BYU Law Review

Volume 1975 | Issue 3 Article 10

10-1-1975

# Federal Income Taxation--Accumulated Earning Tax--Valuation of Marketable Securities for Purpose of Determining Liability for Accumulated Earnings Tax--Ivan Allen Co. v. United States

Jon D. Anderson

**Federal Income Taxation**—ACCUMULATED EARNINGS TAX—VALUATION OF MARKETABLE SECURITIES FOR PURPOSE OF DETERMINING LIABILITY FOR ACCUMULATED EARNINGS TAX—*Ivan Allen Co. v. United States*, 422 U.S. 617 (1975).

Ivan Allen Company (Ivan Allen) is a corporation engaged in the sale of office furniture, equipment, and supplies. Its management invested corporate earnings and profits[1] in securities which increased in value to over 10 times the original cost by 1965 and to almost 20 times the original cost by 1966.[2] Upon examination of the corporation's 1965 and 1966 tax returns, the Commissioner of Internal Revenue, valuing the securities at fair market value, determined that Ivan Allen was "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders" in that it had accumulated earnings and profits beyond the

1. The phrase "earnings and profits" is found in the Internal Revenue Code sections relevant to the accumulated earnings tax, and will therefore be used throughout this note.

The meaning of "earnings and profits" is not specifically defined by the Code but basically represents an attempt to distinguish gain derived by virtue of the conduct of the business from capital contributed by shareholders. Luckman v. Commissioner, 418 F.2d 381, 383 (7th Cir. 1969).

2. The bulk of the increase came from holdings of securities issued by Xerox Corp.

| | Taxable year end 6-30-65 | | Taxable year end 6-30-66 | |
|---|---|---|---|---|
| | Cost | Fair market value | Cost | Fair market value |
| 11,140 shares Xerox common (listed) | $116,701 | $1,573,525 | — | — |
| 10,090 shares Xerox common (listed) | — | — | $102,479 | $2,479,617 |
| $30,000 Xerox Conv. debentures (listed) | 30,625 | 48,424 | 30,625 | 69,768 |
| Total | $147,326 | $1,621,949 | $133,104 | $2,549,385 |

Brief for Respondent at 3, Ivan Allen Co. v. United States, 422 U.S. 617 (1975).

During the same period, Ivan Allen's net income (taxable income less federal income taxes paid) was substantially greater than the dividends distributed to stockholders.

| | Taxable year end 6-30-65 | Taxable year end 6-30-66 |
|---|---|---|
| Reported taxable income | $ 341,045.82 | $ 629,512.19 |
| Undistributed earnings | $2,200,184.77 | $2,360,146.52 |
| Dividends distributed | | |
| Cash | $ 48,945.30 | $ 50,267.49 |
| 870 shares Xerox Common | $ 6,564.34 | — |
| 10% stock dividend | — | — |

Ivan Allen Co. v. United States, 422 U.S. 617, 619-20 (1975).

reasonable needs of the business. The Commissioner then assessed accumulated earnings taxes for both years. Ivan Allen paid the taxes and, after being denied a refund, commenced the instant action.

The United States District Court for the Northern District of Georgia rejected the Government's argument that, for the purpose of determining whether earnings and profits had accumulated beyond the reasonable needs of the business, marketable securities should be valued at *fair market value*[3] and accepted Ivan Allen's contention that such assets should be valued at *cost*.[4] The United States Court of Appeals for the Fifth Circuit reversed,[5] and the United States Supreme Court affirmed, holding that, pursuant to the purpose and intent of the accumulated earnings tax, readily marketable securities should be valued at net realizable market value.[6]

## I. Background

The Internal Revenue Code[7] provides for eventual double taxation of corporate income—first when earned by the corporation,[8] and again when distributed as dividends to the shareholders.[9] Because the second stage of taxation does not accrue until

---

3. Less costs of conversion to cash. *See* note 6 *infra*.

> The legal definition of fair market value is the price at which property would change hands in a transaction between a willing buyer and a willing seller, neither being under compulsion to buy or sell, and both being reasonably informed as to all relevant facts.

Jack Daniel Distillery v. United States, 379 F.2d 569, 574 (Ct. Cl. 1967).

4. Ivan Allen Co. v. United States, 349 F. Supp. 1075 (N.D. Ga. 1972), *rev'd*, 493 F.2d 426 (5th Cir. 1974), *aff'd*, 422 U.S. 617 (1975).

5. Ivan Allen Co. v. United States, 493 F.2d 426 (5th Cir. 1974), *aff'd*, 422 U.S. 617 (1975).

6. Ivan Allen Co. v. United States, 422 U.S. 617 (1975). Net relizable value is equal to fair market value less costs of conversion to cash.

The Court freely interchanges the phrases "net liquidation value" and "net realizable value." There is no difference in meaning for the purposes of this case. Both are part of the fair market value approach, merely reflecting an adjustment for costs of conversion to cash.

The parties stipulated that such costs would include at maximum a 6 percent brokerage commission and a 25 percent capital gains tax on the fair market value in excess of the commission upon sale and the cost of the securities. Petitioner's Brief for Certiorari, appendix, at 55, Ivan Allen Co. v. United States, 422 U.S. 617 (1975).

7. Unless otherwise indicated, all references to "Code" or "section(s)" refer to the Internal Revenue Code of 1954 as amended.

8. Int. Rev. Code of 1954, § 11.

9. Int. Rev. Code of 1954, §§ 1, 61(a). Individuals may exclude dividends received from domestic corporations to the extent that they do not exceed $100.00. Int. Rev. Code of 1954, § 116(a).

actual distribution to shareholders, it can be delayed, reduced, or avoided altogether if a corporation accumulates rather than distributes its earnings and profits.[10] In order to secure the full measure of this double taxation, Congress has, since the Tariff of 1913,[11] provided an accumulated earnings penalty tax to compel corporate distribution of unneeded earnings and profits to shareholders.[12]

### A. *Operative Language of the Code*

Section 531 of the Internal Revenue Code imposes an accumulated earnings tax[13] on "every corporation[14] . . . formed or

---

10. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 8.01 (3d ed. 1971); 1976 PRENTICE HALL, FEDERAL TAX COURSE ¶ 3130 (students ed. 1975).

The individual tax will be *delayed* until actual dividend distribution of cash or property to shareholders. *See* INT. REV. CODE of 1954, §§ 61(a), 301, 316.

*Reduction* in the individual tax can be procured by allowing earnings and profits to accumulate in the corporation, which should be reflected by an increase in stock prices, and subsequently taking advantage of the 50 percent long-term capital gains deduction upon sale. *See* INT. REV. CODE OF 1954, § 1202. Also, by timing dividend distributions in order to maintain a more even taxable income over the years, individual taxpayers can avoid high income peaks (with higher marginal tax rates) and take advantage of lower marginal rates by receiving dividends during years of otherwise low income. *See* INT. REV. CODE OF 1954, § 1. Reduction will also occur if dividend distribution is delayed until retirement. *See* INT. REV. CODE OF 1954, § 37.

Section 1014 provides a "stepped up" basis for property acquired from a decedent. Therefore, if earnings are accumulated until the taxpayer's death, the increase in the market value of the stock resulting from that accumulation need not be recognized as income by the recipient of the stock upon its disposition. In this manner the individual income tax can be *avoided* altogether. *See* INT. REV. CODE OF 1954, § 1014.

