Working Capital Needs and the Taxation of Accumulated Earnings: Adjustments to the Bardahl Formula

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COMMENTS

WORKING CAPITAL NEEDS AND THE TAXATION OF ACCUMULATED EARNINGS—ADJUSTMENTS TO THE BARDAHL FORMULA

I. INTRODUCTION

The accumulated earnings tax is a tax on corporations which are "formed or availed of for the purpose of avoiding the income tax with respect to [their] shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed."1 The fact that earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business is prima facie evidence of a purpose to avoid income tax.2 One test of a corporation's reasonable business needs is "the reasonably anticipated needs of the business."3 This figure includes, inter alia, the corporation's working capital needs,4 in other words, those funds necessary to carry on the day-to-day operations of the corporation. By comparing the statistically computed working capital needs of the corporation with its actual working capital, courts can determine whether an unreasonable accumulation of corporate income has occurred. In recent years, this comparison method has become a major consideration in accumulated earnings tax controversies. Consequently, courts have been increasingly called upon to establish a more meaningful formula for the measurement of the reasonable working capital needs of a corporation.

II. WORKING CAPITAL NEEDS

The initial attempts of the courts to measure working capital needs resulted in several short-lived formulas: two-and-one-half-to-one ratio of current assets to current liabilities,5 capital to meet operating expenses for at least one year,6 and surplus ranging from two-thirds and three-fourths of the annual oper-

1. I.R.C. § 532(a).
2. I.R.C. § 533(a).
ating cost. These essentially arbitrary rules of thumb were eventually replaced in 1965 with an objective test based on the operating cycle of the corporation. Known as the Bardahl formula, this test has become the generally accepted measure of working capital needs of corporations for purposes of the accumulated earnings tax.

The Bardahl formula was first adopted in Bardahl Manufacturing Corp. to allow the taxpayer to accumulate earnings and profits to provide a working capital reserve sufficient to meet ordinary operating expenses incurred during one complete operating cycle. The corporation’s operating cycle was described as “the period of time required to convert cash into raw materials, raw materials into an inventory of marketable Bardahl products, the inventory into sales and accounts receivable, and the period of time required to collect its outstanding accounts.” The original Bardahl formula consisted of the following steps:

1. Determine the length of the operating cycle by adding the inventory and receivable cycles.
   (a) Determine the length of the inventory cycle by dividing the average inventory during the year by the cost of goods sold for the year and convert to a percentage of one year.
   (b) Determine the length of the receivable cycle by dividing the average balance of accounts receivable during the year by the net sales for the year and convert to a percentage of one year.
2. Multiply the operating cycle by the sum of the cost of goods sold and operating expenses (excluding depreciation and federal income taxes) during one year to determine working capital requirements.
3. Compare working capital requirements to actual working capital of the corporation to determine whether a working capital excess or shortage exists.

This formula is expressed mathematically as follows:

9. Id. at 65-1141.
10. A variation of the Bardahl formula was used in Apollo Indus., Inc. v. Commissioner, 358 F.2d 867 (1st Cir. 1966), which treated the inventory cycle and account
average month inventory
---
cost of sales
+
average month accounts receivable
---
net sales
=
operating cycle as decimal
part of a year
×
costs of sales + expenses — depreciation — income taxes
=
allowable accumulation for working capital needs

In an effort to eliminate its natural distortions, subsequent cases have introduced modifications and adjustments to this basic formula.

III. Average v. Peak Operating Cycles

The original Bardahl formula assumes that working capital needs are computed using a whole year's figures. However, this may not be appropriate in every case. A seasonal business which has greater working capital needs during one month than another may wish to use its maximum or peak cycle instead of an average yearly cycle. For example, a construction company can justify a greater cycle need by using a cycle which includes the summer months instead of a cycle which applies an annual average.\(^1\) The court first endorsed peak operating cycles over average operating cycles in Bardahl International,\(^2\) noting:

\(^1\) See Kingsbury Investments, Inc., 1969 T.C.M. (P-H) ¶ 69,205, in which a manufacturing company which experienced an inventory buildup every year from March to May used a cycle which included the spring months.

