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TAX CHANGES AFFECTING CORPORATIONS *

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The several corporate topics I have to discuss are quite distinct in nature. They each contain significant changes and their significance is in part explained, if you keep in mind the underlying spirit of the revision, namely, increased investment incentive as outlined in the President's pre-enactment budget message. The keystone was "taxroom for growth," especially within the area of new corporate businesses, spelled out with greater clarification and simplification into language that gives statutory guidance to every major corporate action.

With respect to the topics outlined for my discussion, the drafters had in mind, either curtailment of corporate tax avoidance on the one hand or easing some excess penalizing features of the old law, especially where hampering legitimate expansion, on the other. As you know, about the only reduction measures were with respect to lower bracket individual taxpayers.

ACQUISITIONS TO AVOID TAX—SECTION 269

Taking up the policing measures and starting first with Section 269, one recalls that Congress over a decade ago foresaw that obtaining the loss carry-overs and unused excess profits tax experience of existing shell companies would catch the eye of corporate management starting up strong in wartime ventures.

The gimmick of acquiring loss companies to ease the tax on expected high profits was then anticipated, especially in connection with World War II excess profits tax. In Section 129, enacted in 1943, Congress figured it had forestalled the temptation to carry on new business within the framework of loss companies.

In fact, the government had theretofore a pretty fair arsenal to block such traffic. There was some favorable high court interpretation on "business purpose" requirement, as in the *Gregory, Griffiths, Smith and Spreckels cases.*[1] These and old Section 45 (now 482) held the front pretty well up to that point. However, the broader net pulled together in 129, intended to strengthen these rules, but never succeeded. The storehouse of business purpose cases was immediately and sadly depleted or weakened by a series of adverse decisions, starting with the *Alprosa Watch* decision,[2] where the Tax Court just reached out and slapped the new section down before it actually got started.

There, the acquisition occurred in a fiscal year just prior to the effective date of 129 but the Tax Court more or less gratuitously construed it as applying only where an acquirer survives after absorbing the loss or other unused allowance from a deficit com-

* From an address, given at the University of Denver Tax Institute, 1954.

[1] Gregory v. Helvering, 293 U.S. 465, 79 L. Ed. 596, 55 S. Ct. 266 (1935); Griffiths v. Helvering, 308 U.S. 355, 84 L. Ed. 319, 60 S. Ct. 277 (1939); Smith v. Higgins, 308 U. S. 473, 84 L. Ed. 406, 60 S. Ct. 355 (1940); Spreckels v. Commissioner, 315 U.S. 626, 86 L. Ed. 1073, 62 S. Ct. 777 (1942).

[2] Alprosa Watch Corp. v. Commissioner, 11 TC 240.

pany. It took the entity tack and set off an endless chain of downstream mergers into loss companies. The department took its licking, acquiescing as it went along, thereafter, in Tax Court cases where 120 was invoked, such as in the *Alcorn* decision,[3] where it sought to extend application to a corporate "split-up," followed by the *Berlands, Commodore Terminal, A. B. Container,*[4] and other decisions.

The only inroad was the four-judge dissent written by Judge Opper who heard the *Chelsea case,*[5] but an appeal even, in that instance, to the Third Circuit was unsuccessful. The only victory, if one would call it that, was *Advance Machinery,*[6] an outside factual situation so thin it didn't warrant litigation. There, however, the court ignored the 129 argument altogether and used Section 22, and on appeal Section 45 was applied.

With such solid proof of failure for the government in the background, what does 269 now provide? What kind of an "assist" did Congress give the Commissioner in the new law? First, we note that the imposition and general coverage provisions of the section remain the same. But a new proof element is provided to boost the Commissioner over the tax-versus-business-purpose hurdle in these cases.

