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SUGGESTED STATUTORY STANDARDS FOR THE APPLICATION OR NON-APPLICATION OF SECTION 531

E. K. SNYDER*

Section 531 of the Internal Revenue Code is as old as the post-XVIth Amendment income tax. The Tariff Act of 1913 provided for a penalty tax to be imposed on the shareholders if the corporate device was used to reduce the surtax on an individual income.¹ Following the landmark decision of *Eisner v. Macomber*,² where the majority opinion indicated that the shareholder could not be taxed on corporate profits prior to their distribution, the Revenue Act of 1921 imposed the penalty tax on the corporation, where it has since remained. Provision was made in the 1921 act for a consent dividend.³

The reason that Congress has considered a penalty necessary to prevent shareholder tax avoidance by simply failing to pay dividends is readily apparent inasmuch as no satisfactory system has been devised to tax corporate profits only once, except to the limited extent available in Subchapter S. Where Subchapter S is not available, or where individual marginal rates of tax are higher than the marginal corporate rate, one time taxation of corporate profits is an obvious goal for those who *a priori* place a low marginal utility factor on additional personal income in hand.

The various revenue acts since 1921 have all been directed at accumulations of earnings,⁴ but as a practical matter accumulated earnings have never been taxed under Section 531 and its predecessors.

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¹ "For the purpose of this additional tax the taxable income of any individual shall embrace the share to which he would have been entitled of the gains and profits, if divided or distributed, whether divided or distributed or not, of all corporations, joint-stock companies or associations however created or organized, formed or fraudulently availed of for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed." Act of October 3, 1913, § II, (A), (2); 38 Stats. 114 at 166.

² 252 U.S. 189 (1920).

³ Act of November 23, 1921, § 220; 42 Stats. 227 at 247.

⁴ INT. RVE. CODE OF 1954, § 532: "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 . . ." *Id.* § 533(a): "the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders."

There are no cases on record where the penalty was assessed because of the size of the earnings retention. The tax itself is an additional assessment on the earnings of a particular year rather than a levy on a retained earnings account. The tax is a penalty imposed upon closely held corporations showing excessive liquidity or whose fiscal activities are inconsistent with the non-payment of dividends. Let us examine, briefly, these three areas:

Closely Held Corporations

There is only one instance on record of a corporation with a large number of shareholders being assessed a Section 531 penalty, the famous *Trico* case,⁵ and "That corporation was in effect a privately owned corporation, as a minority of 21 shareholders owned approximately 75% of the stock and controlled the corporation, although there were about 2200 other stockholders."⁶ There is nothing in the statutory language exempting publicly-held corporations from the tax⁷ and an attempt by the House to insert such a provision was rejected by the Senate in 1954.

It has long been the law in Section 531, as elsewhere, to infer intent from overt actions.⁸ It strains one's credulity to believe that directors of publicly held corporations disregard the effects upon their personal income tax liabilities of the dividend actions which they take. It has been said:

Historically, section 102 has been applied to the comparatively small closely held and closely controlled corporations rather than to the large public corporations. Admittedly, the existence of the interdicted purpose would be more likely to occur in the case of private corporations in which there is a close or complete identity of shareholders and corporate officers (i.e., corporate directors). On the other hand, there is much evidence which indicates that many of our large public corporations are subject to control, either directly or indirectly, by small groups of shareholders who, it may be presumed, are not unconscious of personal surtax savings resulting from surplus accumulation. Large numbers of shareholders should not be permitted to disguise the existence of a control group and the possible shaping of corporate policy to serve personal advantage. In view of the purpose and intent of the section, it appears that the Bureau might properly direct attention to public, as well as to private, corporations.⁹

⁵ 46 B.T.A. 346 (1942); *aff'd* 137 F.2d 424 (2d Cir. 1943).

⁶ 7 MERTENS, LAW OF FEDERAL INCOME TAXATION § 39.34 at 75 (supp. 1966).

⁷ INT. REV. CODE of 1954, § 532.

⁸ Although intent is a state of mind, it is nevertheless a fact to be proved and found as are other facts. *William C. DeMille Productions, Inc.*, 30 B.T.A. 826 (1934).