\(^2\) 1966 T.C.M. (P-H) ¶ 66,182.
We agree with the petitioner that reasonably prudent businessmen, in considering the cash needs of a business such as this, would take into consideration the fact that the business had peak periods during the year when cash was tied up on inventory and receivables for longer periods than usual, and would be justified in accumulating sufficient net liquid assets to meet the needs of the business during this peak period, rather than just an average operating cycle.

The Bardahl International court considered the peak period reasonable, even though its use each year rather than the average for the entire year would usually distort the picture of the cash needs of the business. Although courts continued to adopt an average operating cycle after Bardahl International, their decisions did not turn on the computation of working capital, but on the need for expansion or diversification, and are not generally considered strong precedent for the use of average operating cycles. The majority of later cases led by Magic Mart, Inc. v. Commissioner, have reverted to the use of peak operating cycles.

However, the peak cycle method of computing working capital need may not be upheld in every case. For example, in Bahan Textiles Machinery Co. v. United States, the court rejected the use of peak cycles where Bahan had maintained no inventory records to support its claim to peak inventory balances, but had relied on the estimates of management in its calculations. In W.L. Mead, Inc., the court rejected the use of peak account receivables for a business without inventory stating that "the use in the formula of peak receivables would exaggerate the petitioner's need for operating capital, and that

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13. Id. at 66-1062.
14. Id.
21. Peak receivables were used without comment. But see Cataphote Corp. v.
the use of average receivables provides amply for such need.”\(^{22}\) In *Mead* the evidence failed to prove that longer periods of time were required to collect larger amounts of account receivables or that Mead’s regular receipts were inadequate to cover expenses during any of its business cycles. In fact, the court pointed out that usually Mead’s monthly cash balances substantially exceeded its expenses. By relying on the actual time necessary to collect peak receivables as compared to average receivables, the court in *Mead* introduced an element of subjectivity into the computation of working capital needs which had theretofore been absent.\(^{23}\) Consequently, although the courts prefer peak cycles over average cycles, it would be advisable for the corporate taxpayer to substantiate its peak cycles by the use of monthly balances of both inventory and accounts receivable and to demonstrate an actual need for a longer cycle and higher accumulated income.

**IV. CREDIT CYCLE**

A credit cycle has been defined as the “time in which actual payment for materials and inventory is delayed either by the collection process of the supplier, terms of the trade, delayed payment by the purchaser, or by the normal inconsistencies in ordering, shipment, receipt of goods and billing practices.”\(^{24}\) One commentator\(^{25}\) has suggested that the credit cycle be computed by dividing monthly trade payables into the total of cost of goods sold and below-the-line expenses (general, administrative and sales expenses) less depreciation and nonoperative expenses such as pension and profit-sharing contributions. The resulting figure is converted into a number of days and subtracted from the inventory and collection cycle.

Controversy has arisen over the inclusion of a credit cycle into the *Bardahl* formula. Critics of the credit cycle\(^{26}\) claim that it reduces the amount of allowable accumulations on the assumption that the credit will continue uninterrupted and un-

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changed throughout the year, when, in fact, management has little, if any, control over the credit policies of its suppliers. In apparent agreement with these criticisms, the credit cycle was summarily rejected in *Schenuit Rubber Co. v. United States*,27 and applied only sparingly in two other cases. The first case, *Bardahl International Corp.*,28 restricted the use of the credit cycle to inventory supplied to International by Bardahl Manufacturing, a sister corporation. The court noted that although the supplier might theoretically demand payment on delivery and eliminate the lag between receipt and payment, International was not required to pay for the inventory until the tenth of the following month under its contract with Manufacturing. In fact, because of its practice to pay all other third-party creditors first and Manufacturing only when it had funds available, International did not pay for its inventory until well after the tenth of the month. Consequently, the court found a consistent credit cycle for payments due Manufacturing. Although in a second case, *Kingsbury Investments, Inc. v. Commissioner,*29 the credit cycle was extended to include third-party account payables, the importance of that decision is diminished because the case was decided on the basis of anticipated extraordinary expenses and not on the basis of computation of working capital. In addition, both the government and taxpayer argued for the inclusion of some credit cycle reduction.30