Here is statutory paraphrasing with only formalistic deletion: (1) Whenever individuals acquire directly or indirectly 50 per cent control of a corporation or a corporation acquires directly or indirectly property of another corporation not theretofore so controlled by it or its stockholders and (2) the basis of such property in the hands of the acquirer is determined by reference to basis in the hands of the transferor and (3) the principal purpose for such acquisition was tax avoidance by securing the benefit of a deduction, credit or other allowance which would not otherwise obtain, then, in such instances, the benefit shall be disallowed except in the discretion of the department to allow part or to apportion such benefit to a degree deemed not tainted by avoidance in principal aspect. That is the old 129 provision.

Comes now the pertinent amendment, and I quote the statute: "The fact that the consideration paid upon an acquisition . . . is *substantially disproportionate* to the aggregate—(1) of the adjusted basis of the . . . interest . . . or of the property . . . and (2) of the tax benefits . . . not available . . . otherwise . . . shall be *prima facie* evidence of the principal purpose of evasion or avoidance . . ." [our italics].

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[3] Alcorn Wholesale Co. v. Commissioner, 16 TC 75, CCH Dec. 18,034, 1951 CCH 7234.

[4] Berland's. Inc. v. Commissioner, 16 TC 182, 1951 CCH 7257, CCH Dec. 18,057, 1951-2 CB 1; Commodores Point Terminal v. Commissioner, 11 TC 411, 1949 CCH 7010; A. B. Container Corporation v. Commissioner, CCH Dec. 17,641, 14 TC 842 (1950).

[5] Commissioner v. Chelsea Products, Inc., 197 F (2d) 620 (3rd Cir. 1952).

[6] Advance Machinery Exchange v. Commissioner, 196 F (2d) 1006 (2nd Cir. 1952).

Here then is an added presumption based on dollar tax savings. The House version had made this evidence in itself governing or determinative but the Senate softened the blow, thinking that it might, in its effect, automatically bar incidental tax benefit otherwise available or make it too tough to prove that avoidance was not the real reason for the acquisition.

This amendment is hard to evaluate. Except for this change, we have to work with the old law as it was interpreted by the Tax Court. The "substantially disproportionate" phrase is unfortunate. That language has always been too relative for any kind of uniform court handling, and, elsewhere in the reorganization sections of the revised code, we notice Congress went to great pains to legislate it out of existence.

The Senate's rejection of a "clear preponderance" burden gives some hope for a continued favorable court interpretation where the dollar imbalance between the business and tax advantage isn't too obvious.

The "aggregate" of adjusted basis plus tax benefit will present valuation problems. Depreciable assets, for instance, with a high base and a very low value may be offset by securities with a low basis and a high value.

The valuing of the tax benefit "not otherwise available" to the acquirer can produce difficulty in close cases. Apparently a tax benefit fully paid for is available regardless of purpose. That word "substantial" is hard to focus in any given set of facts and is the key bad word of the new provision. What this new presumption is going to do remains to be seen. The Commissioner has his usual presumption riding with the determination in every case, but I guess this new one is designed to pull the government's case out of the subjective realm and present a practical fact test for the courts.

Throughout the history of old 129 the court backed away from weighing levels of intent. It looked for a sound business purpose and if it existed the taxpayer got his break. This later presumption will arise now on proof of a basic fact of substantial disproportion. Instead of digging into the evidence to find whether or not a live business motive is squirming within each transaction, the court is expected to weigh first the dollar advantages stemming strictly from tax considerations, and, if the taxpayer isn't quick to show offsetting business risk or relative dollar disadvantages, the government has its purpose wrapped up and its case won.

The new section forces the court into close practical dollar analysis of each transaction before it can find purpose on one side or the other. It behooves those planning acquisitions with some tax benefit in the picture to do the same analysis and perhaps to get a prospective ruling from the department in a close situation. If the ruling is adverse, it can then weigh its litigating chances against the background of the old law.

This section has to be worked in with the new limitations on net operating loss carry-overs added by Sections 381 and 382 and is pretty closely related to Section 1551 coming up next in our discussion.