⁹ Kendall, *Joint Committee on the Economic Report 82nd Congress, 2d Session* 187 (1952).

After the *Trico* tax case was decided unfavorably to the Corporation, there was a minority stockholder suit against its Directors. The literature of the day was rife with speculation that the suffering of a Section 531 penalty would, *ipso facto*, make Directors liable to damages in stockholder suits. The *Trico* stockholder suits were settled out of court and there is, accordingly, no authority on this subject one way or the other. Perhaps the Treasury reasons that attempted enforcement against publicly held corporations would raise such a hue and cry as to result in outright repeal of Section 531. There is some ground for the Treasury's fear. The 1946 Corporate Return contained the "infamous" question 8¹⁰ which merely queried a taxpayer regarding a standard set by the Treasury in Treasury Decision 4914,¹¹ for the guidance of examining agents. Even though Treasury Decision 4914 was seven years old by 1946, the hue and cry which resulted from question 8 may well have accounted for the dropping of the question from subsequent returns. Whatever may be the Treasury's reasons for non-enforcement against publicly held corporations, in spite of apparently ample grounds, as we shall discover later, the record speaks for itself notwithstanding the statutory language and what appears to be clear Congressional intent.

*Apollo Industries, Inc.*¹² is not an exception to the foregoing even though that company is listed on the Amercian, Pacific Coast, and Pittsburgh Stock Exchanges. *Apollo Industries, Inc.* is the successor in interest to *Alles and Fisher, Inc.* which was acquired by *Apollo* in 1962. The years under review were 1956 and 1957.¹³

¹⁰ "If the total of line 1 or Schedule M, page 4, is less than 70 percent of the earnings and profits for the taxable year, state reasons for retention of such earnings and profits. (See instruction J)."

¹¹ "(1) Corporations which have not distributed at least 70 percent of their earnings.

(2) Corporations which have invested earnings in securities or other properties unrelated to their normal business activities.

(3) Corporations which have advanced sums to officers or shareholders in the form of loans out of undistributed profits or surplus from which taxable dividends might have been declared.

(4) Corporations, a majority of whose stock is held by a family group or other small group of individuals, or by a trust or trusts for the benefit of such groups.

(5) Corporations the distributions of which, while exceeding 70 percent of their earnings, appear to be inadequate when considered in connection with the nature of the business or the financial position of the corporation or corporations with accumulations of cash or other quick assets which appear to be beyond the reasonable needs of the business."

¹² 44 T.C. 1 (1965), *rev'd* 358 F.2d 867 (1st Cir. 1966).

¹³ It is interesting to note that several section 531 defendants have subsequently "gone public." The marked increase in the prices of some of them make one speculate whether today's defendants might not well be the "hot stocks" of tomorrow. *American Metal Products Corp.*, 34 T.C. 89 (1960), *aff'd* 287 F.2d 860 (8th Cir. 1961); *Becton, Dickinson & Co.*, P-H Tax Ct. Mem. 42-441, *aff'd* 134 F.2d 354 (3rd Cir. 1943); *Helvering v. National Grocery Co.*, 304 U.S. 282 (1938); *Olin Corp.*, 42 B.T.A. 1203 (1940), *aff'd* 128 F.2d 185 (7th Cir. 1942); *Seaboard Security Co.*, 38 B.T.A. 560 (1938); *Wean Engineering Co.*, P-H Tax Ct. Mem. 43-348 (1943).

Excessive Liquidity

This has been and remains the area of great mystery in Section 531 and at the same time is the reason for the vast majority of assessments. The chain of reasoning runs something like this: There is a statutory prohibition against accumulating earnings and profits beyond the reasonable needs of the business. The best way to exemplify unreasonable accumulations is to be liquid beyond the needs of the business. Ergo, excessive liquidity calls for the sanctions. Dr. James K. Hall wrote in 1952 and, in reviewing all the cases to that date said,¹⁴

The critical factor in vulnerability under the section appears to be the liquidity ratio. The ratios of earned surplus to total assets and current assets to current liabilities do not appear to be significant, per se, because of a large earned surplus which may be representative of real assets, and a very favorable ratio of current assets to current liabilities may be an expression of a very small amount of current liabilities. Retention of a large proportion of current earnings may not cause the corporation to become excessively liquid—and, hence, vulnerable. To avoid section 102, however, the corporation must be able to explain satisfactorily to the Bureau its high liquidity—which is the danger signal.