On the other hand, more recent cases, *W. L. Mead, Inc. v. Commissioner,*31 and *Hooper, Inc. v. United States,*32 have taken the corporation’s credit arrangements into consideration in applying the *Bardahl* formula, on the ground that “to the extent that payment of expenses may be postponed as a result of credit arrangements, plaintiff’s need for operating capital is reduced . . . . [A]nd the failure to take into consideration such arrangements would result in overstating the amount of operating capital needed for a business cycle.”33 It should be noted that in *Hooper*, the *Bardahl* formula was applied to a service corporation with no raw materials except its personnel.

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32. 539 F.2d 1276 (Ct. Cl. 1976).
33. 1975 T.C.M. (P-H) ¶¶ 75,215, 75,911 (citations omitted).
Consequently, the credit arrangements consisted primarily of employee salaries payable either once or twice a month. Because the corporation itself and not an outside supplier fixed its terms for payment, the inclusion of a credit cycle in the Bardahl formula did not create the distortion feared by earlier critics. The court in Ready Paving and Construction Co.\textsuperscript{34} also included an accounts payable turnover cycle in its formula, noting that the company did not pay its accounts, such as accounts payable, to subcontractors until it had been paid by the person for whom the construction was being done.

These cases indicate that, despite earlier criticism, where the credit cycle is fixed either by the corporate taxpayer itself or through a special arrangement with a supplier, courts may be persuaded to include a credit cycle deduction in their Bardahl computations.

V. APPLICATION OF THE BARDAHNL FORMULA TO SERVICE BUSINESSES

Service businesses differ from manufacturing businesses in that inventories do not exist in the usual sense of the word. As a result, one-half of the operating cycle, the inventory turnover cycle, appears to be missing. For this reason, most courts refuse to apply the Bardahl formula to service businesses. For example, in the Cheyenne Newspaper, Inc.\textsuperscript{35} case, the court considered a Bardahl computation to be of little value. Instead, the court allowed an accumulation of working capital for an apparently arbitrary period of ninety days. In that case the taxpayer operated a newspaper publishing concern. Its sole inventories were stocks of newsprint and other miscellaneous supplies. Because inventory annually composed less than fifteen percent of operating costs and because accounts were paid within thirty days, the court concluded that the taxpayer had working capital needs for a relatively short period as compared to businesses which had product inventories and doubtful receivables. The case of Simons-Eastern Co. v. United States\textsuperscript{36} involved an engi-

\textsuperscript{34} 61 T.C. 827 (1974). See also Cataphote Corp. v. United States, 535 F.2d 1225 (Ct. Cl. 1976).
neering consulting firm which maintained no inventory of salable products. Although the IRS computed Simons-Eastern's operating cycle for purposes of the Bardahl formula, the court held that the standard Bardahl formula could not be rigidly applied to a service business:

As seen, the plaintiff is strictly a service organization and this makes a manufacturing formula inappropriate for rigid application. Moreover, "it has no magic" and the soundest approach seems to call for an examination of the particular needs of the business in question. Neither the taxpayer nor the government is bound by the rigidity of the mathematical precision of Bardahl nor of a set period.37

