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Homer L. Elliott

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THE ACCUMULATED EARNINGS TAX AND THE REASONABLE NEEDS OF THE BUSINESS: A PROPOSAL

HOMER L. ELLIOTT*

The accumulated earnings tax has been referred to as "a penalty on success itself." [1] Of all the taxes imposed upon business, this is probably one of the most unpopular, involving an after the fact verdict on management's business judgment. As long as substantial differences exist in the tax rates imposed upon the corporation on the one hand and upon the individual on the other, however, there will continue to be a need for such tax "as a barrier to . . . tax avoidance." [2]

Presently two tests, one subjective and the other objective, are used to determine whether the tax will be imposed. The subjective test is derived from section 532(a) of the Internal Revenue Code of 1954, which provides that the accumulated earnings tax is to be imposed if the corporation was formed or availed of to avoid income tax on its shareholders by permitting earnings and profits to accumulate. In short, this test is based on the subjective intent of the shareholders in accumulating earnings and profits. The objective test is derived from section 533(a) and (c) of the Code. Section 533(a) creates a presumption that the purpose of avoidance is present if earnings are accumulated beyond the reasonable needs of the corporation's business. Section 535(c) provides a credit in computing accumulated taxable income for "such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business." [3]

The thesis of this discussion is that the subjective test no longer serves a valid purpose, and should therefore be discarded in favor of the objective test, one based on whether the accumulation serves the reasonable needs of the business.

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*A.B., 1960, Indiana University; J.D., 1969, College of William and Mary. Member of the firm: Steptoe and Johnson, Washington, D. C.

1. Lang, *Section 531—The Burden of Success*, U. So. CAL. 1968 TAX INST. 279.

2. J. HALL, SMALL BUSINESS AND THE NONINTEGRATED INCOME TAX STRUCTURE: STUDY PREPARED FOR THE JOINT COMMITTEE ON THE ECONOMIC REPORT, 84th Cong., 1st Sess. 682 (1955).

3. INT. REV. CODE of 1954, § 535(c).

THE ACCUMULATED EARNINGS TAX

Background

Precedents for taxing undistributed profits date back to at least 1864, when "gains and profits of all companies, whether incorporated or [not were to] be included in estimating the annual gains, profits, or income of any person entitled to the same, whether divided or otherwise." [4] A similar provision was included in subsequent taxing statutes up to 1870.[5] But no definitive legislation was enacted until after the adoption of the Sixteenth Amendment in 1913. Since 1913, the revenue acts have contained some provision to prevent avoidance of tax through the corporate form.[6] The 1913 act provided that if a corporation was "formed or fraudulently availed of" to avoid the individual income tax by permitting "gains and profits to accumulate" rather than be distributed, each shareholder's ratable share of the corporate income was taxable to him "whether . . . distributed or not." [7] The fact that a corporation was a mere holding company, or that gains and profits were permitted to accumulate beyond the reasonable needs of the business was prima facie evidence of a fraudulent purpose to escape the individual income tax.[8] This was to be so construed, however, only if the Secretary of the Treasury certified that the accumulation exceeded the reasonable needs of the business.[9] The word "fraudulently" was deleted in 1918.[10] In 1921, due to doubt cast by the decision of *Eisner v. Macomber*[11] on the constitutionality of taxing a shareholder on income which he had not received and which he had no right to receive, Congress abandoned the direct tax on shareholders and, instead, imposed the tax on the corporation itself.[12] Certification by the Secretary was dropped as a requirement in 1924.[13] Since then, mere

4. Act of June 30, 1864, ch. 173, § 117, 13 Stat. 282.

5. *See* R. PAUL, TAXATION IN THE UNITED STATES 192 (1954).

6. *Id.*

7. Tariff Act of 1913, ch. 16, § 2, 38 Stat. 166, 167.

8. *Id.*

9. *Id.*

10. Revenue Act of 1918, ch. 18, § 220, 40 Stat. 1072.

11. 252 U.S. 189 (1920). This case held that the distribution of common stock by a corporation having only common stock outstanding could not constitutionally be taxed as income to the shareholders.

12. Revenue Act of 1921, ch. 136, § 220, 42 Stat. 247. As to Congressional doubts concerning the constitutionality of the tax on the shareholders, *see* H.R. REP. No. 350, 67th Cong., 1st Sess. 12-13 (1921). The constitutionality of the tax as revised was upheld in Helvering v. National Grocery Co., 304 U.S. 282 (1938).