Inasmuch as the predecessors of Section 531 were used against both operating and holding companies prior to 1934, when the first Personal Holding Company sections were enacted, the proportion of cases involving liquidity as compared to other reasons has risen since 1952. The literature is replete with suggestions as to factors by which liquidity can be judged as excessive or not excessive and there have been several judicial attempts to set standards starting with *Goodman*¹⁵ and most recently in *Bardahl*,¹⁶ but it would be a brave counsellor, indeed, who would attempt to set a workable liquidity standard for a client.

Historically, these judicial attempts to set standards began in 1948 with *Goodman*.¹⁷ In reviewing the years 1942 and 1943 where income was \$127,009 and \$130,113 respectively, \$36,000 in dividends having been paid in each year, the Court said, "The evidence also shows that a large amount of cash was necessary in order to operate the business. For example, its returns show that its annual operating expenses amounted to more than \$162,000 during the years 1942 and 1943. There was a reasonable necessity for sufficient capital to meet operating expenses for at least one year."

Recognizing that the business cycle might very well be longer or shorter than a calendar or fiscal year, the court said in *Smoot Sand&*

¹⁴ Kendall, *supra* note 9 at 137.

¹⁵ 11 T.C. 530 (1948).

¹⁶ P-H Tax Ct. Mem. 65-200 (1965).

¹⁷ Note 15 *supra*.

*Gravel Corp.*¹⁸ "Working capital needs of a business vary, being dependent upon the nature of the business, its credit policies, the amounts of inventories and rate of turnover, the amount of accounts receivable and the collection rate thereof, the availability of credit to the business, and similar relevant factors."

In a decision promulgated on April 2, 1965, the Tax Court indicated that a more precise definition of liquidity than the previous generalizations was needed. In *Apollo Industries, Inc.*¹⁹ the Tax Court said:

The petitioner maintains, however, that additional funds were required for ordinary business operations. As evidence of this alleged need, the petitioner presented certain testimony and computations by the certified public accountant who had prepared Alles' financial statements. The accountant applied what he termed a "rule of thumb" and added for each of the taxable years in question, amounts equal to the closing accounts receivable, the closing inventory, the total operating expenses for the year (excluding depreciation), and the fixed assets acquired during the year, to arrive at a figure purportedly representing the amount of capital needed for Alles' operations. He testified that his computations had been prepared in connection with the trial of the case, having been "thought of by our attorney," and there is no indication that any similar analysis had been made for Alles during the taxable years. . . .

The petitioner may not rely merely upon a rule of thumb to establish the alleged needs for working capital where the evidence not only does not support the method employed, but requires a contrary conclusion.

Not quite four months later, the Tax Court came up with its elaborate formulation in the first *Bardahl* case.²⁰ The accounting in *Bardahl* is performed with all the glorious logic of the ten-column work-sheet. All this precision, however, follows a finding that an intra-year business cycle is 35% of a fiscal year, accordingly, 35% of anticipated costs for the next fiscal year is non-excessive liquidity. To this reviewer, the 35% finding seems to be rather "rule of thumbish", nonetheless it is used to determine, with caliper-like precision, the odd-dollar amounts which represent excess-liquidity, as follows:

| | 1956 | 1957 | 1958 | 1959 |
|--|-----------|-----------|-----------|-------------|
| A. Net liquid assets | \$500,063 | \$639,824 | \$764,789 | \$1,090,729 |
| B. Anticipated operating expenses, one cycle | 293,400 | 480,000 | 488,000 | 488,100 |

¹⁸ 241 F.2d 197 (4th Cir. 1957).

¹⁹ 44 T.C. at 14, 15.

²⁰ Note 16, *supra*.