Claiming that its only real asset was its highly educated, skilled technicians, the taxpayer argued for a six month operating cycle equivalent to an operating reserve of six times the monthly professional and technical payroll. Instead, the court added to the IRS's statistically computed operating cycle, calculated using accounts receivable turnover alone, an allowance for a professional and technical payroll of sixty days. The court noted that this additional allowance would "allow sufficient reserve for one cycle of full operation plus a reasonable period, i.e., 60 days, of curtailed operation to recapture business or in the alternative, to face up to hard decisions on reducing the scope of the entire operation or abandoning it."38 Other courts have also applied the Bardahl formula to businesses without an inventory cycle.39

Both the Cheyenne Newspaper method of rejecting the Bardahl formula in favor of various rules of thumb, and the Simons-Eastern method of combining the Bardahl-calculated operating reserve with some subjectivity determined additional allowance have been severely criticized. Tretheway notes that the only purpose of the measurement of inventory is to start the work product cycle of the business running.40 He argues that in

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37. Id. at 1007.
the case of an advertising agency, for example, this period of time measurement could be commenced by the initial call on a potential or continuing client by the account executive to begin the process of designing an advertising program. The inventory turnover cycle would be computed by determining a ratio of the total man-hours involved in the completion of a program to the total man-hours worked during the year. Davison, taking a similar view advocates simply substituting the peak months' work in process for the peak month inventory in the formula. Work in process includes payroll expenses and all costs that the corporation must incur in project development and completion prior to billing and cost recovery. Davison suggests that a service corporation maintain a work in process account in conjunction with a job order cost accounting system to measure its work in process. To each of these inventory cycles, the time lag between expenditure and recovery of costs would be added to complete the operating cycle. The work in process approach was adopted for a paving and construction company in Ready Paving and Construction Co. The court noted that the taxpayer had no inventories except its work in process which was billed shortly after work was done.

Other commentators have computed the operating cycle by applying human resource accounting to service organizations. Human resource accounting assumes that a corporation's most valuable asset is its personnel. Accordingly, the total hourly services available at any particular period can be viewed as an inventory of the product which the company markets. Billable hours that are passed on to the client would represent sales. Any nonproductive time incurred during the month can be viewed as obsolete inventory with no salvage value, while time spent in professional development or training is an asset that can be amortized over an individual's expected service life with the organization. Similarly, the salaries and wages which the corporation pays its employees constitute the accounts payable that the service organization incurs for its

42. 61 T.C. 826 (1974).
goods (i.e., labor), and the fringe benefits attached to salaried employees are deferred benefits to workers but current expenses to the company. This accounting method results in a human resource inventory cycle equaling a ratio of the average unbilled but billable dollars for the period over the total billable dollars for the period. The accounts payable cycle would equal the ratio of the average direct salary expense payable over the total direct salaries.⁴⁴

A Bardahl formula using an inventory cycle was applied to a service business for the first time in Hooper, Inc. v. United States.⁴⁵ The taxpayer in that case was engaged in the businesses of measurement of radio audiences and of performing market research on a custom basis by telephone interviews. In the performance of its services, the taxpayer employed a network of approximately 3,000 telephone interviewers working out of their homes in from 350 to 400 market areas throughout the United States. The taxpayer’s radio-surveying business consisted of continuously measuring in-home radio listeners on a market-by-market basis and preparing periodic reports on listening habits in each market to be sent to subscribers. The taxpayer’s marketing research work involved questionnaires and precisely constructed interviewing procedures tailor-made to the particular client and product. The information garnered from this research was tabulated, coded, processed and compiled into a report for the particular client

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44. The entire formula would appear as follows:

\[
\text{human resource inventory} = \frac{\text{average unbilled but billable }}{\text{dollars for the period}} \quad \frac{\text{total billable dollars for}}{\text{the period}}
\]

\[+\]

\[
\text{accounts receivable cycle} = \frac{\text{average receivables}}{\text{net billings}}
\]

\[\text{accounts payable cycle} = \frac{\text{average direct salary expense payable}}{\text{total direct salaries}}
\]