13. Revenue Act of 1924, ch. 234, § 220, 43 Stat. 253, 277.

unreasonable accumulation has been prima facie evidence of the proscribed purpose.[14]

Because of the inherent difficulty of proving a mental state,[15] the provision was amended in 1938 to state that an accumulation of earnings "beyond the reasonable needs of the business" is determinative of the tax avoidance purpose, "unless the corporation by the clear preponderance of the evidence shall prove to the contrary." [16] With minor modification this presumption has been retained ever since.[17]

Summary of the 1954 Code Provisions

The accumulated earnings tax is imposed upon every corporation (except a personal holding company, a foreign personal holding company or a tax exempt corporation) "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed." [18] Two basic presumptions are brought to bear on the proscribed tax avoidance purpose. First, the fact that the corporation is a holding or investment company is prima facie evidence that its purpose is to avoid the income tax on its shareholders.[19] Second, the fact that the corporation has accumulated earnings and profits in excess of its reasonable business needs (including its "reasonably anticipated needs" [20]) is determinative of the purpose to avoid income tax on its shareholders unless the corporation proves otherwise by a preponderance of the evidence.[21] In the Tax Court, under certain circumstances, the taxpayer can shift the burden of proof to the Commissioner on the issue of whether earnings

14. *Id.*

15. *See* R. KILCULLEN, TAXING ACCUMULATION OF CORPORATE SURPLUS UNDER SECTION 102, at 3 (rev. ed. 1952).

16. Revenue Act of 1938, ch. 289, § 102(c), 52 Stat. 447, 483.

17. INT. REV. CODE of 1954, § 533(a) provides:

> UNREASONABLE ACCUMULATION DETERMINATIVE OF PURPOSE.—For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.

18. INT. REV. CODE of 1954, § 532(b).

19. *Id.* § 533(b).

20. *Id.* § 537.

21. *Id.* § 533(a).

and profits have been allowed to accumulate beyond the reasonable needs of the business.[22]

When applicable, the accumulated earnings tax is levied at the rate of 27½ percent of the first $100,000 of accumulated taxable income, and at 38½ percent of the accumulated taxable income in excess of $100,000.[23] "Accumulated taxable income" is the corporation's taxable income after certain adjustments, less the sum of: (1) the deductions for dividends paid;[24] and (2) an accumulated earnings credit which is, generally,[25] the earnings retained for the reasonable needs of the business, but not less than $100,000 during the lifetime of the corporation.[26]

Objectives of the Accumulated Earnings Tax and Corporations Subject to the Tax

Because of the disparity existing between the individual income tax

22. Int. Rev. Code of 1954, § 534 provides in part as follows:

(a) General Rule.—In any proceeding before the Tax Court involving a notice of deficiency based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, the burden of proof with respect to such allegation shall—

(1) if notification has not been sent in accordance with subsection (b), be on the Secretary or his delegate, or

(2) if the taxpayer has submitted the statement described in subsection (c), be on the Secretary or his delegate with respect to the grounds set forth in such statement in accordance with the provisions of such subsection.

(b) Notification by Secretary.—Before mailing the notice of deficiency referred to in subsection (a) the Secretary or his delegate may send by certified mail or registered mail a notification informing the taxpayer that the proposed notice of deficiency includes an amount with respect to the accumulated earnings tax imposed by section 531. In the case of a notice of deficiency to which subsection (e)(2) applies and which is mailed on or before the 30th day after the date of the enactment of this sentence, the notification referred to in the preceding sentence may be mailed at any time on or before such 30th day.

(c) Statement by Taxpayer.—Within such time (but not less than 30 days) after the mailing of the notification described in subsection (b) as the Secretary or his delegate may prescribe by regulations, the taxpayer may submit a statement of the grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business.

23. Int. Rev. Code of 1954, § 531.

24. *Id.* § 561.