In connection with both Sections 269 and 1551, the reorganization provisions have to be watched. Gain recognition can mean greater cost taxwise than a deduction or credit allowance.

DISALLOWANCE OF EXEMPTION AND EARNINGS CREDIT—SECTION 1551

Section 1551, the multiple entity or split-up provision, had its forerunner in 15(c) enacted in 1951 and otherwise expiring with the excess profits tax last year. The latter, which has an interesting legislative history, is now taken over and extended indefinitely and entirely intact. The only exception is a disallowance of the new minimum accumulated earnings credit which has been tacked on to the minimum surtax exemption in place of the old minimum excess profits tax credit.

The split-up technique whereby corporate taxpayers laden with earnings would, instead of climbing the surtax ladder and meeting a high excess profits burden, make a tax-free exchange of heavy income-producing assets for stock in new companies. This spawning of new companies was accomplished without loss of control or other disadvantage and was pure tax savings. Congress, fully aware of what was going on, put this new law into effect to curb such proliferation of corporate entity; but again, as in old 129, it set out some dye-markers for the loophole seekers.

The House had proposed H.R. 123 before 15(c) was adopted. This 123, if passed, would have been a road blocker for sure for all multiple entity traffic. The House limited the $25,000 surtax exemption and the $25,000 minimum EPT credit to one, i.e., to the parent member of the group of related companies as though they in association were a single business. This applied where 95 per cent common stockholding was defined through constructive ownership tests.

The split-up technique was near its worst at that time and the House committee saw it as a clear unintended tax advantage to the big corporate operators with no advantage to small business.

No doubt at that point the drift to artificial corporate splitting created a gap needing immediate legislative attention, but, as the Senate then recognized, this would be a harsh enactment. It would have had a bad effect on new small growing businesses which are frequently required to incorporate separately if state law forbids chartering for more than one purpose. Also a related new company is frequently necessary when a new and risky enterprise is sought to be developed. The Senate, in rejecting it, also pointed out that existing multiple corporations would have a tremendous advantage over those seeking the same type of tax-saving expansion.

This discrimination between new and old corporations and other inequitous features were forceably brought to the attention of the Senate by real estate and other groups vitally interested in blocking passage of H.R. 123. In any case, we have had for over three years 15(c) as a compromise on the books with no case law yet to tell us just what it means. The government has been understandably a little timid about this companion piece to their business-versus-tax-purpose problem after their 129 experience.

This topic, Section 1551, is much narrower and must be closely associated with our 269 discussion.

Here again I'm parroting the statute in its significant aspects. It provides (1) if a corporation transfers all or part of its property other than money to another corporation created for such purpose or to one actually in existence though not actively engaged in business at the time of acquisition and (2) if after transfer, the contributing company or its stockholders or both are in 80 per cent control of such transferee during that or any subsequent taxable year, then, in such instance, the latter shall not for such year be entitled to either the $25,000 surtax exemption or the new $60,000 accumulated earnings credit *unless* such acquiring company establishes, by a clear preponderance of evidence, that neither of such tax benefits were a "major purpose" of such transfer.

Note that only transfers between corporations are encompassed here and the acquirer can be either newly created or an existing shell company. This leaves open, more or less, for "common law" tax restriction, that is, court decisions aided by Section 482 (the old Section 45), to catch those overly thin spin-off arrangements to sole proprietorships, partnerships, trusts, etc.

The problem in this area has been to reintegrate or in effect consolidate entities for income-reporting purposes. About all they have wrung out of old 45 is reallocation of income and deductions. In fact that's all Section 45 regulations provided. Court homage to corporate entity have delimited application all the way, heretofore. At least that has been 269's history.

The same cushion of discretionary allowance in whole or part by the department is provided, as in 269, and the same rule of constructive ownership for control purpose is provided. In fact, Section 269 is cross referenced throughout this 1551 split-up section. In other words, the section is still supplemental and is to be applied consistently with 269.