A decimal percentage \(X\) \([\text{Billable salary expense} + \text{Unbillable salary expense} + \text{Indirect costs of salaries} + \text{Total other expenses} - (\text{FIT} + \text{Amortization of professional development})]\)

= working capital needs for personnel

45. 539 F.2d 1276 (Ct. Cl. 1976).
paying for the project. In adopting an inventory turnover cycle for this business, the court stated: "Although plaintiff did not have inventories in the conventional sense, the time required for production of its reports prior to billing may fairly be compared to the production of inventory."46

The court then apportioned two-thirds of the corporation’s "inventory" to its marketing research business and one-third to its radio-survey business. The court furthermore based the corporation’s credit cycle on employee salaries and nonsalary payables.

VI. ADJUSTMENT TO THE BARDAL Formula

One shortcoming of the Bardahl formula is that it measures future working capital needs without considering the effect of cyclical business fluctuations, normal growth and inflation, and other foreseeable circumstances.47 In Bardahl Manufacturing Corp.48 the court attempted to accommodate for the growth factor by assessing costs and expenses of the next succeeding year. More often, courts incorporate an adjustment figure into the formula based on historical growth and inflation. In Delaware Trucking Co. v. Commissioner,49 the taxpayer increased its allowable accumulation for working capital needs seventy-five percent by this method. The court stated:

It is clear that a business cannot safely assume that its working capital needs will remain approximately the same from year to year for at least two reasons: (1) possible future growth and (2) increased expenses. This petitioner was faced with future working capital needs involving both of these needs. It contends that it should not be restricted to a static position during the taxable years, i.e., a single cycle amount, without any recognition of probable future increased needs.

46. Id. at 1281.
47. One commentary notes, for example: "Historical factors are used to measure future needs—neglecting the potential growth of the company, the possibility of more intense competition and spiraling expenses, all of which are directly affected by inflationary pressures." Borini, et al. Section 531 Tax—Working Capital Needs and the Operating Cycle, 1 Tax Advisor 305 (1970).
48. 1965 T.C.M. (P-H) ¶ 65,200. See also Empire Steel Casting, Inc., 1974 T.C.M. (P-H) ¶ 74,034, where the court allowed the use of the subsequent years amounts but refused to give the taxpayer the option of using the higher of the subsequent or current expenses and costs.
49. 1973 T.C.M. (P-H) ¶ 73,029.
By its evidence herein, the petitioner has corroborated the soundness of this position, namely, its 1970 single cycle amount is approximately 75 percent greater than its 1967 amount. Hence, we think that petitioner is entitled to look at the future as it decided how much earnings should be retained for subsequent working capital needs.  

The seventy-five percent growth and inflation adjustment used in Delaware Trucking represented the increase in the corporation's salary expense since the last Teamster's Union contract had been negotiated four years earlier. Davison, however, predicts that the four-year time frame used in Delaware Trucking will be shortened in the future to two years for most situations. As for inflation adjustments, the case of W. L. Mead, Inc. demonstrates that unless the evidence establishes that increases in expenses are due to inflation and not to some other cause, such as increased business activity, courts will not accept the adjustment.  

Recently, the court in Dielectric Materials Co. noted that adjustments may also be appropriate for reasonably anticipated contingencies affecting costs and expenses, such as labor shortages, strikes, embargos and wars. In 1966 Dielectric, which manufactured copper wire, stockpiled copper in advance of an anticipated strike and resulting copper shortage. The court found that in 1966 an actual strike in foreign copper mines had occurred and that there existed the prospect of a domestic copper strike. The strike in fact occurred the following year and lasted eight months. The court stated:  

The resulting economic turmoil in the copper industry and its potential effect upon petitioner's business in terms of availability of supplies, ability to satisfy customers, and prices of both purchases and sales seem obvious. . . . Under such circumstances, the normal cash flow utilization contained in the Bardahl Formula for determining working-capital needs may not provide sufficient flexibility to meet cash requirements; cash generated by current sales (which may, at any given moment, be low due to inventory shortages) may well be insufficient to cover purchases or raw materials whenever and  