11. Ch. 16, § IIA, 38 Stat. 166.

The original scheme taxed shareholders individually on their share of undistributed earnings and profits of corporations formed or fraudulently availed of for the purpose of avoiding tax on shareholders. *See id.* The modern version, INT. REV. CODE OF 1954, §§ 531-537, taxes the corporation. *See* notes 13-17 and accompanying text *infra*.

12. "[T]he purpose . . . is to compel the company to distribute any profits not needed for the conduct of its business so that, when so distributed, individual stockholders will become liable not only for normal but for surtax on the dividends received." Helvering v. Chicago Stock Yards Co., 318 U.S. 693, 699 (1943); *accord*, United States v. Donruss Co., 393 U.S. 297 (1969).

Nevertheless, because the maximum accumulated earnings tax penalty is 38½ percent and maximum marginal individual tax rates are 70 percent, it will be profitable in some cases to accumulate earnings and profits beyond reasonable business needs, pay the penalty tax, and avoid the individual tax on shareholders. *See, e.g.*, Comment, *Reasonable Needs of the Business: The Section 537 Question*, 6 ST. MARY'S L.J. 444, 471 (1974).

13. § 531 imposes an accumulated earnings tax equal to the sum of—

(1) 27½ percent of the accumulated taxable income not in excess of $100,000, plus

(2) 38½ percent of the accumulated taxable income in excess of $100,000.

Accumulated taxable income is defined in INT. REV. CODE OF 1954, § 535.

14. The tax does not apply to:

availed of for the purpose[15] of avoiding the income tax with respect to its shareholders . . . by permitting earnings and profits to accumulate instead of being divided or distributed."[16] In determining whether a corporation has such purpose, section 533 provides that:

> [T]he 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, unless the corporation by the preponderance of the evidence shall prove to the contrary.[17]

### B. *Judicial Interpretation of the Code*

Initially, a court adjudicating an accumulated earnings tax controversy must determine the *reasonable needs of the business*[18] for the accumulation of earnings and profits during the

---

(1) personal holding companies, governed by §§ 542-547;

(2) foreign personal holding companies, governed by §§ 551-558;

(3) corporations exempt from tax under subchapter F (§§ 501-515).

INT. REV. CODE OF 1954, § 532(b).

15. A purpose to avoid the income tax with respect to shareholders need be only one of the purposes for accumulation. Liability will be imposed even if numerous other purposes exist. *See, e.g.*, United States v. Donruss Co., 393 U.S. 297, 301-03 (1969).

16. INT. REV. CODE OF 1954, § 532(a).

17. INT. REV. CODE OF 1954, § 533(a).

This aid to the Commissioner in proving the prohibited purpose to avoid the income tax with respect to shareholders has existed in similar form since 1913. *See* Tariff of 1913, ch. 16, § IIA, 38 Stat. 166.

In 1954 Congress recognized several "undesirable consequences" of the imposition of the burden of proof on taxpayers. As a partial remedy, § 534 was enacted as part of the 1954 Code. *See* H.R. REP. No. 1337, 83d Cong., 2d Sess. 52, 2 U.S. CODE CONG. & AD. NEWS 4017, 4077 (1954); S. REP. No. 1622, 83d Cong., 2d Sess. 70, 2 U.S. CODE CONG. & AD. NEWS 4621, 4702 (1954). INT. REV. CODE OF 1954, § 534 allows the taxpayer to shift the burden of proof to the Commissioner in Tax Court proceedings if (1) the Secretary or his delegate has not sent the taxpayer notice that a proposed deficiency includes an amount with respect to the accumulated earnings tax, or (2) the taxpayer has responded to such notification with a statement

> setting forth the grounds (together with facts sufficient to show the basis thereof) on which it relies to establish that all or any part of its earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business.

Treas. Reg. § 1.534-2(a)(2) (1959).

18. The phrase *reasonable needs of the business* is used in a variety of confusing contexts. As the central issue of § 533, it is a term of art representing the difference between a corporation's current and reasonably anticipated operating needs and its financial ability to satisfy them. However, *reasonable needs* is also a common label referring to the sub-issue of current and reasonably anticipated operating needs. *See* note 20 *infra*.

The examination of reasonableness is subjectively made on an ad hoc basis. Treas. Reg. § 1.537-1(a) (1972) provides that:

> An accumulation of the earnings and profits (including the undistributed earn-

year in question. The inquiry leading to this determination is a highly subjective after-the-fact[19] analysis, that compares the reasonable business needs[20] existing at the end of the tax year in question with the corporation's financial status, or ability to satisfy those needs, at that same point in time. The most crucial problem in the inquiry is to *identify* and *value* the corporate assets then available to meet current operating needs.[21]

---

> ings and profits of prior years) is in excess of the reasonable needs of the business if it exceeds the amount that a *prudent businessman would consider appropriate* for the present business purposes and for the reasonably anticipated future needs of the business (emphasis added).
>
> Whether a particular ground or grounds for the accumulation of earnings and profits indicate that the earnings and profits have been accumulated for the reasonable needs of the business or beyond such needs is *dependent upon the particular circumstances of the case.*

Treas. Reg. § 1.537-2(a) (1959) (emphasis added); *accord*, Cheyenne Newspapers, Inc. v. Commissioner, 494 F.2d 429, 432 (10th Cir. 1974); World Publishing Co. v. United States, 169 F.2d 186, 189 (10th Cir. 1948).

The courts are reluctant to substitute their judgment for that of corporate management.

> The reasonableness of the needs is necessarily for determination by those concerned with the management of the particular enterprise. This determination must prevail unless the facts show clearly the accumulations were for prohibited purposes.

Henry Van Hummell, Inc. v. Commissioner, 364 F.2d 746, 749 (10th Cir. 1966), *cert. denied*, 386 U.S. 956 (1967); *accord*, R. C. Tway Coal Sales Co. v. United States, 3 F. Supp. 668, 671 (W.D. Ky. 1933); Golconda Mining Corp., 58 T.C. 139, 161 (1972), *supp. opinion*, 58 T.C. 736 (1972), *rev'd on other grounds*, 507 F.2d 594 (9th Cir. 1974).

19. Accumulated earnings tax deficiences are assessed and litigation brought long after disputed accumulations of earnings and profits are made. Courts must make determinations of reasonableness, and ultimately whether a purpose to avoid the income tax with respect to shareholders existed, with respect to the time at which the allegedly improper management decisions were made. In addition, courts must isolate their inquiries from events subsequent to the accumulations in question.

> [O]nly the facts as of the close of the taxable year should be taken into account in determining whether an accumulation is reasonable. If the retention of earnings is justified as of the close of the taxable year, subsequent events should not be used for the purpose of showing that the retention was unreasonable in such year.