The control in 1551 must be 80 per cent before denial can be accorded by the Treasury. A shift of 21 per cent of stock would clear, but here again recognition problems can crop up when you disturb ownership.

A significant break is retained in that a transfer of money is not prohibited. The section covers only all or part of any property transferred which might raise a question about intangibles—transfer of management, good will, etc.

Over-all, while the section is narrower, it is intended as a much tighter provision. That "major purpose" is a pretty low ceiling, and, as I said, we have no court guide for this carry-over provision as yet.

The regulations under both old 129 and 15(c) shed some light as to what we can expect in the new ones. They both drew out of the law everything Congress put in it. "Principal purpose" is that exceeding any other purpose. "Major purpose" is an important consideration or factor. Fixing a degree of difference between a major purpose in this section or the principal purpose in the other would, as one writer put it, take more of a semanticist than a lawyer. One would safely derive that a major purpose need not be a principal purpose, of course, so that a company seeking these two 1551 benefits would get caught much quicker, but what transaction of any consequence today is without a major tax consideration? Clearing the reorganization "business purpose" (old 112(g)) hurdle is not help here under present regulations.

The regulations will likely go as far as they can to screen corporate transactions falling within the purview of these sections. The last time a "major" purpose was going on the Treasury's books as meaning any purpose other than "incidental" such a howl of administrative legislation was raised that Treasury backed off.

The legislative history of this section and its forerunner doesn't disclose why "money" was excepted, probably on the theory that the purpose is to discourage tax segregation of a single company's operating or income producing assets, while money is a neutral commodity. It can be otherwise acquired through borrowing and that act itself would show business purpose. Besides the one credit it denies on a premise of a major purpose, the $60,000 accumulation credit would collide with an expansion allowance specifically permitted by the Senate Committee report on Section 531 (old 102) which we will discuss later.

A summary prepared by the Joint Committee staff when its predecessor Section 15(c) was enacted states that any company wishing to expand may use any part of its funds, whether accumulated earnings or not, to form capital for a new company. The transferee can then presumably with these funds turn around and buy any stock-in-trade or property from the transferor, and thus do indirectly what seems directly prohibited.

Apparently, if there is failure by a clear preponderance in showing that either the surtax exemption or accumulations credit were not a major purpose, both benefits are lost.

While the Tax Court pointed out in its recent "business purpose" cases today's need to scrutinize the tax feature of any business change, it seems a tight squeeze to clear this section. There hasn't been much stress in minutes in all these won cases. This is a point to watch if there is a heavy incidental tax break involved within a plan!

Advisers should urge caution, but if there exists an actual provable business need, I doubt if the Service will assert 1551 and deny these two benefits. In the first place, now there is not the tax-saving factor there was when first enacted. A "boot" or mixed transfer of money plus assets ought to clear easier. In a divisive-type reorganization it may be otherwise difficult to get total non-recognition.

It is a degree question in each case. You can't take the tax factor out of a plan of business division, but it's the abusive, amoebic sort of entity multiplication without any evident business causation that puts the tax element out in front. In this multiple entity area, the Commissioner may now don all of his new armor—Sections 269, 1551, 482 and whatever label 22(a) is wearing now—to make a multiple attack in a good situation to get some favorable case law on the books.

CONTRIBUTIONS-BASIS-DEDUCTIONS—SECTIONS 118, 362, 246

With respect to our next subject, Sections 118 and 362, the enactment codifies the general rule that gross income is not to include any capital contribution. There is one significant new provision, however, 362(c), dealing with a situation where property is contributed by non-shareholders or those without proprietory interest. The old *Brown Shoe* situation [7] dealt with this a few years ago in the Supreme Court.

Occasionally, a commercially aggressive Chamber of Commerce, association of businessmen, or even a government has contributed, without cost, property to induce a big manufacturing concern to locate a factory in a particular area. All such contributions received after the middle of this year, when not contributed by shareholders themselves, take a zero base in the recipient company on transfer date.