50. Id. at 73-119.  
52. 1975 T.C.M. (P-H) ¶ 75,215.  
wherever they become available, to say nothing of the ac-
companying increased price demand of suppliers.\textsuperscript{44}

In \textit{W. L. Mead, Inc.} the court found that a similar possibility
of a labor strike justified the accumulation of one month's fixed
accumulated operating costs per year, where labor strikes on
arbitrarily selected transportation terminals frequently oc-
curred every three years when the Teamster's Union labor con-
tracts were renegotiated.\textsuperscript{45} However, the court rejected an ad-
justment for the possibility of a labor walkout in \textit{Empire Steel
Casting, Inc.},\textsuperscript{55} where the actual work interruptions caused by
labor walkouts in the preceding thirty years had amounted to
only thirty-three weeks and a strike was not imminent.

Other contingent liabilities may also justify an adjustment
to working capital needs. An adjustment has been allowed for
a self-insurance reserve to cover annual uninsured losses,\textsuperscript{57}
a reserve to procure government work performance bonds for
paving and construction companies,\textsuperscript{58} and a reserve for personal
and property damages, substantial repairs, environmental
problems, national emergencies, labor replacements and as-
essment of tax deficiencies.\textsuperscript{59}

After having been eliminated as an expense of the business
in the operating cycle in the \textit{Bardahl} cases, an adjustment for
federal income taxes was included in the working capital for-
\textit{mula} in \textit{Delaware Trucking Co.}\textsuperscript{60} and \textit{Empire Steel Casting,
Inc.}\textsuperscript{61} The court in \textit{Empire Steel Casting} reasoned: "Since peti-
tioner was required to pay estimated taxes during each of the
years in issue, this item is an operating expense which should
be approximately reflected in the equation used to determine
the monetary amount used to fund operations for one business
cycle."\textsuperscript{62}

\section*{VII. Actual Working Capital}

The determination of whether an accumulation of earnings
and profits exceeds the reasonable needs of the business so as

\begin{itemize}
\item [\textsuperscript{54}]{\textit{Id.} at 599.}
\item [\textsuperscript{55}]{1975 T.C.M. (P-H) \$75,215.}
\item [\textsuperscript{56}]{1974 T.C.M. (P-H) \$74,034.}
\item [\textsuperscript{57}]{W. L. Mead, Inc., 1975 T.C.M. (P-H) \$75,215.}
\item [\textsuperscript{58}]{Ready Paving & Constr. Co., 61 T.C. 826 (1974).}
\item [\textsuperscript{60}]{1973 T.C.M. (P-H) \$73,029.}
\item [\textsuperscript{61}]{1974 T.C.M. (P-H) \$74,034.}
\item [\textsuperscript{62}]{\textit{Id.} at 74-153.}
\end{itemize}
to invoke the penalty tax requires a comparison of the statistically computed minimum working capital needs of the corporation with its actual working capital. Actual working capital is generally defined as “current assets less current liabilities.”\(^6\) The calculation of actual working capital raises questions of which assets and liabilities to incorporate in the structure of the corporation’s actual working capital and how to value such assets and liabilities.

VIII. STRUCTURE OF ACTUAL WORKING CAPITAL

The threshold consideration in structuring actual working capital under section 531 is whether the corporation can pay dividends because it has liquid assets that are not needed in the business. *Smoot Sand and Gravel v. Commissioner*\(^4\) adopted this liquidity approach, stating:

To the extent the surplus has been translated into plant expansion, increased receivables, enlarged inventories, or other assets related to the business, the corporation may accumulate surplus with impunity.... When, on the other hand, the accumulation of surplus is reflected in liquid assets in excess of immediate or reasonably foreseeable business needs of the corporation, there is a strong indication that the purpose of the accumulation is to prevent the imposition of income taxes upon dividends which would have been distributed to the shareholders.\(^5\)

Consequently, a determination of whether assets are current assets available for distribution as dividends entails an analysis of whether the assets are current or long-term, liquid or static,\(^6\) and whether the earnings are invested in assets related or extraneous to the business.