25. Unless barred by *id.* §§ 1551 or 269.

26. *Id.* § 535(a), (c).

rate (presently the maximum is 70 percent[27]) and the corporate tax rate (the maximum is now only 48 percent,[28] and dividends received from domestic corporations are generally taxable at rates much less than this[29]), individuals have often been tempted to utilize the corporation to escape the higher individual income tax rates, especially if they are in the upper income brackets. Indeed, it is true that the after-tax corporate income will not immediately be available to the shareholder for his personal use. Such earnings, however, might be accumulated in the corporation for later distribution to the stockholders through liquidation of the corporation[30] or by sale of the stock,[31] either of which would normally result in capital gain rather than ordinary income; or the shareholders might desire to exchange their stock for that in a publicly held corporation in a tax-free merger.[32] It should also be noted that the transfer of a shareholder's stock interest at his death results in a new tax basis for the stock equal to its fair market value, without imposition of a capital gain tax on the appreciation in value.[33] These are examples of the tax advantages which could be achieved by the accumulation of earnings in a corporation were it not for various restrictions imposed by law, of which the principal one is the accumulated earnings tax imposed by section 531.[34] The purpose of the tax, then, is to deter the shareholders of a corporation from avoiding the individual income tax by having the corporation accumulate earnings beyond its business needs, rather than distributing such earnings as dividends.[35]

Applied literally, the language of the Code would subject any corporation other than a personal holding company (domestic[36] or for-

27. *Id.* § 1.

28. *Id.* § 11.

29. *Id.* § 243.

30. *Id.* § 331(a)(1).

31. *Id.* § 1201(b).

32. *See id.* §§ 354, 368.

33. *Id.* § 1014.

34. Other restrictions are imposed by the penalty taxes on personal holding companies, *id.* §§ 542-47; by the special treatment of foreign personal holding company shareholders, *id.* §§ 551-58; and by the special treatment given collapsible corporations, *id.* § 341.

35. *Id.* § 532(a). *See* H.R. REP. No. 350, *supra* note 12; R. PAUL, *supra* note 5, at 192-93.

36. INT. REV. CODE of 1954, § 532(b)(1).

eign[37]) or a tax-exempt corporation[38] to the accumulated earnings tax.[39] The tax would be imposed whenever such corporation was "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed." [40] Under this strict construction of the law, it would not matter that the accumulation was for the purpose of sheltering a corporation shareholder from the income tax, or that the corporation was publicly held by thousands of small shareholders or closely held by a few related individuals. Since the tax avoidance motive is minimal where the shareholder is a corporation, because it is permitted an 85 percent deduction yielding an effective tax rate of about 7.0 percent for intercorporate dividends,[41] it would be rather difficult to show the proscribed purpose of tax avoidance in such a situation.[42] The regulations state that the concern of the government is directed toward corporations "formed or availed of to avoid or prevent the imposition of the *individual* income tax on its shareholders, or on the shareholders of any other corporation . . . ." [43] In other words, the tax will be imposed only if the accumulation is for the purpose of avoiding the imposition of a tax on individual shareholders of the same or another corporation. The latter situation may occur where the accumulating corporation's stock is owned by a second corporation which has individual shareholders, and the purpose of the accumulation is to avoid the imposition of tax on the shareholders of the parent corporation. The imposition of individual income tax would have occurred if the accumulating corporation had distributed its earnings to its parent corporation and the parent corporation had, in turn, paid a dividend to its individual stockholders.[44]

37. *Id.* § 532(b)(2). Both personal holding companies and United States shareholders of foreign personal holding companies are subject to special penalty taxes on undistributed income. *See id.* §§ 541-47, for the former, and *id.* §§ 551-58, for the latter.

38. *Id.* § 532(b)(3).

39. *Id.* § 532.

40. *Id.*

41. *Id.* § 243.

42. Note, however, that as to foreign corporations, where the rate is 15% under treaty or 30% under statute, the tax avoided by corporate shareholders is a more significant element.

43. Treas. Reg. § 1.532-1(a)(1) (emphasis added).

44. § 1.532-1(a)(2). For this provision's history, *see* Mead Corp. v. Commissioner, 116 F.2d 187 (3d Cir. 1940). For application thereof, *see* Hedberg-Freidheim Contracting Co. v. Commissioner, 251 F.2d 839 (8th Cir. 1958).