The committee went a step further and provided, where money is contributed by non-shareholders and property is acquired with the donated funds within twelve months, such purchased property takes a zero base to the recipient and any excess proportionately reduces other properties. Regulations will prescribe a selection method. Both property purchased and property so reduced will start from zero at the end of the twelve-month period following transfer. The drafters felt that since this type contribution constitutes neither a gift nor indirect compensation for future service such handling provides a practical solution.

With respect to the 85 per cent dividends-received deduction to corporate stockholders (Section 246), there isn't much change, the code continues the disallowance to China trade corporations, those whose income is from U. S. possessions, exempt companies, farmers' co-ops, etc., as before.

It is interesting to note that the House bill denied this benefit to insurance companies. The latter were quick to protest this proposed enactment, however, and the Senate defeated the proposal,

[7] Brown Shoe Co. v. Commissioner, 339 U.S. 583.

pointing out that some types of companies such as stock, casualty, etc., pay the full corporate tax, and, furthermore, in present intercorporate arrangements recipient corporations would be unable to meet commitments if denied this credit.

ELECTION FOR CORPORATE TAX TREATMENT—SECTION 1361

Turning now to the "tax break" side of the corporate picture, we bump into a new election privilege extended to proprietorships and partnerships. They can now be taxed as corporations without actually changing their legal form.

Pointing out principal requirements of this new privilege, which, I am afraid, will have to be pretty heavily supplemented by regulations, we see the law specifies such election can be made not later than sixty days after any taxable year in which qualification is sought. It applies to any unincorporated business enterprise, and all partners owning an interest at any time during a taxable year in which qualification is sought must join in the election.

Such an election qualifies corporate tax treatment provided:

(1) At all times after the first day of the first taxable year to which it applies, the enterprise is owned by an individual or partnership of not more than fifty members.

(2) No proprietor or partner having over a 10 per cent interest in profits or capital is similarly qualified in another such unincorporated business and is not an alien or foreign partnership.

(3) The enterprise is one in which capital is a material income-producing factor. For example, if a manufacturer or merchandiser seeks election, such assets as plant and inventory must stand in strong ratio to income. Personal service partnerships such as law and accounting are excluded. The withholding for employees, the pension trust and such things do not apply to the member partners or proprietor.

(4) At any time there is a change of ownership amounting to 20 per cent a new election must be made by all continuing partners, but there is a privilege of carry-over to successor enterprises not otherwise failing the ownership test. Constructive ownership rules apply for purposes of interest determination.

(5) The normal tax, surtax, accumulation tax, alternate capital gains tax, etc., all apply as in the case of a corporation.

(6) Personal holding income is excluded. It is treated as though there were no election and taxed direct to the partners. In other words, only the operating-income portion is subject to election, and, if personal holding income is distributed during the year, it is not to be taxed as a corporate distribution. Any amount not distributed is considered as paid-in surplus or a contribution to capital. The income and expense attributable to such income are considered expense to each partner or proprietor in accordance with his distributive share. This personal holding company application provides automatic separation as to income, so there is no possibility of entrapment as a personal holding company.

(7) Other distributions, current and in liquidation, are treated the same as corporate distributions and a reasonable salary is allowed working partners. Another exception is that the enterprise is not given corporate treatment for reorganization purposes.

I should mention that with respect to counting, if a partnership owns another partnership electing these provisions, all the partners in the first partnership must be counted in determining the fifty-partner limitation.

This is a tricky new provision and, as I indicated, the privilege will likely not be availed of to any great extent until more clearly defined by regulations. There are some obvious "bugs" or at least gaps in the law. For instance, if a disqualifying event occurs and is remedied within twelve months, is there an automatic liquidation? Is there liquidation gain if ownership falls below 80 per cent after election but is later reacquired?