Current assets have been held in the past to include United States and state obligations,\(^6\) United States Treasury notes,\(^8\) United States government obligations,\(^7\) United States Treasury notes,\(^8\) and other liquid assets.

\(^{63}\) *ACCOUNTING RESEARCH BULLETIN* No. 43, CURRENT ASSETS AND CURRENT LIABILITIES—WORKING CAPITAL, at 20-21 (1953).

\(^{64}\) 274 F.2d 495 (4th Cir. 1960).

\(^{65}\) Id. at 501.

\(^{66}\) Generally the difference between liquid and static assets is clear cut. Liquid assets include cash and noncash items as prepaid expenses, inventories, accounts receivable, bank deposits, and cash surrender values of insurance. Static assets include land, buildings and machinery.

\(^{67}\) Smoot Sand & Gravel Corp. v. Commissioner, 274 F.2d 495 (4th Cir. 1960).

\(^{68}\) Dielectric Materials Co., 87 T.C. 587 (1972).
United States Government bonds,\textsuperscript{69} and stocks and bonds in private corporations, but not stock of other corporations which the taxpayer was required to have to insure an adequate material supply or to fund a profit-sharing trust.\textsuperscript{70} Recently, questions about the scope of "current assets available for distribution as dividends" have arisen again. In \textit{Ready Paving and Construction Co.},\textsuperscript{71} the assets involved were special assessment warrants received by a paving and construction company from a municipality in payment of services. Despite the corporation's argument that the warrants were long-term receivables, the court held them to be readily marketable assets. The court noted that the total face value of the warrants equaled the total contract price of the construction job, while the fair market value of the warrants at the time of receipt was actually ninety-two percent to ninety-six percent of face value. Although the corporation could hold the warrants until maturity and turn them in for total face value, there was at the time of receipt a ready market for the warrants at a discount price, and in fact, some of the warrants had been sold before maturity. The court also ruled that the warrants, although acquired in connection with the work of Ready Paving and Construction Co. did not, after they were acquired, have any relationship to its business and were completely subject to use as it saw fit. In \textit{Sandersville Railroad v. United States},\textsuperscript{72} the assets in question were stockholdings of a bank and a publicly held mainline railroad. The court held these assets to be long-term, related business investments which should not be considered as current assets available for payments of dividends. However, this case was unique in that Sandersville Railroad, being afflicted with the stigma of financial instability attached to all shortline railroads, relied on its strong relationships with the bank and the mainline railroad to lend dependability to its operation. The bank helped the Sandersville Railroad with the railroad's financing and relationship with customers and provided current income and strengthened the current financial statements of Sandersville. The mainline railroad also aided customer relations as well as settling accident claims, performing interline car and

\textsuperscript{69} Bremerton Sun Publishing Co., 44 T.C. 566 (1965).
\textsuperscript{70} Id.
\textsuperscript{71} 61 T.C. 826 (1974).
\textsuperscript{72} 34 A.F.T.R.2d 74-5485 (M.D. Ga. 1974). See Comment, \textit{The Accumulated}
freight accounting, and providing locomotive maintenance for the taxpayer.