C. Extraordinary

| | | | | |
|--------------------------------------|---------|---------|---------|---------|
| Anticipated needs of the business | 320,610 | 345,500 | 223,571 | 465,553 |
|--------------------------------------|---------|---------|---------|---------|

D. Excess Liquidity

| | | | | |
|-------------|-----------|-----------|--------|-----------------------|
| (C + B — A) | (113,947) | (185,676) | 53,218 | 137,076 ²¹ |
|-------------|-----------|-----------|--------|-----------------------|

To the excess liquidity so neatly determined, the amounts of investments and loans unrelated to the business are added to determine the amount subject to the penalty tax. Thus, for 1956, there is determined to be a working capital deficiency of \$113,947. Unrelated to the business investments and loans of \$86,333 and \$50,000 respectively, when added to this negative figure, leave precisely \$22,386 subject to Section 531 penalties for that year.

Bardahl was decided before the First Circuit Court of Appeals heard the appeal in *Apollo*²² and the *Bardahl* formula was adopted by that Court in spite of some apparent misgivings on the part of the Treasury with its own handiwork:

Our analysis is similar to that followed in *Bardahl Mfg. Corp. v. Commissioner*. In that case the Court determined petitioner's needs for working capital by computing the amount of cash reasonably expected to be sufficient to cover its operating costs for a single operating cycle. Such a cycle consists of the period of time required to convert cash into raw materials, raw materials into inventory of marketable products, the inventory into sales and accounts receivable, and the period of time required to collect its outstanding accounts. No specific reason has been suggested to us, in brief or argument, why such an approach is not appropriate. All that government counsel have said is that it "fails to take into consideration all of the relevant factors."

The business of the *Bardahl* interests is conducted by two corporations. The 1965 decision applied only to the manufacturing corporation. The sales corporation came before the Tax Court in 1966.²³ The taxpayer argued that the division of the year into cycles was over-precise because many expenses of the business, for example the costs of an advertising campaign, occur early in the year, therefore, the liquidity necessary to cover the costs of a particular intra-year cycle are not the same for all cycles. This further logical extension of *Goodman, Smoot*, and first *Bardahl* itself was rejected by the Court. It is extremely interesting to note that the Tax Court itself designated both *Bardahl* cases as memoranda decisions whereas *Apollo* was a reported decision. Does this imply, except in the First Circuit, that the Tax Court rejects rules of thumb and that the precision of *Bardahl* signifies nothing more than the disposition of that case?

²¹ *Ibid.*

²² Note 12, *supra*.

²³ P-H Tax Ct. Mem. 66-182 (1966).

Evidently, the Court of Claims finds little precedent value in *Bardahl*.²⁴ In *Halby Chemical Company, Inc. v. United States*,²⁵ 30% of anticipated sales is allowed as non-excess liquidity. This is highly significant because in *Bardahl* the proration of working capital needs is on the anticipated cash expense needs of the business. An argument that income taxes be allowed among the expenses was rejected. Nonetheless, *Halby* is allowed cash expenses, non-cash expenses such as depreciation, taxes, and profit itself. The Court in *Halby* stresses the fact that the taxpayer is a small company competing with such giants as DuPont, hence its needs for conservative fiscal policies. *Bardahl* not only competes with DuPont, but also with Shell, General Motors, and Chrysler. In spite of the vast difference in results between *Bardahl* and *Halby*, the Court sounds like the spirit of *Goodman* and *Smoot*: "His assignment of 30% of anticipated annual sales to cover working capital needs for inventory, accounts receivable, and cash requirements is likewise indicative of his conservative management goals. It is true, as pointed out by defendant, that in each of his companies manufacturing processes of the various products were completed in a matter of hours, inventory was turned over in 30 days, accounts receivable were collected promptly (with almost no losses through bad debts), wherefore the corporations' needs for working capital should have been provided on a cyclical basis (of 3 or 4 months) instead of being based on annual forecasts."

We are not given much financial data on which to analyze *Halby* further. No balance sheets are provided and we are only told that the current ratio for the years under review is between 4 and 5 to 1, and that about ten percent of earnings have been paid in dividends. Extrapolating on the information available, it would appear that the same determiner of fact who allowed *Bardahl* 35% of annual costs would have allowed *Halby* something less than 15% of costs, rather than 30% of sales.