It may develop quite a break for high bracket proprietors or small groups when you consider the salary allowance, lowering corporate tax rates and the progress toward eliminating double tax on corporate dividends. A 20 per cent shift in and out may become pretty simple. At least, one can now choose a corporate tax bracket without other legal incident. A sole-proprietor witness testifying before the Ways and Means Committee for this new privilege pointed out that over eight million reporting businesses are sole proprietorships as against a little over one-half million corporations.

You can appreciate the many variables that will attend each reporting business considering this new provision. A taxpayer should make a close tax analysis before election.

Personal Holding Company—Section 541

Cutting now into the personal holding company topic (Section 541), we note that the rates and basic outline of the old law remains the same but there are several inequities cured.

Historically, I found it interesting to note that there were less than 5,000 of this type of corporate filing less than ten years ago. I don't know what it is now, but how many there have been that have met the definition and haven't been caught would be an interesting speculation. As you know, this isn't a revenue source, but the revenue received in forced dividend payments would be another matter.

You are all familiar with the tricky, embarrassing, return-filing feature on this creature. The old regular corporate returns asked the questions, which, after superficial scrutiny or perhaps none, were answered negatively; and sometimes after a few years, a zealous agent looking for a 102 deposit or similar adjustment checks out a change of stock ownership or a new income definition that one could only find through such careful search. The penalty was heavy in such cases and avoidable only if full professional blame was assumed, and any ensuing penalty and interest couldn't be wiped out by deficiency dividend procedure! If you qualify, the return is now to be filed with the regular corporate income tax form on a separate schedule, and the Commissioner has a six-year statute if you fail to furnish the right information.

As an automatic or self-governing type penalty, this section is quite in contrast to the old subjective business purpose test applying within the improper accumulations provision. It is an extreme measure designed to outlaw rather than discourage corporate investment income accumulation. The rates remain the same. They had been raised in 1934 and retained within the framework of the 1939 code. They are 75 per cent for the first $2,000 and 85 per cent thereafter.

The basic qualifications are, of course, stock ownership in five or less indivduals and income of 80 per cent or more from specified non-operating or personal investment sources.

The main substantive changes include:

(1) A flat 80 per cent test each year with respect to income, which replaces the old 80 per cent for the first year and 70 per cent thereafter for 3 years, before you can get out of the trap and reacquire the 80 per cent limit again.

(2) A tax-exempt stockholder now counts as an individual with an exception respecting religious and educational organizations.

(3) The consolidated return privilege is extended with limitations to non-railroad affiliated groups and income definition is changed in some material respects.

(4) Rental income from stockholders is tested for personal holding classification only if there is other type personal holding company income exceeding 10 per cent. In other words, only where there is clear abuse will the old "country home" or "yacht" type lease arrangement now classify. This was catching many innocent real estate operators so the Senate eased the situation.

(5) The deficiency dividend method of wiping out the tax portion less interest and penalty is broadened. The taxpayer is given more time. The company has ninety instead of sixty days after "determination" to distribute and 120 days to file claim for deficiency dividend deduction. There isn't the delay in getting final approval that previously existed. Now added to the closing agreement and Tax Court determinations is an informal determination signed by the district director and the taxpayer.

The definition of undistributed personal holding company is changed in several places which I won't go into here. Generally, any change made there and with respect to adjustment to income are on the taxpayer's side.

There is one significant new gap. There is nothing in the new law keeping an otherwise personal holding company from increasing its rental income to 50 per cent or more of gross and thus avoiding income classification. This it may do by buying real estate with company owned bonds pledged as securities. The Senate committee caught this gap but a proposal to sew it up was dropped in conference.

The one restrictive change in connection with counting exempt shareholders doesn't go far. It doesn't include religious or educational, and you can see there is nothing to prevent five 20 per cent stockholders from transferring one-half of their stock to five tax exempts and thus fall outside the stockholding requirement.