In practice, widely held public corporations have been exempted from the accumulated earnings tax. As long as management is not dominated by a few large stockholders, and individual stock interests are so diffused that no single group effectively controls corporate dividend policy, it is virtually impossible to impose the tax because of the resultant difficulty of showing the presence of the prohibited intent required by the statute.[45] Two important factors tending to negate such a showing are the presence of stockholder pressure for the payment of dividends, and the possibility of a stockholder law suit if the corporation were to improperly accumulate its earnings.[46] Congress seemed to recognize this in 1954, when the House version of the 1954 Code proposed that corporations with more than 1500 stockholders be exempted from the section 531 tax if no individual or his family owned more than ten percent of the corporation's stock.[47] This proposal was defeated in the Senate.[48] At least one commentator thought that this defeat demonstrated that publicly held corporations were subject to the law.[49] The committee reports, however, contain language leading to the contrary view.[50] To qualify for the exemption, the corporation had to show that it met the stock ownership requirement, and since the provisions of section 544[51] pertaining to constructive ownership were to be applied,[52] many corporations feared that they would be unable to prove that no individual or family owned more than ten percent of their stock. Because of this, and because "this tax is not now in practice applied to publicly held corporations," the Senate Finance Committee decided that "it was desirable to remove the exemption" which the House bill had provided.[53] Indeed, the

45. INT. REV. CODE of 1954, § 532(a).

46. These suits may be in the form of an action to compel dividend payments as in Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919), or in the form of a stockholder's derivative action on behalf of the corporation to recover from the directors any section 531 tax paid. *See, e.g.*, Mahler v. Trico Products Corp., 296 N.Y. 902, 72 N.E.2d 622 (1947); Note, *Derivative Actions Arising from Payment of Penalty Taxes under Section* 102, 49 COLUM. L. REV. 394 (1949).

47. H.R. REP. No. 1337, 83d Cong., 2d Sess. 54 (1954).

48. S. REP. No. 1622, 83d Cong., 2d Sess. 69 (1954).

49. R. HOLZMAN, THE TAX ON ACCUMULATED EARNINGS 5-6 (1956): "The very fact that this provision was deleted from the final language of the law is an emphatic reminder that Congress decided that publicly-held corporations were a proper subject of the law."

50. S. REP. No. 1662, *supra* note 48.

51. INT. REV. CODE of 1954, § 544.

52. H.R. REP. No. 1337, *supra* note 47 at A172.

53. S. REP. No. 1662, *supra* note 48.

only reported case in which the accumulated earnings tax has been imposed on a publicly held corporation is *Trico Products*.[54] In that case, since six stockholders held about two-thirds of the shares, the corporation was effectively closely held, and the courts were able to determine that the accumulations were the result of a tax avoidance purpose. It would, therefore, appear that "a common denominator in all section 531 cases is concentration of ownership and control of the corporation in a small group of stockholders,"[55] and that public corporations are generally exempt from any great concern over the tax.

THE MULTIPLE TESTS: REASONABLE BUSINESS NEEDS AND TAX AVOIDANCE PURPOSE

The Test of Reasonable Business Needs

Section 533(a)[56] establishes a presumption that the purpose to avoid taxes is present if earnings are accumulated beyond the reasonable business needs of the corporation. Section 535(c) provides a credit in computing accumulated taxable income for "such part of the earnings . . . for the taxable year as are retained for the reasonable needs of the business."[57] The presumption of section 533(a) is rebuttable; and even if a corporation accumulates earnings beyond its reasonable needs, the tax is inapplicable if it can establish that it has not utilized the excess for the forbidden purpose.[58] It is difficult for the taxpayer to rebut the presumption of a tax avoidance purpose where the accumulation is shown to exceed reasonable business needs.[59] Although there is no statutory definition of the term "reasonable needs of the business," since 1954 the *reasonably anticipated needs* of the business have been included.[60] The regulations state that the reasonable needs

54. Trico Products Corp., 46 B.T.A. 346 (1942), *aff'd*, 137 F.2d 424 (2d Cir.), *cert. denied*, 320 U.S. 799 (1943).

55. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 214 (2d ed. 1966).

56. INT. REV. CODE of 1954, § 533(a).

57. *Id.* § 535(c).

58. *Id.* § 532. *E.g.*, Bremerton Sun Publishing Co., 44 T.C. 566 (1965); Gus Blass Co., 9 T.C. 15 (1947), *appeal dismissed*, 168 F.2d 833 (8th Cir. 1948).