Is there now, following first and second *Bardahl*, *Apollo*, and *Halby* a viable judicial standard for non-excess liquidity? To be sure, the arithmetic used to determine the precise amount to be taxed each year at Section 531 rates is measured with the frenzied slide-rule of the cost accountant in *Bardahl*. No rule of thumb, following *Apollo* in the Tax Court, is appropriate. Yet the rejection of the argument of second *Bardahl* that even within the business cycle there must be a staggering of requirements makes one suspicious that the finder of excess liquidity fact could just as easily back into his percentage, after having first decided the amount of excess liquidity by the seat of his pants, if thumbs cannot be used. Hindsight decision as to prospective extraordin-

²⁴ P-H Tax Ct. Mem. 65-200 (1965).

²⁵ Court of Claims N. 186-65 (June 9, 1967), 19 Am. Fed. Tax R. 1589.

ary needs of the business in *Bardahl* appears to be subject, on a foresight basis, to the statisticians give or take a billion. What is the significance, to the advisor, of the gulf between *Bardahl* and *Halby*? Is the advice to be to pay the tax and to sue for a refund in the Court of Claims? This is hardly a firm basis for a foresighted business decision which must be made during or immediately following the year under review. To repeat, it would be a brave counsellor, indeed, who would attempt to set a workable liquidity standard for a client.

At this time certain voluntary actions, however, are an open to admission of being water-logged. Thus, if it has sufficient idle current assets to enable it to make loans to shareholders, make casual investments unrelated to its business, or redeem some of its outstanding shares "Quite naturally the question immediately arises as to why the corporation does not pay dividends to its shareholders, if it is able to make loans to them out of its earning and profits."²⁶ In fact, the first case tried under the rationale of Section 531 was a situation where the corporation had borrowed in order to make loans to its sole shareholder.²⁷ Since the enactment of the Personal Holding Company sections²⁸ in 1934, loans and casual investments have been relatively unimportant in Section 531 enforcement.

In the third instance of actions which admit hyperliquidity, redemptions, there have been a number of interesting cases over the years. Redemptions and Section 531 are particularly intriguing because it may well be that the Congress has baited a trap in allowing inter-vivos redemptions²⁹ at capital gains rates and what will more often than not be tax-free treatment³⁰ to redemptions by an estate. The redemption sections are in no way coordinated with Section 531 even though it would appear that they were specifically designed as relief measures for the very type of successful closely-held corporation against whom Section 531 has always been invoked.

A redemption of 50 percent of outstanding shares by the heirs of a "partner" has been allowed where the redemption took the form of a debt to the redeeming shareholders.³¹ Obviously, the Court felt that no trap had been intended when it said, "When Congress specifically provided favorable tax treatment for such transactions and sought to encourage them to facilitate the administration of estates, it hardly could have intended to penalize the corporation for doing the favored act."³²

²⁶ 7 MERTENS, *supra* note 6, § 39.34 at 75 (supp. 1966).

²⁷ *United Business Corporation of America*, 19 B.T.A. 809 (1930), 62 F.2d 754 (2d Cir. 1933).

²⁸ INT. REV. CODE of 1954, § 541 *et seq.*

²⁹ *Id.* § 302.

³⁰ *Id.* § 303.

³¹ *Mountain State Steel Foundries, Inc. v. Commissioner of Internal Revenue*, 284 F.2d 737 (4th Cir. 1960).

³² *Id.* at 745.

While the Court's opinion as to a possible trap is unequivocal, it is nonetheless describing a Section 303 testamentary redemption whereas the case itself involved a Section 302 inter-vivos redemption, in that the heirs, not the estate, had redeemed the shares.