IX. Valuation of Assets

The courts have been split on the question of whether unrelated business investments should be valued at cost or fair market value. In Golconda Mining Corp.,73 Henry Van Hummel, Inc.,74 and Fenco, Inc. v. United States,75 the courts included the unrealized profit of unrelated business investments in calculating the corporations' actual working capital. The basis of these decisions, as stated by the Tax Court in Van Hummel, were:

Although petitioner carried all of its investments on the balance sheet at cost, our findings of total net liquid assets include the liquid investment at market value. Here again it is clear that, while cost may be a proper valuation for conservative accounting statement purposes, market value is a much more meaningful figure for purposes of our analysis. We are concerned with the total assets available as of a given time to meet business needs. Hence, the assets (including investments) must be valued at such amount as is most likely to be realized if they were to be converted into cash to meet business needs. The historical cost of the investments means very little in such an inquiry. While market value as of December 31 of any given year may not turn out to be the exact amount realized on the date on which the asset is turned into cash to meet business needs, it is clearly a closer estimate than historical cost.76

On the other hand, in American Trading and Production Corp.77 and Ivan Allen Co. v. United States78 the courts refused to take unrealized appreciation into account. The taxpayers in those cases argued:

73. 35 A.F.T.R.2d 75-331 (9th Cir. 1974), remanding 58 T.C. 139 (1972), supplemental opinion on motion for rehearing, 58 T.C. 736 (1972).
74. 1964 T.C.M. (P-H) ¶ 64,290, aff'd, 364 F.2d 746 (10th Cir. 1966).
76. 1964 T.C.M. (P-H) ¶ 64,290, 64-1957, aff'd, 364 F.2d 746 (10th Cir. 1966).
Neither the statute nor the relevant Treasury Regulations suggest that the unrealized appreciation of a corporation’s assets should be taken into account for purposes of the accumulated earnings tax. To force a corporate taxpayer to sell part of its retained earnings investment portfolio in order to avoid an accumulated earnings tax because the investments have increased in value since purchase is inconsistent not only with sound tax accounting principles but also with better business judgment. Normally, gains are not recognized until realized and in this case the proper value of the securities, until they are converted into cash, is their cost.79

The question was finally decided on appeal of the Ivan Allen decision. The Supreme Court, in a six-to-three decision,80 established the standard for the valuation of listed and readily marketable securities as fair market value less expense of conversion to cash, emphasizing that although the accumulated earnings tax itself is not directed at the unrealized appreciation of liquid securities, such securities are important in determining the reasonableness of the accumulated earnings and profits independently existing.

This decision has not gone uncriticized. Although the Court in a footnote81 restricted its decision to readily marketable portfolio securities and declined to express a view as to operating assets such as inventory and accounts receivable, one legal commentator82 fears that by failing to define precisely the class of assets to which unrealized appreciation is of “profound importance” and by emphasizing the true financial condition of the taxpayer, this decision will encourage the IRS to ignore the dichotomy between operating and nonoperating assets where appreciation is found. This critic also notes that although the Code does not provide that a corporation cannot be an investor, it threatens criminal liability for willful tax evasion to corporations which invest in illiquid assets.

X. CONCLUSION

With rates varying between twenty-seven and one-half percent and thirty-nine and one-half percent, the accumulated

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79. Id. at 1077.
80. 422 U.S. 617 (1975).
81. Id. at 629 n.9.
82. Borden & Briskin, Supreme Court’s Ivan Allen Holding Based on Economic
earnings tax imposes a heavy burden on corporate taxpayers which overestimate their reasonable business needs. Consequently, it is critically important that any formula which is used to compute working capital needs (and any standard which is used to allocate assets and liabilities to actual working capital) reflect the true financial condition of the corporation. Although the *Bardahl* formula is a major step in this direction, it is nonetheless only a rule of thumb. As was stated in *Magic Mart, Inc.*, 83 concerning other, now discarded, rules of thumb: “The rule of thumb so stated may be one for administrative convenience but should rise to no higher level. The search must always be concerned with the needs of the particular business as they existed during the particular year.” 84 Current developments indicate that courts are heeding the advice of the *Magic Mart* case and are not, in computing working capital needs (or actual working capital), restricting themselves to a rigid formula, but are attempting to account for the dynamic and constantly evolving nature of each corporation.

Kathleen Hyland

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*Reality May Cause 531 Problems, 42 J. Tax. 130 (1975).*

83. 51 T.C. 775 (1969).

84. Id. at 792.