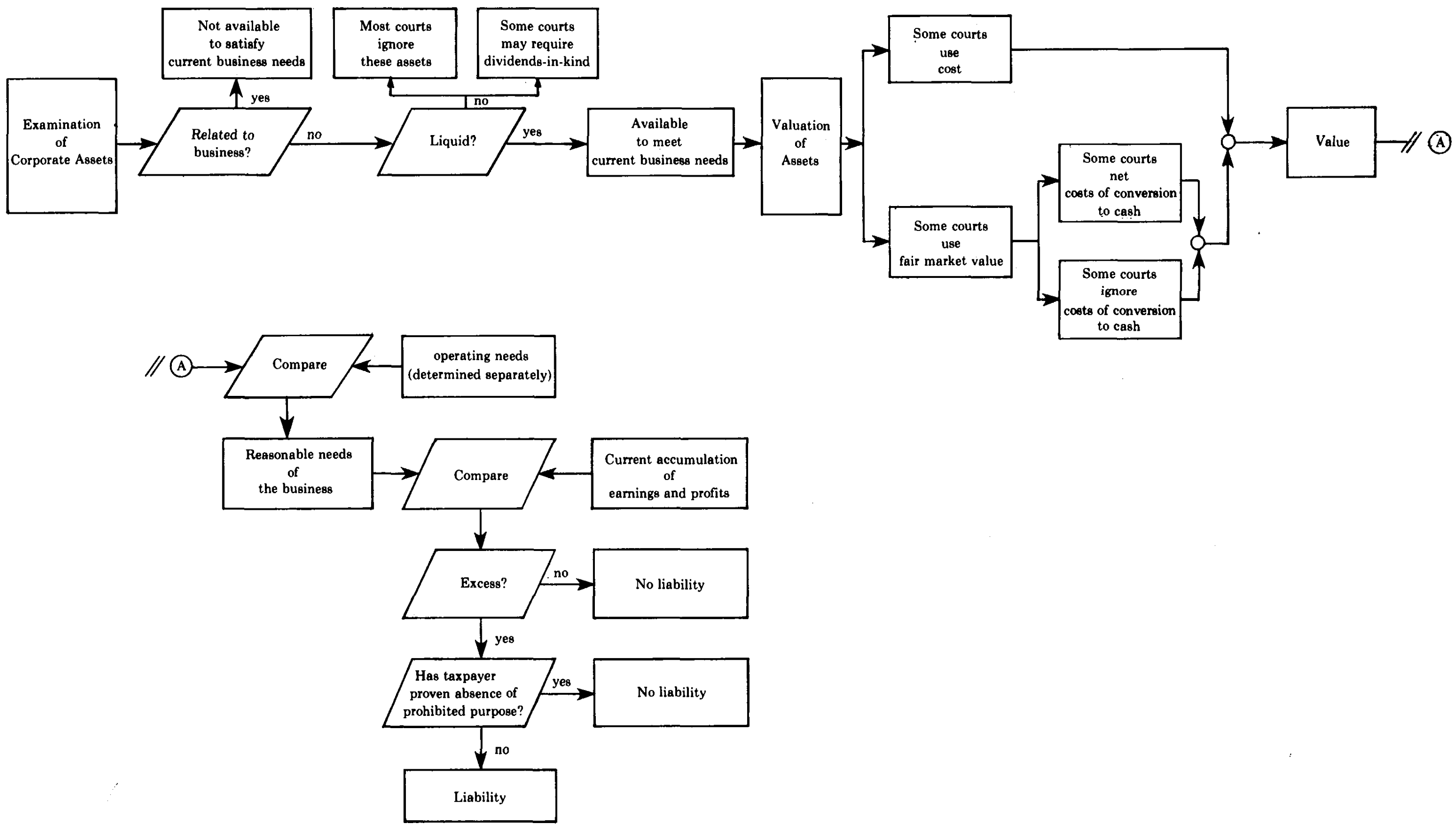
S. REP. NO. 1622, 83d Cong., 2d Sess. 69-70, 2 U.S. CODE CONG. & AD. NEWS 4621, 4701 (1954).

20. "Reasonable needs" include the reasonably anticipated needs of the business. INT. REV. CODE of 1954, § 537(a)(1). To justify accumulation of earnings and profits for reasonably anticipated needs,

> there must be an indication that the future needs of the business require such accumulation, and the corporation must have specific, definite, and feasible plans for the use of such accumulation.

Treas. Reg. § 1.537-1(b)(1) (1972), *amending* T.D. 6377, 5-12-59; *see* Smoot Sand & Gravel Corp. v. Commissioner, 241 F.2d 197, 202 (4th Cir. 1957), *cert. denied*, 354 U.S. 922 (1957).

21. The following diagram presents an overview of a court's inquiry:




For the tax computation procedure, see INT. REV. CODE OF 1954, §§ 531, 535.

*1. Identifying assets available for distribution or satisfaction of current needs*

To be available to meet current business needs, an asset must not be committed to a valid business-related use. This requirement of availability is determined by the related-unrelated test, explained below. If an asset is found to be unrelated, courts will look further to determine whether the asset can be used, or translated into a usable form, to satisfy current business needs. This second step in the analysis is based on the "liquidity concept."

*a. Related v. unrelated assets.* Since the inception of the accumulated earnings tax,[22] Congress has allowed corporations to accumulate earnings and profits for the "reasonable needs of the business."[23] While some early decisions emphasized the *size* of the corporation's undistributed current and prior earnings and profits,[24] modern decisions focus on the *nature* of corporate assets and do not impose tax liability to the extent that accumulated earnings and profits are translated into assets related to the taxpayer's business.[25] The general rule is stated in *Smoot Sand & Gravel Corp. v. Commissioner:*[26]

---

22. Tariff of 1913, ch. 16, § IIA, 38 Stat. 166.

23. Under the current Code, § 535(c)(1) provides an "accumulated earnings credit" which reduces accumulated taxable income by the amount of earnings and profits for the taxable year that are retained for the reasonable needs of the business (less the long-term capital gains adjustment in § 535(b)(6)).

For a demonstration of how the accumulated earnings credit fits into the computation of accumulated taxable income, *see* INT. REV. CODE OF 1954, § 535.

24. Ziegler, *The "New" Accumulated Earnings Tax: A Survey of Recent Developments*, 22 TAX L. REV. 77, 84 (1966).

Ziegler summarizes the fallacy of emphasizing "earnings and profits" as stated on the corporation's balance sheet:

> (1) A corporation cannot distribute *earnings* which are merely an arithmetical result reached by subtracting certain costs and expenses from certain items of income. Similarly, a corporation's *accumulated earnings* are not something which can be the subject of retention or distribution—rather, accumulated earnings are merely the result reached by subtracting the corporation's liabilities and capital stock from the amount of its assets. If anything, accumulated earnings represent a cross section of the corporation's assets.
>
> (2) What a corporation may accumulate or distribute are *assets*, that is, cash, inventory, receivables, equipment, et cetera.

*Id.* (emphasis in original).

25. *See* Comment, *Accumulated Earnings Tax: An Appeal for Flexibility*, 52 N.C.L. REV. 1179, 1217 (1974).

Congress clearly did not intend the tax to apply to reasonable accumulations of earnings and profits for business-related purposes. *See* S. REP. No. 1622, 83d Cong., 2d Sess. 72, 2 U.S. CODE CONG. & AD. NEWS 4621, 4704 (1954).

26. 274 F.2d 495 (4th Cir. 1960), *cert. denied*, 362 U.S. 976 (1960).

> [T]o the extent that surplus has been translated into plant expansion, increased receivables, enlarged inventories, or other assets related to its business, the corporation may accumulate surplus with impunity.[27]

For purposes of the tax, then, all types of assets, including marketable securities, are considered unavailable to meet current operating needs[28] as long as they are related to the taxpayer's business.[29] Conversely, assets unrelated to the business are considered available to satisfy current operating needs. As a result, investment in unrelated assets is evidence of an unreasonable accumulation of earnings and profits,[30] which is ultimately determinative of the condemned "purpose of avoiding the income tax with respect to shareholders."[31]

---

27. *Id.* at 501. Treas. Reg. §§ 1.537-2(b)(4), (1) (1959) provide that "(4) [t]o provide necessary working capital for the business" or (1) "[t]o provide for bona fide expansion of business or replacement of plant" are reasonable grounds, if supported by sufficient facts, for reasonable accumulation of earnings and profits.