Where it was shown that dissident minority shareholders were redeemed, no penalty was assessed.³³ But where a dissident majority interest was redeemed, the penalty was imposed.³⁴ A dissident majority is certainly an anomaly, yet insofar as the corporate taxpayer itself was concerned it was just that, had there been no redemption the corporation would have lost its independent existence. The standard for the closely-held corporation at the time of redeeming its shares is obviously no more clearly discernable than the standard for liquidity, even if the redemption is accomplished by borrowing. Only if the corporation accumulates liquid assets to prepare for a redemption specifically authorized in Sections 302 and 303 can it be certain of the consequences. It pays the penalty.

The Counsellor of the closely-held company is hard pressed not only by the problems of uncertainty as to how much liquidity is too much or whether a particular option is available to his client, but to explain why a publicly held company can cross, apparently with impunity, any of the hair-triggers which would bring almost automatic sanctions on the closely-held company. For example, under the rationale that the very act of making a casual investment proves dividends could have been paid and in the spirit of Treasury Decision 4914, a closely-held company owning approximately 6%, .02%, and 1% of the shares of Owens-Illinois Glass, U.S. Steel, and Libby-Owens-Ford respectively would be automatically suspect, yet Allied Chemical is in that situation.³⁵ We have seen that redemption of one's shares by a closely-held company frequently brings a law-suit, yet Curtis-Wright and Schenley have redeemed substantial portions of their outstanding shares in recent years. Schenley is particularly interesting in view of the concentrated holding of about 30% of its shares. Filtrol Corporation as of December 31, 1966, had a current ratio of 23/1, with the bulk of its assets invested in tax-exempts.³⁶ What of the maker of a tender-offer? The purpose of the foregoing is not *Paccuse*, but to point out that a double standard of enforcement does in fact exist and one can infer that official tenderness toward small business ceases when small business becomes successful. Our target is not Treasury enforcement of Section 531, but the law itself.

³³ *Gazette Publishing Co. v. Self*, 103 F. Supp. 779 (D.C.E.D. Ark. 1952); *Dill Manufacturing Co.*, 39 B.T.A. 1023 (1939).

³⁴ *Pelton*, 28 T.C. 153 (1939).

³⁵ *Moody's Handbook of Common Stocks*.

³⁶ *Standard & Poor's Listed Stock Reports*.

Conclusion

In several much-litigated areas the Congress has seen fit, over the years, to adopt standards of conduct which at least allow the taxpayer to chart a safe course. There are several instances of this. For example, the ten years trust³⁷ which laid a firm foundation under the fruit and tree uncertainty raised by the *Clifford Case*.³⁸ Another example is the rule that only gifts made within three years of death are rebuttably presumed to have been made in contemplation of death.³⁹ Prior to this amendment, literally any gift made at any time might be considered to be in contemplation of death. Similarly with the rules on corporate reorganizations.⁴⁰ For some twenty years the Treasury itself felt that standards of conduct in the Section 531 area were viable.⁴¹

It is recommended, therefore, that the following statutory standards be adopted in connection with Section 531, to be applied in the alternative.

1. *Prohibited Acts. Loans to shareholders* would be presumed to bring the corporation under the sanctions of Section 531. Frequently, closely held corporations make advances to their shareholders during the year for both corporate and personal reasons. Mere convenience to the shareholder should not be proscribed, but an advance which is cleared for a few days as at the end of the fiscal year should not be allowed. Therefore, a standard providing that advances to shareholders shall be repaid within 30 days after they have been made, or accounted for as an expense within 90 days, would provide the convenience which does not violate the spirit of the Section and, at the same time, a workable rule.

Investments in unrelated securities should be permitted, in any total management determines. If such investments are, in fact, a majority interest in another enterprise, or convertible into a majority interest in another enterprise, they should not be deemed to be "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."⁴² The purpose of this proviso is to bring the closely-held company into something approaching parity with the publicly-held company insofar as diversification is concerned. The publicly-held company can diversify with less than a majority interest.

³⁷ INT. REV. CODE of 1954, § 673.

³⁸ *Clifford*, 309 U.S. 331 (1940).

³⁹ *Id.* § 2035.

⁴⁰ *Id.* § 351.

⁴¹ Note 11, *supra*. T.D. 4914 was issued in 1939 as a guide for examining agents. T.D. 5398, issued in 1944, amended T.D. 4914 by requiring every agent's report to include a resume of Section 531 status. T.D. 4914 was revoked by T.D. 6378, issued in 1959.