59. United States v. Duke Laboratories, Inc., 337 F.2d 280 (2d Cir. 1964); I. A. Dress Co., Inc., v. Commissioner, 273 F.2d 543 (2d Cir. 1960); Bremerton Sun Publishing Co., 44 T.C. 566 (1965); Ted Bates & Co., 34 P-H Tax Ct. Mem. 1476 (1965).

60. INT. REV. CODE of 1954, § 537. The Tax Reform Act of 1969 added two others: the section 303 redemption needs of the business, and the excess business holdings redemption needs of the business. *Id.* § 537(a)(2) and (3).

of the business include "the amount that a prudent businessman would consider appropriate for the present business purposes and for the reasonably anticipated future needs of the business." [61] Although this does not greatly expand the statutory wording, the regulations are helpful in furnishing the following examples of reasonable accumulations:

> (1) To provide for bona fide expansion of business or replacement of plant;
> (2) To acquire a business enterprise through purchasing stock or assets;
> (3) To provide for the retirement of bona fide indebtedness created in connection with the trade or business, such as the establishment of a sinking fund for the purpose of retiring bonds issued by the corporation in accordance with contract obligations incurred on issue;
> (4) To provide necessary working capital for the business, such as, for the procurement of inventories; or
> (5) To provide for investments or loans to suppliers or customers if necessary in order to maintain the business of the corporation.[62]

Apart from these examples, which the regulations state are not exclusive,[63] others developed by case law include:

(1) The need to meet business competition;[64]
(2) The need to finance employee pension or profit sharing plans;[65]
(3) The need for various business risk and contingency reserves;[66]
(4) The need for protection against the possible loss of customers;[67]
(5) The need for plant relocation;[68]
(6) The need for self-insurance against loss of key employees;[69]
(7) The need for surety bond requirements in taxpayer's business.[70]

61. Treas. Reg. § 1.537-1(a).
62. § 1.537-2(b).
63. *Id.*
64. John P. Scripps Newspapers, 44 T.C. 453, 470 (1965).
65. Bremerton Sun Publishing Co., 44 T.C. 566, 585 (1965).
66. Smoot Sand & Gravel Corp. v. Commissioner, 241 F.2d 197 (4th Cir. 1957) (reserves against risks); Smokeless Fuel Co., 12 P-H Tax Ct. Mem. 1350 (1943) (threat of strikes).
67. L. R. Teeple Co., 47 B.T.A. 270 (1942).
68. *Id.*
69. Bradford-Robinson Printing Co. v. United States, 1 Am. Fed. Tax R.2d 1278 (D. Colo. 1957).
70. Vuono-Lione, Inc., 24 CCH Tax Ct. Mem. 506 (1965).

Indeed, the reasons justifying the accumulation of earnings and profits are as wide-ranging as modern business itself. Moreover, the business of the corporation is not limited to that which it has carried on in the past but includes "any line of business which it may undertake." [71]

The regulations set forth the following as indications that the accumulation is beyond the reasonable needs of the business:

> (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.[72]

The fact that the transaction falls within one of the above examples does not necessarily mean that the penalty tax of section 531 will attach. The presence of one or more of these factors, however, does serve to draw the government's scrutiny to the accumulation.[73]

Since 1954, the reasonable needs of the business have included its reasonably anticipated needs.[74] This provision does away with any requirement of an immediate need for the funds in order to justify their retention, although the plans of the corporation must not be too uncertain or vague.[75] The regulations provide:

> In order for a corporation to justify an accumulation of earnings and profits for reasonably anticipated future needs, there must be an indication that the future needs of the business require such ac-

71. Treas. Reg. § 1.537-3(a).
72. *Id.* § 1.537-2(c).
73. *See* B. Bittker & J. Eustice, *supra* note 55, at 224.
74. Int. Rev. Code of 1954, § 537(a)(1).
75. Treas. Reg. § 1.537-1(b).

> cumulation, and the corporation must have specific, definite, and feasible plans for the use of such accumulation.[76]

If the plans for the use of the funds are vague or uncertain, suggesting that they were only an afterthought, there arises a strong implication that the needs were not reasonably anticipated, and the tax has generally been imposed.[77] Subsequent events are not to be employed to vitiate an accumulation as long as the retention of the earnings or profits was reasonable at the close of the taxable year.[78] Subsequent events, however, may be considered in determining whether the taxpayer actually intended to carry out its alleged plans.[79] In other words, the "reasonable business needs" test is to be an objective one based upon the circumstances as they exist at the end of the taxable year, and not as they happen to turn out afterward. Later events are to be viewed only as bearing on the original intent at the time of the accumulation.