Investments in accounts receivable and inventory are generally but not always "business-related" assets. For example, a corporation may deliberately purchase or manufacture excess inventory in order to reduce otherwise unreasonable cash accumulation. Similarly, speculative purchase of commodities such as gold, copper, and zinc may be financed under the guise of "inventory" where these materials are also used in the corporation's manufacturing process. Ziegler, *supra* note 24, at 88-89.

To the extent that such accumulations are beyond business needs, they will be considered available to satisfy valid current operating needs in the ultimate determination of "reasonable needs of the business." *See* Sears Oil Co. v. Commissioner, 359 F.2d 191, 197 (2d Cir. 1966).

28. Business needs can include provision for expansion, acquisition of other enterprises, retirement of indebtedness, working capital, and business-related investments. Basically, any reasonable ground, supported by sufficient facts, will be permissible. Treas. Reg. § 1.537-2 (1959).

29. Cheyenne Newspapers, Inc. v. Commissioner, 494 F.2d 429, 435 (10th Cir. 1974) (marketable securities); Ziegler, *supra* note 24, at 91.

30. Examples of purposes which may indicate unreasonable accumulation of earnings and profits are provided by Treas. Reg. § 1.537-2(c) (1959):

> (1) Loans to shareholders, or the expenditure of funds of the corporation for the personal benefit of the shareholders;
> (2) Loans having no reasonable relation to the conduct of the business made to relatives or friends of shareholders, or to other persons;
> (3) Loans to another corporation, the business of which is not that of the taxpayer corporation, if the capital stock of such other corporation is owned, directly or indirectly, by the shareholder or shareholders of the taxpayer corporation and such shareholder or shareholders are in control of both corporations;
> (4) *Investments in properties, or securities which are unrelated to the activities of the business of the taxpayer corporation*; or
> (5) Retention of earnings and profits to provide against unrealistic hazards (emphasis added).

31. INT. REV. CODE OF 1954, § 532(a).

The Fifth Circuit Court of Appeals has declared:

*b. The liquidity concept.* An asset available to satisfy current business needs must, in addition to being unrelated to the taxpayer's business, be in or changeable to a currently usable form. Assets in a form available for use in current operations are referred to as liquid assets.[32]

The earliest use of the liquidity concept is found in *United Block v. Helvering*: "The really important question is, now how much capital of all sorts, but how much quick assets, it was reasonable to keep on hand for the business . . . ."[33] Thus, in determining the reasonableness of accumulated earnings and profits, courts do not analyze all balance sheet assets but focus on liquid assets, namely those which can be sold or used to meet current needs.[34]

---

> Generally, the diversion of earnings from a taxpayer's business and its reasonable business needs for use in activities or investments unrelated to that business is usually persuasive evidence that the diverted earnings are not reasonably needed in the business and/or that the corporation is being availed of for the proscribed purpose.

Mead's Bakery, Inc. v. Commissioner, 364 F.2d 101, 106 (5th Cir. 1966).

32. Neither the Code nor the Treasury Regulations refer to "net liquid assets." The liquidity concept is a judicial gloss on §§ 533 and 535. Note, *Accumulated Earnings Tax: Should Marketable Securities Be Valued at Cost or at Fair Market Value in Determining the Reasonableness of Further Accumulations of Income?* 40 BROOKLYN L. REV. 192, 197-200 (1973) (providing an excellent discussion of the development of the "net liquid assets" test).

One court used the following formula to calculate net liquid assets:

| | | |
|---|---|---|
| Current Assets | | |
| Cash | $ xx | |
| Accounts Receivable (less reserve for bad debt) | xx | |
| Inventories | xx | |
| Securities — at market | xx | |
| Note Receivable | xx | |
| Total | | $xxx |
| Current Liabilitites | | |
| Accounts Payable | $ xx | |
| Note Payable | xx | |
| Accrued expenses | xx | |
| Amount due officer | xx | |
| Total | | xx |
| Net Liquid Assets | | $ xx |

Apollo Industries, Inc. v. Commissioner, 358 F.2d 867, 877 (1st Cir. 1966).

While some courts use the terms *liquid* and *quick* interchangeably, they do have different accounting meanings. Quick assets represent funds which may be made readily available for paying current obligations and include cash, accounts receivable, short-term notes, and temporary investments in marketable securities. Inventories are not included because they must be sold and collection made before cash is available. Liquid assets include those considered quick plus inventories. G. WELSCH, C. ZLATKOVICH & J. WHITE, INTERMEDIATE ACCOUNTING 1047 (3d ed. 1972).

33. 123 F.2d 704, 705 (2d Cir. 1941), *cert. denied*, 315 U.S. 812 (1942).

34. *See* Ziegler, *supra* note 24, at 87.

While cash is the epitome of liquidity, marketable securities held for investment, rather than for business-related purposes, are also liquid assets considered available to satisfy current operating needs.[35] Where securities are not readily marketable,[36] however, courts do not include them among liquid assets.[37]

## 2. *Valuation of marketable securities*

While the liquidity concept is now generally accepted by litigants and scholars,[38] the problem of valuing the available liquid assets has been a fruitful source of litigation with inconsistent results. The fundamental dispute, and the issue of the present case, is whether unrelated marketable securities should be valued, for purposes of the accumulated earnings tax, at cost[39] or at fair market value.[40]

During the Depression, several courts recognized that reductions in the market value of assets should properly be considered

---

35. Note, *The Accumulated Earnings Tax: The* Smoot *Analysis and Valuation of Marketable Securities*, 30 WASH. & LEE L. REV. 507, 515 (1973); *see* Cheyenne Newspapers, Inc. v. Commissioner, 494 F.2d 429, 435 (10th Cir. 1974); Starks Building Co., 32 CCH Tax Ct. Mem. 1201, 1213 (1973).

Business-related securities are not considered available for current operating needs and are not subject to the tax liability determination. *See* note 28 and accompanying text *supra*. Such securities include shares of stock pledged as collateral for a business loan and investment in businesses that are essential to the operation of the taxpayer corporation.

36. For example, Securities and Exchange laws regulate certain large liquidations. American Trading and Prod. Corp. v. United States, 362 F. Supp. 801, 809 (D. Md. 1972), *aff'd without opinion*, 474 F.2d 1341 (1973).

37. *See* Golconda, 58 T.C. 736, 740 (1972); American Trading and Prod. Corp. v. United States, 362 F. Supp. 801, 809 (D. Md. 1972).

In theory, this rationale would extend to all nonliquid investments. If the liquidity concept is accepted to this extent, it is apparent that some unrelated assets, such as investments in land, will escape the accumulated earnings tax. Even though this problem could theoretically be solved by INT. REV. CODE OF 1954, § 7201, which imposes criminal penalties on persons who wilfully attempt to evade taxes, there has been a noticeable failure to apply § 7201 to accumulations of unrelated nonliquid assets.

38. *See* Note, *Accumulated Earnings Tax, supra* note 32, at 199.

39. Cost is defined in these terms:

> *Cost* is the amount, measured in money, of cash expended or other property transferred, capital stock issued, services performed, or a liability incurred, in consideration of goods or services received or to be received.

2 APB ACCOUNTING PRINCIPLES, ACCOUNTING TERMINOLOGY BULLETIN No. 4—COST, EXPENSE AND LOSS ¶2, at 9523 (1957) (emphasis in original).

40. The use of fair market value is strictly limited to the determination of reasonableness, *see* note 18 and accompanying text *supra*, and is not used for computing any tax. The market value approach includes unrealized appreciation only for the purpose of determining whether further accumulation of earnings and profits was reasonable. The computation of the penalty tax in no manner includes such unrealized appreciation. *See* INT. REV. CODE OF 1954, § 535.