⁴² INT. REV. CODE of 1954, § 532(a).

If such investments comprise less than a majority interest, their total should be considered as a current asset in connection with liquidity standards to be discussed later. Following the rationale of *Goodman, Smoot, and Bardahl*,⁴³ management should be free to keep its reserves for future expansion, replacement, and competitive purposes in such securities it deems appropriate.

2. *The statute should apply only to closely-held companies.* The existing administrative attitude should be confirmed by statute. It is suggested that a concentration of ten percent ownership, subject to attribution rules, be deemed to be sufficient for the corporation to be influenced in its dividend decisions by the marginal tax rates of the owners of the ten percent interest.

3. *Payment of 60% of current year earnings in dividends.* The present rules relative to dividends paid found in Section 561 IRC should continue to apply. There is no really good reason for placing the rule at 60%, rather than 50 or 70 except that it is somewhat higher than the rate currently in vogue for the 30 companies which make up the Dow-Jones Index. The remaining 40% of earnings would, of course, tend to increase liquidity for future years. However, the tax is imposed upon the earnings of a given year and the dividends attributable to that year, following Section 561, would exempt that year, future years to fend for themselves, and also being exempted if they met the dividend or some other standard. The 40% of earnings remaining after payment of dividends, even if it is simply retained as cash, would constitute a reserve for replacement of assets, assuming the usual situation that replacement must be at a higher price than historic costs. For the personal service corporation, the 40% retained would be a form of keyman insurance.

4. *Specifically integrate Sections 302, 303 and 531.* If the earnings retained in liquid form are actually used for a Section 302 or a Section 303 redemption and have not violated any other standard, so be it. If, in addition to the use of such liquidity, a loan is used to accomplish the redemption, it should be specifically provided that the use of current earnings for repayment of such loan is not the avoidance of tax with respect to the shareholders.

5. *A current ratio of 3 to 1 or less.* Current assets and liabilities to be included in such a computation are easily defined. Inasmuch as our tests are to be applied in the alternative, and the taxpayer to be exempted if he meets any one, for this purpose loans to shareholders described above as prohibited acts would not be included as current liabilities. Investments in unrelated securities which do not comprise a

⁴³ J. L. Goodman Furniture Co., 11 T.C. 530 (1948); Smoot Sand & Gravel Corp., 241 F.2d 197 (4th Cir. 1957); Bardahl, P-H Tax Ct. Mem. 65-200 (1965).

majority interest should be included in current assets. It follows that investments in a majority interest would not be current assets. Obviously, there might be difficulty in defining investments related and unrelated to the business, however, this test should be no more difficult than that encountered in connection with loss carry forwards of acquired companies. It is conceded that an unnecessary short term loan could distort a current ratio. However, this distortion can be forestalled by annualizing loans.

6. *Current assets comprise less than 25% of total assets.* Using the same definition of current assets as that to determine the current ratio, this exemption is suggested to cover the situation where liquid assets are stockpiled to expand or preserve the business, but in the opinion of management, the time is not yet right to move. Borrowing a concept from the reserve ratio test introduced in Revenue Ruling 62-21, a hindsight test could be introduced. That is, if less than 25% of assets were current in any one of five years following the year under review, the intent to reinvest liquidity in the business would be proven. The test would also be met by the acquisition of a majority interest in a diversified enterprise because we have defined such investments as a non-current asset.

7. *Proof by the taxpayer that in spite of his not meeting any of the foregoing tests, the corporation still has not been formed or availed of for avoidance of surtaxes on its shareholders.* The burdens of proof and going forward with the evidence would both rest with the taxpayer. The nice questions raised by Section 534 such as that recently raised in *Chatham*⁴⁴ as to whether or not the taxpayer had shifted the burden would thus be avoided. This is, of course, a return to pre-Section 534 standards, however, it is submitted that the bastion provided against the Section 531 onslaught contained herein is considerably more substantial than the weak reed of Section 534.

⁴⁴ 48 T.C. 145 (1967).