 8-32.

44. *Id.* at 7-33. The authors hint at this when they state:

> . . . [A]n alleged salary might be allocated among a combination of the following three categories: (a) compensation, deductible by the corporation under section 162 and taxable to the recipient as compensation; (b) unreasonable compensation, not deductible by the corporation under section 162 but taxable to the recipient as compensation; and (c) distributions disguised as compensation, not deductible by the corporation

unique, there are cases which support the position that improper deductions which were not distributed pro rata among stockholders of the same class are not entitled to a dividends-paid deduction.[45]

The court stated that the Commissioner did not "press the matter at trial," and that Dielectric acceded to the stipulation as to stock ownership, relying on the dividends-paid deduction. Moreover, the court felt that under the circumstances, Dielectric was not afforded adequate opportunity to ask to be relieved of the stipulation and offer evidence directed to the issue belatedly raised by the Commissioner. Hence, the court refused to consider whether the amount it determined to be unreasonable compensation should be subject to the accumulated earnings tax via section 562.

The court instead centered its opinion on the issue of whether Dielectric permitted its earnings and profits to accumulate beyond the reasonable needs of the business. Turning to Dielectric's section 534 statement, the court found that the net effect of the Commissioner's credits was to reduce Dielectric's purportedly unreasonable accumulations of earnings to $20,531 out of total accumulations of $636,130.[46] The court felt this margin of error was small, but still enough to make section 531 applicable. The court found, however, that there was an unusual factor to be considered. The market shortage of copper and economic turmoil in the copper industry due to foreign strikes and potential domestic strikes in the copper mines made normal cash flow formulas inapplicable.[47] This being the case, the court decided that the Commissioner's analysis in computing credits for Dielectric did not ade-

and taxable to the shareholder (who is not necessarily the recipient) only under section 301.

Id.

45. *See, e.g.*, Lemp Brewery v. Commissioner, 18 T.C. 586 (1952); W.T. Wilson Co. v. Commissioner, 10 T.C. 251 (1948).

46. It is interesting to note that the court never determined whether Dielectric's section 534 statement was sufficient to shift the burden to the Commissioner, a general problem heretofore discussed. The court stated:

> Petitioner has asserted that its statement filed pursuant to section 534(c) operated to shift the burden of proof to respondent. Our ultimate finding of fact herein, in favor of petitioner, has been made on the assumption that the burden remained with petitioner and, consequently, there is no need for us to deal with petitioner's claim in this regard.

57 T.C. at 597.

47. *See, e.g.*, Bardahl Mfg. Corp. v. Commissioner, 24 CCH Tax Ct. Mem. 1030 (1965) (need for working capital computed by the amount of cash reasonably expected to be sufficient to cover its operating costs for a single operating cycle); John P. Scripps Newspapers v. Commissioner, 44 T.C. 453 (1965) ("rule of thumb," ratio of current assets to current liabilities in the neighborhood of 2½ to 1 is an indication of a reasonable accumulation of surplus); James M. Pierce Corp. v. Commissioner, 38 T.C. 643 (1962) (accumulation of earnings to meet operating expenses for at least one year is reasonable).

quately take into acount the vagaries of the market situation in which petitioner expected to, and did, find itself at the end of 1966. Thus, the court concluded that in light of the total circumstances Dielectric had sustained the burden of proof that the accumulation of its earnings and profits for 1966 was required by the reasonable needs of the business.

The Commissioner's Position: Analysis

The court's skirting of the issue regarding whether section 531 is applicable to compensation determined to be excessive leaves the problem unsolved. Analysis of the relevant Code sections leads to the conclusion that the Commissioner's position is sound. Section 562(c)[48] distinctly provides that "any" distribution shall not be considered a dividend for purposes of computing the dividends-paid deduction unless distributed pro rata to stockholders of the same class. Upon the court's determination that Isenberg's compensation was excessive, the portion paid out by Dielectric which was disallowed became a distribution of the corporation's profits rather than compensation for services. As a distribution rather than a deduction it becomes subject to section 562(c). Due to the fact that Isenberg owned only 95 per cent of the stock, this distribution was not pro rata to the holders of the same class of stock, and as such became a "preferential dividend," thus loosing its eligibility as a dividends-paid deduction.