For an explanation of "fair market value" and related terms, see notes 3 and 6 *supra*.

in determining whether accumulations of earnings and profits have exceeded the reasonable needs of the business.[41] In *C. H. Spitzner & Son, Inc.*,[42] the United States Board of Tax Appeals, in determining reasonable business needs, stated that "the assets would be useful to the business only to the extent of their actual market values. The fact that they cost a greater amount would not benefit the business."[43] The court considered market value superior to cost as a measure of the realistic present economic condition of the corporation.

Though the market value approach gained acceptance when applied to corporations with substantially depreciated assets, it was resisted by taxpayers and some courts when extended to *appreciated* securities. In *Harry A. Koch Co. v. Vinal*,[44] a federal district court recognized that market value should be used when securities prices are below cost but held that when the securities have appreciated in value, cost is the proper standard. The court reasoned that due to the volatility of securities market prices and the 25 percent corporate capital gains tax[45] imposed on any appreciation realized upon sale, it would be "unrealistic" to expect that the taxpayer could use the unrealized appreciation in his business.[46]

The Tax Court, however, was willing to apply the market value approach to appreciated securities. In *Henry Van Hummell, Inc.*,[47] the Tax Court held that "total net liquid assets include the liquid investment at market value," reasoning 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."[48]

41. Helvering v. National Grocery Co., 304 U.S. 282, 291 (1938); C. H. Spitzer & Son, Inc., 37 B.T.A. 511, 517 (1938).

42. 37 B.T.A. 511 (1938).

43. *Id.* at 517-18.

44. 228 F. Supp. 782, 784 (D. Neb. 1964).

45. INT. REV. CODE OF 1954, § 1201 currently provides for a 30 percent Alternative Tax (25 percent for taxable years beginning before January 1, 1975) on long-term capital gains where such tax is less than that imposed by §§ 11, 511, 821(a), (c), and 831(a).

The courts have disagreed as to whether the capital gains tax should be deducted for the purpose of determining net realizable value. *See, e.g.*, American Trading and Prod. Corp. v. United States, 362 F. Supp. 801, 809 (D. Md. 1972) (recognizing the effect of the 25 percent tax); Golconda Mining Corp., 58 T.C. 736, 739 (1972) (concluding that a calculation of the tax would be "totally impossible").

46. 228 F. Supp. at 784.

47. 23 CCH Tax Ct. Mem. 1765 (1964).

48. *Id.* at 1779; *accord*, Golconda Mining Corp., 58 T.C. 736, 737 (1972).

The concept of "fair market value," as applied to the accumulated earnings tax, at times involves complex problems for which the Code and case law provide little help. Two

The cost versus fair market value controversy was the primary issue presented for resolution in the present case.[49]

## II. THE SUPREME COURT'S DECISION

The Supreme Court held that the proper measure of readily marketable securities,[50] for purposes of the accumulated earnings tax, is net realizable market value.[51] The Court recognized that the tax should be imposed only after analyzing the "economic reality" of a corporation's current financial condition. Cost was said to be largely an irrelevant gauge of a taxpayer's true financial condition, with economic reality being best determined by measuring idle liquid assets, specifically readily marketable securities, at present net realizable market value. The Court supported its holding by referring to the series of cases applying market value first to depreciated assets and eventually to liquid, appreciated securities.[52]

The Court rejected all of Ivan Allen's arguments for cost valuation. First, while agreeing with Ivan Allen that unrealized appreciation in the value of securities should not enter into the determination of section 533 "earnings and profits," the Court emphasized that such unrealized appreciation is relevant to determine whether the corporation has liquid assets in excess of the

---

of the most important problems are (1) how is fair market value to be *measured*; and (2) on what *date* should the measurement be made. The courts have yet to seriously confront either issue. The usual treatment in passing has been to assume that some degree of marketability need be established in order to ascertain comparable trading prices; those prices are generally measured at the *end* of the taxable year. *See, e.g.*, Cheyenne Newspapers, Inc. v. Commissioner, 494 F.2d 429, 435 (10th Cir. 1974) ("marketable" securities); Starks Bldg. Co., 32 CCH Tax Ct. Mem. 1201, 1214 (1973) ("value of securities . . . as of the end of each taxable year"). For an analysis of these problems, see notes 71-83 and 84-95 and accompanying text *infra*.

49. The precise technical question presented to the Court by stipulation was:

> Whether, in determining the amount of the taxpayer's net liquid assets at the close of each of the suit years, for purposes of determining the applicability of Section 533(a) of the Internal Revenue Code of 1954, the taxpayer's marketable securities should properly be taken into account at their cost, as the taxpayer contends, or at their fair market value (less the cost of converting them into cash), as the government contends.

Ivan Allen Co. v. United States, 349 F. Supp. 1075, 1076-77 n.3 (N.D. Ga. 1972).

50. The issue of the case was specifically limited by the Court to listed and readily marketable securities, purchased out of the corporation's earnings and profits. 422 U.S. at 619.

51. The relationship between "net realizable value" and "fair market value" is explained at note 6 *supra*.

By holding that anticipated taxes upon conversion should be deducted to determine net realizable value, the Court has settled an important conflict in the lower courts. See note 45 *supra*.

52. *See* notes 41-48 and accompanying text *supra*.

reasonable needs of the business.[53] The "realization of income" concept of *Eisner v. Macomber*,[54] requiring realization of a taxpayer's gains and profits before subjecting him to taxation, was deemed irrelevant to the issue at hand. The Court repeatedly pointed out that the use of fair market value does not subject unrealized appreciation to taxation;[55] that appreciation is considered only in determining whether the taxpayer had liquid assets exceeding its reasonable business needs.[56]

Ivan Allen argued that market value should not be used, as it effectively forces conversion of appreciated assets to cash in order to meet business needs.[57] The Court reasoned that the fair market value approach does not interfere with management's exercise of sound business judgment and does not dictate to management the timing of asset liquidation. The existence of the accumulated earnings tax admittedly affects management decisions, but such an effect, resulting from the corporate income tax as well, clearly is not a valid reason to deny the application of the tax. Congress expressly intended the accumulated earnings tax to affect business decisions.[58]

Finally, Ivan Allen's argument that fair market valuation of securities conflicts with standard accounting practice was dismissed. Congressional policy underlying a revenue statute takes precedence over accounting principles when a conflict between the two arises.[59]

Three justices dissented, pointing out that:

> The Court's decision departs significantly from the relevant statutory language, creates a rule of additional tax liability that places business management in a perilous position, and vests in

53. 422 U.S. at 633.

54. 252 U.S. 189 (1920).

55. 422 U.S. at 633-34.

The Internal Revenue Code provides that gain shall be recognized from the "sale or exchange or other disposition of property" to the extent that the amount realized exceeds the adjusted basis. INT. REV. CODE OF 1954, §§ 1001, 1002.

56. *See* 422 U.S. at 633.

57. Apparently Ivan Allen reasoned that the use of fair market value, where the value of the securities is greater than cost, will permit management to retain a lesser quantity of earnings and profits. Thus, to comply with the requirement to accumulate only enough earnings and profits to satisfy the reasonable needs of the business, a corporation would be forced to sell more of its unrelated assets.

The Court observed that even if the unrelated securities were valued at *cost*, for which Ivan Allen argued, situations requiring their conversion to cash could arise. 422 U.S. at 634.

58. *Id.* at 635.

59. *Id.*

> the Internal Revenue Service an inappropriate degree of discretion in administering a punitive statute.[60]

The dissent strongly suggests that cost is the proper measure of the value of marketable securities for purposes of the tax.