(6) The House committee eliminated from the old code the consent dividend privilege, but the Senate restored it after simplifying the restrictions as to dividend distribution within each year. It pointed out that some regulated corporations would need this allowance to avoid possibility of a surtax penalty.

Accumulated Earnings Tax—Section 531

Coming now to my final topic, Section 531. If you don't recognize its new label, it's the old 102 penalty and now new "Accumulated Earnings" tax.

This penalty has been eased to where it is perhaps pretty well out of reach for most corporate taxpayers in this vicinity. I imagine that most of those reporting locally average substantially below middle-band in size, and the new $60,000 earnings credit, with other new features we will point out, affords much needed protection to small companies.

A lot has been written about the unreasonable accumulations penalty. Corporate managers have always felt nervous and shaky about this section. They witnessed the discomfort of their competitors or corporate neighbors who were tapped by the agent for what looked like unseasonable rather than unreasonable accumulations. Historically, it had been in the law from the beginning and is designed to prevent surtax avoidance by a family or closed corporation through the medium of accumulating corporate earnings and avoiding the second dividend tax to the stockholders on distribution.

The psychological scare of this section has lessened in recent years. Its bark is worse than its bite. Rate changes have taken out much of its sting. The cost of penalty and distribution about equalize at the $100,000 corporate and $12,000 single stockholder level—both about 46.3 percent. It may be wise or unwise to accumulate and accept the penalty but it is still an important dollar decision, that is, it is still much more economical if you can accumulate and not pay the penalty! The new and substantial overhauling given this section is a very significant break to young, close corporations, especially in an expanding competitive industry.

An interesting congressional study, picking up the eleven years following the 1938 enactment, when the present rates of 27½ per cent on the first $100,000 accumulation and 38½ percent accumulation thereafter were enacted, along with the presumption attending the fact of excess accumulation over immediate business need, has been prepared by Professor Hall of the University of

Washington. This study, made from government records, covered about 70 percent of all cases. It showed that roughly five hundred companies with less than twice that many years had been subjected to penalty.

Projecting this study, we see something less than eight hundred companies have paid a penalty out of the approximate half million filing. Only about one hundred cases in all were tried and the government's batting average was less than half. In the last few years, about a dozen cases were tried, of which the Commissioner won two and collected less than 10 per cent of the asserted penalty. Despite this and the fact that the section hasn't produced much revenue, the penalty, as they say, has "set in" at every year-end dividend meeting as a dominant director and too frequently tipped the scales to distribution affecting permanent damage to the growth of the company.

With this background of the old section, we shall see where the committee has answered the complaint of the tax bar in its revision.

The rates are the same as before, 27½ percent on the first $100,000 and 38½ percent thereafter.

The penalty applies to every company, except the personal holding company and an exempt corporation which is formed or availed of for the purpose of avoiding the surtax. The fact that earnings of the company are permitted to accumulate beyond the reasonable needs of business shall be determinative to avoid the tax on shareholders unless, by a preponderance of evidence, the taxpayer proves to the contrary. It was clear preponderance in the old law, of course. If the company is a mere investment company, there is a *prima facie* case for the government.

The committee report is replete with criticisms of the administrative handling of the old law, and I dare say the new provision, even as watered down, will be given a cautious hand by Treasury. Before getting into the revision feature very far, one should again emphasize the spirit behind this amendment. Congress sought to clear out any opportunity to continue the use of this section as a threat to settle other issues. Heretofore, if a taxpayer had an excess of 30 percent accumulation with a poor dividend record and no record of immediate need, the government frequently placed the taxpayer on the "hot roof" and watched him dance, handing him waivers until he decided to buckle and trade this one out with its high cost of litigation and dollar fright against unrelated issues.

This old section was a tough section for the government agents also, and for the most part they were reasonable. I believe that some of what was collected was caused by the taxpayer not being prepared.