Section 532[49] imposes the accumulated earnings tax on the "accumulated taxable income" as defined in section 535.[50] Section 535(a) defines "accumulated taxable income" as "taxable income, adjusted in the manner provided in subsection (b), minus the sum of the dividends-paid deduction (as defined in section 561) and the accumulated earnings credit (as defined in subsection (c)." Therefore, since Dielectric's payment of unreasonable compensation does not qualify under section 561 as a dividends-paid deduction, it is not subtracted from its "taxable income" and hence is exposed to the accumulated earnings tax as "accumulated taxable income."

Conclusion

Assuming arguendo that the problems with respect to the lack of notice to Dielectric did not exist, and that the court would not adhere to

48. Int. Rev. Code of 1954, § 562(c).
49. *Id.* § 532.
50. *Id.* § 535.

the strict interpretation of the pertinent sections of the Code as herein suggested, it would seem that by the court's own analysis the Commissioner's argument should prevail. Clearly the disallowed deduction for unreasonable compensation could not be classified as an accumulation for the "reasonable needs of the business" under the Code definition or any ordinary dictionary definition. Once an amount is paid out by the corporation it is gone. To imply that an amount deducted as compensation is simultaneously an amount accumulated for reasonable needs of the business is an unreasonable conclusion not warranted by case law.[51]

On the other hand, a legitimate argument can be made that the accumulated earnings tax was not *intended* to be applied to disallowed compensation deductions. The basic purpose of sections 531 through 537 is to discourage the use of a corporation as an accumulation vehicle to shelter its individual stockholders from the personal income tax.[52] In a situation where a stockholder-employee has received compensation, whether reasonable or unreasonable, he must pay personal income tax on the amount received. Thus, the corporate taxpayer, by paying compensation which is later disallowed, has not acted contrary to the basic purpose behind the tax.

This argument can be supported by the language used in section 532(a),[53] which imposes the tax on corporations "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders . . . ."[54] A corporation which pays unreasonable compensation to its shareholder-employees is not "availed of" for the purpose of avoiding shareholder income taxes. In fact, it has produced the opposite effect, since by paying out compensation to its shareholder-employees the personal income tax will be paid. Therefore, the corporation which

51. *See, e.g.*, New England Wood Ware v. United States, 289 F. Supp. 111 (D. Mass. 1968) (records of correspondence among board directors revealing a need to either liquidate or to expand, as well as hiring of a consultant firm to explore new lines of business); Mohawk Paper Mills v. United States 262 F. Supp. 365 (N.D.N.Y. 1966) (definite plans for reasonable business needs included: preliminary drawings and cost estimates for new machinery, and subsequent plant improvements as tangible evidence of the taxpayer's intent to expand his business). *See* Henry Van Hummell, Inc. v. Commissioner, 23 CCH Tax Ct. Mem. 1765 (1964). The holdings of these cases indicate that the definiteness required to justify accumulations could not be achieved by a deduction which is simultaneously placed on the records as an accumulation for business needs.

52. BITTKER & EUSTICE, *supra* 25, at 8-3. The authors write:

The Congressional approach to this problem is a rule phrased in terms of the evil which the statute is designed to prevent, viz, 'unreasonable' accumulations of corporate earnings *for the purpose* of avoiding personal income taxation at the shareholder level.

53. INT. REV. CODE OF 1954, § 532(a).

54. *Id.*

is overly zealous in compensating its shareholder-employees cannot possibly fall within the confines of section 532(a).