## III. Analysis

The Court's decision, to the extent that it resolves the *basic* cost versus fair market value conflict, is correct. The accumulated earnings tax is designed to encourage distribution to shareholders of corporate earnings and profits that are not reasonably needed for the operation of the business.[61] The need, if any, to accumulate current earnings and profits depends to a great extent on the value of unrelated liquid assets available for meeting current business needs. Even accountants are in agreement that the past cost of an asset is irrelevant for purposes of making managerial decisions relating to current operations. Financial information based on current fair market value is essential in projecting current and future capital needs.

The cost concept has some advantages over fair market value which have kept it viable for limited purposes. Basically, it provides certainty. While a fair market value determination is based on the hypothetical sale of an asset,[62] cost information is based

---

60. *Id.* at 635-36 (Powell, J., joined by Douglas & Stewart, JJ., dissenting). The uncertainties created by the Court give the Commissioner

> wide and virtually uncontrolled discretion in deciding which corporations will be subject to additional taxation, or at least in deciding which will be required to rebut the presumption that earnings were accumulated to evade shareholder tax liability.

*Id.* at 651.

Mr. Justice Powell saw the central element of the statutory scheme as the "unreasonable accumulation of earnings and profits beyond the corporation's reasonable business needs." He pointed out that unrealized appreciation is not considered in computing taxable income, and that "sound accounting practice requires that assets be recorded and carried at cost . . . ." The statute provides no basis for the Court's distinction allowing the use of unrealized appreciation in determining reasonable business needs while denying its use in computing earnings and profits. *Id.* at 637-39.

The dissenting opinion also asserts that cost valuation of assets is "the best system yet devised for guiding management, informing shareholders, and determining tax liability." *Id.* at 641. That volatility of stock prices will lead to unfairness in the application of the accumulated earnings tax is demonstrated by the fact that the value range of Xerox common stock during 1974 was 49 to 127; a taxpayer forced to liquidate at the lowest price to meet business needs could lose 61 percent of the "realistic" value of the stock if that value had been determined when the price was 127. *Id.* at 647 n.10, 653.

61. *See* note 12 and accompanying text *supra*.

62. For the legal definition of fair market value, see note 3 *supra*. A determination of value of unsold corporate assets can be better made with a *comparison* of exchange prices on the market for similar assets. The value of an asset will not be known with certainty, however, until it is actually sold. *See* 422 U.S. at 646-47.

on an actual transaction where an ascertainable amount of consideration was given for the asset. For this reason, the accounting principle of objectivity, which favors the use of completed, arms-length transactions,[63] requires the use of cost for reporting financial information to external, non-managerial users.[64] But even the accounting profession recognizes the limitations of using the cost concept. The American Accounting Association has stated:

> Evidence of dissatisfaction with extant accounting principles abounds. A principal criticism relates to the deficiencies of historical cost as a basis of predicting future earnings, solvency, or overall managerial effectiveness. We find historical-cost information relevant but not adequate for all purposes. *We accordingly recommend that current-cost information as well as historical-cost information should be reported.*[65]

While the Court properly recognized that a particular accounting practice does not prevail when it conflicts with a congressional purpose, its reasoning would have been strengthened had it analyzed and applied relevant accounting theory. Thus, instead of finding in that analysis that its decision conflicts with modern accounting practice, the Court would have discovered additional support for the use of market value from accountants' recognition of the limited utility of the cost concept for making internal, as well as external, financial decisions.

The dissenting justices feared that the use of market prices at a particular time would, because of their volatility, potentially

---

63. The objectivity principle provides that

> to the fullest extent possible, accounting should be based on objective data and determinations. In recording and reporting the results of transactions, accounting should look to *completed transactions* resulting from bargaining between parties having adverse interests.

G. Welsch, G. Zlatkovich & J. White, *supra* note 32, at 19 (emphasis added). The concept of conservatism provides that

> where alternatives for an accounting determination are available, each having some reasonable support, that alternative having the *least favorable immediate influence* on the proprietary equity should be selected.

*Id.* at 22 (emphasis in original).

Thus, in an era of rising prices, conservatism would prefer cost over fair market value.

64. These nonmanagerial users generally include investors, creditors, and agencies of the government.

65. American Accounting Association, A Statement of Basic Accounting Theory 19 (1973) (emphasis added).

Chambers, referring to inflation-related problems, stated that:

> The cost doctrine, in fact, disregards one of the most important features of an adaptive society and condemns accounting based on it to being a sterile half-history.

R. Chambers, Accounting Evaluation and Economic Behavior 353 (1966).

lead to an unfair application of the tax.[66] The dissenters felt that if management distributes earnings and profits while relying on particular values of retained assets and subsequently those assets decline in value, there would be inadequate assets available to meet current operating needs. The argument has validity but does not recognize the greater potential for unfairness resulting from adherence to the cost concept. For example, unfairness would occur if two corporations retained assets with identical "balance sheet costs" but different current market values. Applying the cost approach would leave the corporation with the currently less valuable assets at a significant disadvantage since its assets would not have the same real buying power as those of the other corporation. On the other hand, the use of fair market value would place corporations with equal realistic financial positions on the same plane with respect to the administration of the tax.[67]

The volatility of securities prices admittedly creates planning problems for management. But this volatility is inherent in the nature of some securities and will exist whether cost or fair market value is used for purposes of the tax. If management desires to reduce the risks associated with volatility, it is free to hold idle funds in more stable investments.[68] If, however, the corporation chooses to invest in volatile securities, aware of potential needs for liquidation, it must accept the associated risks[69] with the anticipated benefits.

Another significant problem raised by the dissent is the uncertainty involved in determining a realistic fair market value for some assets. The Court attempted to alleviate this problem by limiting the scope of the holding to a very narrow category of

66. *See* 422 U.S. at 646-49 (Powell, J., dissenting).

67. For example, in applying the cost approach, if two corporations (A and B) have identical operating needs and identical asset costs, but corporation B's unrelated liquid assets have a higher fair market value, corporation A will be forced to operate, if it is to comply with the accumulated earnings tax provisions, at a significant disadvantage: it would not be able to retain the same quantity of unrelated liquid assets, thus having a lesser ability to take advantage of investment opportunities that may arise. Similarly, if both corporations retain assets with equal fair market values but different costs, the corporation with the higher historical costs will face a greater risk of being penalized under § 531.

By applying the fair market value approach, on the other hand, the corporations will be able to accumulate earnings and profits based on their realistic economic positions.

68. These could range from absolute stability, *e.g.*, bank savings, time certificates, or Treasury notes, to relatively safe stocks and bonds with little fluctuation in value.

69. The main risk is that securities will have to be sold at a disadvantageous time, i.e., when the price is low or when tax consequences would be unfavorable.

assets for which fair market value can normally be ascertained.[70] The propriety of these limitations will be examined below.

### A. *Significant Limitations on the Scope of the Holding*

The Court took a significant step by departing from the certainty of the easily applied cost concept and adopting a potentially wide-open and uncertain concept of fair market value.[71]

The most difficult problem of the fair market value approach is that of accurately determining the net realizable value for a particular asset.[72] Valuing stocks and bonds actively traded on the New York Stock Exchange is normally not difficult. But when trading activity, listings, and comparable transactions are absent, the determination of market value may become burdensome or even impossible.