I recall one typical situation. Some good tax-paying people came in and a big discussion ensued for a day or so to the effect that they were preparing for a business recession, a capital cushion argument. Actually, one did show a few years later in their industry and they had some need for hedging. Well, they made a beautiful argument, I recall, using hindsight. This was one of our better hindsight cases, because we went even behind the hindsight to some ancient protests prepared years earlier and stored in our "dead file" portion of the case to get another carefully documented argument to the effect that the accumulation was needed for an anticipated boom.

Proof items like that sometimes had the taxpayer rocking back on his heels, and he would pay "blood money" to get rid of the penalty.

Commissioner Andrews before enactment said he welcomed a change, including a burden shift, to convert this into a gentle lever to get the government's share, rather than a club to kill off company growth.

There are some significant subjective changes, some of which were in committee reports and should be incorporated into the regulations. For instance, there will be no more hindsight and there will be no more 70 percent yardstick. An operating subsidiary, if 80 percent controlled, is a legitimate use of accumulated earnings. It makes no difference whether or not it is a divergent line of business, and a fact determination is available if less than 80 percent control is traceable back to the earning source. The "immediacy" test is out. Here the law itself provides that the accumulation shall be unchallenged if it meets the "reasonably anticipated" needs of the business.

There are two big law changes with respect to what earnings the penalty now hits. First, the taxpayer is given a minimum $60,000 accumulated earnings credit. Secondly, the tax now applies only to that portion proved unreasonable. This latter revision has been a strong point in the consistent fight industry has waged on this provision.

Of course, the most dramatic change is with respect to the burden shift which was finally pushed through. Under the old law, not only proof but a clear preponderance was required of the taxpayer that earnings accumulated were business motivated.

The burden shift operates this way. First, before the deficiency notice is sent out, the government sets up the amount they think unreasonable and then by registered notice advises the taxpayer that they are going to assert that much penalty. The taxpayer is then going to be given at least thirty days, possibly more by the new regulations, to spell out in a reply why he needs this accumulation in his business.

The government can then, presumably, back off or move in for such amount or a lesser amount in the final notice. But on any portion in which they have locked preliminary proceedings in this matter, the government has the burden, and it's an automatic shift where there is a jeopardy or the government doesn't send notice. Of course, if the taxpayer fails to send in his reply, he keeps the burden and, as to any new grounds which he didn't cover in his reply to the preliminary notice, he will keep the burden.

The taxpayer has the same old tools to fight with or factors to explain, that is, the criteria spelled out by the courts, such as overcoming or explaining what appears to be excessive liquidity. Why do you need the quick asset position? What about these loans to your stockholders? Your minutes do not show anything about a need! Where is the proposed building contract or expansion commitment?

The taxpayer has until April 15 of the following year to pay dividends or accumulate, thus giving plenty of time to decide which way to jump, under the new code.

Mere preponderance as distinct from a clear preponderance is all that is required from either party, but I don't think this provides much change. There has been a pretty practical attitude shown by the courts, but this fits nicely into the general relaxing scheme of the amendment and gives a judge a nice out in a close case.

The tax only applies to the unreasonably accumulated portion. This gets right into bedrock and takes the dollar fright out of the section. Actually, if one had a good 80 percent business need before, one did not lose one's case, but it was difficult to objectively calculate litigation chances with one facing a penalty up to nearly 40 percent of one's full accumulation.

Since the Commissioner now has the burden, both to the extent as well as to the fact of accumulation, he may be moved back so far in extent of accumulation that he won't have enough to fight over. He will drop it! In other words, with a narrow dollar layer to fight over, there isn't much tolerance for business judgment as to whether one needed the whole amount or not. All in all, anyone that gets seriously hurt now under this new section seemingly deserves it.

The effective date here is important—ninety days after enactment or about November 14—so maybe the service is beating the deadline on cases now in process. It would have behooved them, with this burden coming up, to clean out their old 102 inventory.