This argument, however, can be attacked. First, the strict reading of sections 535(a) and 562, analyzed above, logically requires the application of the tax on disallowed compensation deductions. Second, the accumulated earnings tax is by its nature a penalty tax, whose purpose is to discourage taxpayers from accumulating earnings rather than distributing them as dividends to be taxable as ordinary income to the recipients. Thus, when a corporation deducts unreasonable compensation for the assumed purpose of avoiding corporate taxes through deductions, it would seem within the punitive spirit of the accumulated earnings tax to require its application. Third, when section 532(a) is read with section 533(a), the fact that earnings and profits are permitted to accumulate beyond the reasonable needs of the business is determinative of the tax avoidance purpose. The ultimate result of reading these two sections together is to nullify the "formed or availed of" language of section 532(a) whenever an unjustified accumulation is found under section 533(a).[55]

These points present an apparent inconsistency between sections 532(a) and 533(a), as well as sections 532(a) and 562, when applied to the narrow issue of whether the accumulated earnings tax is applicable to unreasonable compensation. The interpreter of these sections is faced with the policy consideration of whether this inconsistency should be construed in a light favorable to the taxpayer. Perhaps it would be an unreasonable burden on the corporation for the Commissioner to impose this tax after disallowance of its compensation deduction. The corporate taxpayer has already suffered a setback by having its deduction disallowed; the shareholder-employee has already paid personal income taxes; and now he is faced with an additional tax. Obviously this presents a heavy burden on the shareholder-employee who also has the predominant interest in the corporation.

Clearly the court in *Dielectric* was aware of the consequences which would result if it accepted the Commissioner's argument. Such a decision would have a serious impact on a considerable number of corporations where deductions for compensation have been disallowed. In ef-

55. BITTKER & EUSTICE, *supra* note 27, at 8-11. The authors state:
But section 533 is a mere procedural buttress to section 532; the latter is the basic operative provision of the statute. The ultimate question, in other words, is not whether the corporation had business needs for the accumulation, but whether it was formed or availed of for the prohibited purpose.

fect, numerous taxpayers would be subjected to an unanticipated tax. Without any precedent to follow the court was obviously reluctant to decide upon an issue with such far-reaching effects. Thus, the court chose to avoid the Commissioner's argument by determining that the issue was belatedly raised at trial.

Dielectric serves as the vehicle for the introduction of a new and interesting problem. Perhaps it will act as a catalyst for future presentation and resolution of this issue. The real problem, however, lies with the lack of lucidity and consistency between the aforementioned sections when dealing with the application of the accumulated earnings tax to unreasonable compensation. It is submitted that this lack of clarity is a matter which should ultimately be settled by Congress.

Richard M. Serbin

FEDERAL INCOME TAXATION—ALLOCATION OF INCOME AND EXPENSES—IMPUTATION OF INTEREST TO CONTROLLED CORPORATE LOANS AND ADVANCES—TAXABLE INTEREST-FREE LOANS—The Eighth Circuit Court of Appeals has held that section 482 regulations are constitutionally valid and therefore, the Commissioner is permitted to impute income to businesses which make interest-free loans to other members of a controlled group.

Kahler Corp. v. Commissioner of Internal Revenue, 58 T.C. 496 (1972), *rev'd*, 486 F.2d 1 (8th Cir. 1973).

The petitioner, Kahler Corporation, was engaged in the business of owning and operating hotel and motel properties. In 1960 petitioner decided to expand its business by establishing wholly-owned subsidiaries. The subsidiaries' capital structure was patterned according to the norms of the hotel-motel industry which required a 20-30 per cent capital investment with the remainder obtained through financing. A substantial number of advances[1] bearing no interest or definite maturity date were made by petitioner to the subsidiary. The Commissioner sought to "allocate" to petitioner a five per cent interest

1. It was determined that the petitioner owed the First National Bank of Minneapolis, Rochester Band, and North-Western Mutual Life Insurance Company over 6 million dollars, a part of which was used to make advances to the subsidiaries.