The assets involved in the present case were listed on a national exchange and actively traded, which permitted a relatively easy market value determination for any particular point in time. The Court therefore limited the issue to

> whether, in determining the application of § 533(a), *listed* and *readily marketable securities* owned by the corporation and *purchased out of its earnings and profits* are to be taken into account at their cost to the corporation or at their net liquidation value, that is, fair market value less the expenses of, and taxes resulting from, their conversion into cash.[73]

While the requirement of a listed, readily marketable security will generally result in a more accurate determination of market value, it is not clear that such limitations are necessary for a fair administration of the tax. The Court's recognition of the importance of examining a corporation's "true economic condi-

---

70. The Court in the present case limited its analysis to listed, readily marketable securities. 422 U.S. at 619. For a discussion of these limitations, see notes 71-83 and accompanying text *infra*.

71. As the dissent points out, the *cost* basis offers a degree of certainty that the market value approach cannot provide. 422 U.S. at 642. In addition, the ambiguous use of the term "securities" creates uncertainty, as do the terms "readily marketable" and "listed." *Id.* at 642-43.

72. This valuation requires first a determination of fair market value, which can be a difficult task in the absence of readily ascertainable exchange prices. Next, the costs of conversion must be determined. While in the instant case this was not an issue, some courts have found the cost of conversion impossible to calculate. *See* Golconda Mining Corp. v. Commissioner, 58 T.C. 736, 739 (1972), *rev'd on other grounds*, 507 F.2d 594 (9th Cir. 1974) (calculation of capital gains tax "totally impossible").

73. 422 U.S. at 619 (emphasis added).

The stipulation by the parties limited the issue to marketable securities. *See* note 49 *supra*.

tion"[74] should lead to an inclusion of some assets not "listed and readily marketable."

*1. Appropriate unlisted securities*

The Court does not define its use of the term "listed." Even if the term is construed broadly to include numerous local securities exchanges and over-the-counter markets as well as the national exchanges, there are a significant number of *unlisted* securities, particularly those of closely held corporations, with ascertainable market values.

Perhaps the Court limited its analysis to listed securities in the belief that the lack of a central market place would render unlisted securities unmarketable, thereby making them impossible to value. This is simply not the case. A significant body of tax law has been developed to determine the fair market value of unlisted securities for the purpose of valuing decedents' estates.[75] Treasury Regulation section 20.2031-2(f) and Revenue Ruling 59-60 are specifically devoted to the valuation of stocks and bonds where selling prices or bid and asked prices are unavailable.[76] Limiting the application of fair market value to listed securities is not consonant with the Court's emphasis on determining a corporation's true economic condition. Applying fair market value whenever the net liquid value of a security can be reasonably ascertained[77] more accurately reflects economic reality.

---

74. *See* 422 U.S. at 626-27.

75. INT. REV. CODE OF 1954, § 2031(b) provides for valuation of unlisted stocks and securities for purposes of determining the value of the gross estate of a decedent; *see* cases cited in 26 U.S.C.A. § 2031 (1967).

76. Rev. Rul. 59-60, 1959-1 CUM. BULL. 237 provides eight relevant factors for valuing the stock of closely held corporations or those where the market quotations are too sparse or nonexistent:

> (a) The nature of the business and the history of the enterprise from its inception.
> (b) The economic outlook in general and the condition and outlook of the specific industry in particular.
> (c) The book value of the stock and the financial condition of the business.
> (d) The earning capacity of the company.
> (e) The dividend-paying capacity.
> (f) Whether or not the enterprise has goodwill or other intangible value.
> (g) Sales of the stock and the size of the block of stock to be valued.
> (h) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

*Id.* at 238-39. This outline is followed by an extensive examination of each of the eight factors. *Id.* at 239-42.

77. Some courts have been willing to go so far as to suggest dividends-in-kind in cases where unrelated assets were nonliquid. *See* Faber Cement Block Co., Inc., 50 T.C. 317,

### 2. *Other unrelated investments*

The Code prohibits accumulation of earnings and profits beyond the "reasonable needs of the business."[78] As discussed above,[79] a court's inquiry in this area requires an examination of the availability and value of corporate assets. When determining a corporation's true economic condition, courts should not feel constrained by the Supreme Court's narrow holding in the present case. The Court's rationale leading to that holding, as Mr. Justice Powell observes in the dissent, cannot in a principled way be limited to listed securities:

> [U]nimproved real estate within the anticipated growth pattern of a major urban area, improved real estate, unlisted securities of growth corporations that have not "gone public," undivided interests in oil or mining ventures, and even objects of art . . . may be . . . readily marketable . . . .[80]

In order to achieve a practical consistency in the measure of corporate assets available to meet current operating needs, the courts should extend the market value approach to include *all* unrelated marketable assets, whether securities or not, at their net realizable value.

### 3. *Purchased out of earnings*

Corporate capital is derived from two basic sources: earnings and profits, and contributed capital. The Court limited its application of the fair market value concept to securities purchased out of corporate earnings, apparently from a belief that contributed capital will, for some reason, be unavailable for unfettered use by corporate management. While some statutory and contractual provisions restrict, to varying degrees, the use of contributed capital,[81] adequate safeguards against unduly broad applica-

---

327-28 (1968); Nemours Corp., 38 T.C. 585, 603 (1962); Whitney Chain & Mfg. Co., 3 T.C. 1109, 1118-19 (1944), *aff'd per curium*, 149 F.2d 936 (2d Cir. 1945). Such a suggestion flies in the face of the liquidity concept, but should not be ignored, as abandonment of the liquidity requirement is arguably justified. *But cf.* notes 32-37 and accompanying text *supra*.

78. INT. REV. CODE OF 1954, § 533(a).

79. See notes 22-48 and accompanying text *supra*.

80. 422 U.S. at 645.

81. *See, e.g.*, American Trading and Prod. Corp. v. United States, 362 F. Supp. 801, 808 (D. Md. 1972) (original capital not required to be used as a basis of borrowing cash to meet current needs); Trico Securities Corp., 41 B.T.A. 306, 319 (1940) (contractual dividend restrictions recognized as valid reason for accumulation); Loren D. Sale, 35 B.T.A. 938, 941 (1937) (no accumulated earnings and profits until capital restored); Vogtman v. Merchants Mortgage & Credit Co., 20 Del. Ch. 364, 178 A. 99 (1935) (statute prohibiting

tion of the accumulated earnings tax already exist which make the Court's blanket limitation unnecessary. In determining whether earnings and profits have accumulated beyond the "reasonable needs of the business," assets, including contributed capital, already committed to the business are not considered available for either dividend distribution or to satisfy operating needs.[82] An additional safeguard exists in administering the tax, as each taxpayer's situation is considered individually to objectively determine what a reasonably prudent businessman would do in the particular business.[83] These two safeguards insure a fair administration of the tax in light of any restrictions on the use of corporate capital. Therefore, to the extent that unrelated assets purchased out of contributed capital are available for current use, they should be included in the determination at their net realizable value.

### *B. Date of Valuation: Alternatives*

While the Court did not address itself to the appropriateness of any date for determining fair market value, it is obvious that, with volatile securities prices, the selection of a particular time can have considerable significance.[84] Commentators and the courts have offered several alternatives, but none are entirely satisfactory.

#### *1. Date of dividend declaration or denial*[85]

The accumulated earnings tax is determined only after an examination of the reasonableness of managerial decisions to accumulate or distribute earnings and profits. In light of both this fact and the tax's purpose to compel distribution of unneeded earnings and profits to shareholders, the theoretically correct date for determining whether earnings and profits have been allowed to accumulate beyond the reasonable needs of the business is the date management made, or should have made, its dividend decision. This approach is particularly attractive since the ulti-

dividend payment out of current profits if capital is diminished to an amount less than the outstanding stock); 11 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5329 (rev. 1971) (dividends may not be paid out of capital); *id.* at § 5335.1 (unrealized appreciation may not be used to compute dividends).

82. *See* notes 22-31 and accompanying text *supra*.

83. *See* note 18 *supra*.

84. *See, e.g.*, 422 U.S. at 647 n.10 (dissenting opinion) (lowest 1974 price for Xerox 39 percent of highest 1974 price).

85. *See* Note, *Accumulated Earnings Tax, supra* note 32, at 206-07.

mate issue in an accumulated earnings tax case is the subjective purpose for the accumulation.[86] The reasonableness of a particular accumulation can best be judged on the date that accumulation is permitted to take place. Despite its advantages, however, this alternative will often be difficult to apply since not all corporations make regular planning or dividend decisions. In those cases, a different standard would have to be used.

### 2. *Last day of the taxable year*

Many courts have valued securities, for the purpose of the accumulated earnings tax, as of the end of the taxable year in issue.[87] This method is convenient to apply but does not reflect the reasonableness of management's accumulation of earnings and profits for that year unless management either makes dividend decisions on that date or has an opportunity to evaluate and revise past decisions in light of the year-end fair market value of corporate assets. The Code provides such an opportunity for evaluation and revision, however, and thus tends to support the use of year-end market value. Section 563(a) provides that dividends paid up to the fifteenth day of the third month following the close of the taxable year shall be included in the dividends paid deduction[88] for purposes of computing accumulated taxable income. Therefore, since management has ample opportunity to make dividend decisions during the additional 2½ months in response to the fair market value of unrelated assets at the close of the taxable year, valuing the securities as of that date would be sound.

### 3. *Lowest value during the taxable year*

One commentator has suggested that an element of conservatism may be appropriate in applying the accumulated earnings penalty tax.[89] Certainly using the lowest value would give management an additional buffer[90] against volatile market prices, but

---

86. *See* INT. REV. CODE OF 1954, § 532(a).

87. *See, e.g.*, Starks Bldg. Co., 32 CCH Tax Ct. Mem. 1201, 1214 (1973).

88. The dividends paid deduction is part of the computation of accumulated taxable income provided by § 535(a). Basically, it gives management credit for dividends paid in the computation of accumulated earnings and profits.

89. Davidson and Calhoun, *Ivan Allen: Use Market Value for Marketable Securities in Section 531 Controversies*, 52 TAXES 680, 683 (1974). The authors did not suggest that a "lowest value during the taxable year" approach should be adopted, but merely suggested it as a possible alternative. *Id.*

90. The Accumulated Earnings Credit provides a minimum credit of $150,000. Particularly in a small business, this will provide the margin of comfort needed for application of a penalty statute. *See* INT. REV. CODE OF 1954, § 535(c)(2).

it would not accurately measure the value of assets available to management. Such valuation would be subject to chance fluctuations of volatile market prices and would distort the measure of the true economic condition of the corporation.

### 4. *Average price or statistical central tendency*

As is the case with many difficult choices, compromise is inevitably proposed.[91] The use of an average price or statistical central tendency would tend to alleviate the inequities caused by extreme fluctuations in market prices. This proposal, however, along with others not reflecting a consideration of logical times for management dividend decisions, distorts the measurement of a corporation's true economic condition and thereby derogates the progress the Court has made in effectuating the purpose of the accumulated earnings tax by applying the fair market value approach.

## C. *Date of Valuation: Suggested Solution*

The Code and its judicial construction are cast in terms of reasonableness, requiring a comparison of the reasonable needs of the business with the accumulation of earnings and profits.[92] Such a determination is not aided by the adoption of fixed, arbitrary rules. The tax is to be administered in light of the particular circumstances of each corporation. While occasionally a court will consider business "standards" or "rules of thumb,"[93] it is clear

91. *See* Davidson and Calhoun, *supra* note 89, at 683; *cf.* 422 U.S. at 648 (Powell, J., dissenting).

92. *See* notes 22-31 and accompanying text *supra*.

93. *See, e.g.*, Shaw-Walker Co. v. Commissioner, 390 F.2d 205, 214 (6th Cir. 1968), *vacated and remanded*, 393 U.S. 478 (1969) ("one-year rule" allows accumulation of earnings to meet operating expenses for at least one year); Harry A. Koch Co. v. Vinal, 228 F. Supp. 782, 785 (D. Neb. 1964) (current ratio); John P. Scripps Newspapers, 44 T.C. 453, 471 (1965) (current ratio); *contra*, Dixie, Inc. v. Commissioner, 277 F.2d 526, 528 (2d Cir. 1960) (rejects rule of thumb).

A logical formula has been developed by the Tax Court. *See* Bardahl Int'l Corp., 25 CCH Tax Ct. Mem. 935 (1966).

> The underlying principle involved in this approach is that the taxpayer should have sufficient liquid assets on hand to pay all of its current liabilities and any extraordinary expenses reasonably anticipated, plus enough to operate the business during one *operating cycle*.

*Id.* at 944 (emphasis added).

> The operating cycle may be described as the time it takes a manufacturing business to convert cash into raw materials, raw materials into inventory, then convert inventory into accounts receivable, and to convert accounts receivable back to cash.

that the Code's application depends on the particular circumstances and the nature of the business.[94] The accumulated earnings tax, applicable to a wide variety of situations, requires flexibility in order to deal equitably with the various corporations potentially subjected to it.

As discussed above, a determination of the reasonableness of managerial accumulation or distribution of earnings and profits is best made as of the date management made, or should have made, dividend decisions. An effective solution, then, begins with an examination of the value of available corporate assets on the last day of the taxable year. The 2½ month period offered by the Code[95] for reevaluation of dividend decisions in light of year-end values will normally give management ample opportunity to distribute to shareholders earnings and profits that are beyond the reasonable needs of the business. A presumption for the use of the year-end value would be sound, but the analysis should continue. As an important second step, the taxpayer should be allowed to prove that it lacked reasonable opportunity to make decisions in light of the year-end value and that an alternative date should be used for a determination of the reasonableness of its actions.

This proposed solution or analysis can be illustrated with an example. On October 1, a calendar year taxpaying corporation declares a dividend of $100,000 based on a determination that its unrelated investments in marketable securities have a net realizable value of $50,000. But by year end, the securities increase in net realizable value to $100,000. Under the proposed analysis, the reviewing court would use the year-end value of $100,000 on the presumption that the corporation's management had an opportunity to declare an additional dividend before March 15 in response to the increase in net realizable value. On the other hand, if the corporation proves that it did *not* have a reasonable opportunity to reevaluate and increase its dividend, the reasonableness of the dividend decision would be determined as of October 1 and not year end. This proposed analysis, while flexible, does provide a definite framework on which judicial analysis can focus.

## IV. Conclusion

The Court interpreted the accumulated earnings tax correctly insofar as it held that fair market value (less the costs of

---

Comment, *Accumulated Earnings Tax, supra* note 25, at 1187 (footnote deleted).

For a detailed discussion of the computation, see *id.* at 1188.

94. *See* note 18 *supra*.

95. *See* note 87 and accompanying text *supra*.

conversion to cash) is the proper standard for valuing unrelated marketable securities. It is unfortunate, however, that the Court limited this application to listed marketable securities. The congressional intent behind the accumulated earnings tax would be better served by extending the fair market value concept to all unrelated liquid investments to the extent that a net realizable value can be determined and without regard to the source of the financing or the form of the investment.