The Test of Tax Avoidance Purpose

Section 532 states that the accumulated earnings tax applies to every corporation, with certain statutory exceptions, formed or availed of for the purpose of avoiding taxes on its shareholders by permitting the accumulation of earnings and profits.[80] Although this section does not identify the individual or individuals whose purpose is crucial, it seemingly refers to those who control the corporation through share ownership or otherwise. The language of this section 532 places great emphasis on the subjective intent of the corporation and could easily be interpreted to mean that the tax is to be imposed whenever a tax avoidance purpose is present, whether or not it has been accomplished.[81] Indeed, the corporation's intent has been referred to as the important query to be answered in such cases.[82] It is probable, however, that the courts will not impose the tax unless actual tax avoidance has occurred.[83] The presence of a purpose to avoid taxes can be inferred, however,

76. *Id.*

77. *Cf., e.g.,* American Metal Products Corp. v. Commissioner, 287 F.2d 860 (8th Cir. 1961).

78. Treas. Reg. § 1.537-1(b)(2). *See also* Sterling Distributors, Inc. v. United States, 313 F.2d 803 (5th Cir. 1963).

79. Treas. Reg. § 1.537-1(b)(2).

80. INT. REV. CODE of 1954, § 532.

81. *See* B. BITTKER & J. EUSTICE, *supra* note 55.

82. *E.g.,* Young Motor Co., Inc. v. Commissioner, 281 F.2d 488 (1st Cir. 1960); Casey v. Commissioner, 267 F.2d 26 (2d Cir. 1959).

83. *See* B. BITTKER & J. EUSTICE, *supra* note 55, at 214-15.

from the fact that shareholder tax liability has been decreased by the accumulation. It is also common practice for the courts to consider the added tax burden on a shareholder had distribution been made as evidence tending to show a tax avoidance purpose.[84] The mere fact that tax liability would have been increased by a distribution, however, does not necessarily mean that the tax will be imposed.[85] Where the accumulation results from a mistaken although honestly held belief of need for an accumulation, the tax should not be imposed under current doctrine, since the purpose of tax avoidance is absent.[86]

Until recently, there was considerable dispute as to whether the law applied where tax avoidance was merely one of the purposes for the accumulation or whether avoidance had to be the dominant purpose. Section 532 states that the tax applies to a corporation accumulating earnings and profits "for *the purpose* of avoiding the income tax with respect to its shareholders."[87] Some courts have held that the tax applies unless the corporation establishes a total absence of any tax avoidance motive.[88] Other courts have applied the tax unless the corporation could show that tax avoidance was not a significant factor in the accumulation.[89] Simply showing that avoidance was not the primary or

84. *See, e.g.,* Trico Products Corp., 46 B.T.A. 346, 364-65 (1942).

85. R. Gsell & Co., Inc. v. Commissioner, 294 F.2d 321 (2d Cir. 1961).

86. *Accord,* Casey v. Commissioner, 267 F.2d 26 (2d Cir. 1959). Judge Learned Hand in concurring stated:

> I believe that the statute meant to set up as a test of "reasonable needs" only the corporation's honest belief that the existing accumulation was no greater than was reasonably necessary. Section 532(a) was a penal statute, designed to defeat any plan to evade the shareholders' taxes, and there can be no doubt that it presupposes some deliberate purpose to do so and is not satisfied by proving that the corporation was mistaken in its estimate of its future "needs."

Id. at 32.

In United States v. Duke Laboratories, Inc., 337 F.2d 280 (2d Cir. 1964) the government conceded that a corporation's honest but mistaken belief that its earnings were not excessive may exempt it from section 531 liability.

87. INT. REV. CODE of 1954, § 532 (emphasis added).

88. Whitney Chain & Mfg. Co., 3 T.C. 1109 (1944), *aff'd per curiam,* 149 F.2d 936 (2d Cir. 1945). *See also* Bremerton Sun Publishing Co., 44 T.C. 566 (1965); Pelton Steel Casting Co., 28 T.C. 153 (1957). The Tax Court later seemed to move away somewhat from this position in Carolina Rubber Hose Co., 24 CCH Tax Ct. Mem. 1159, 1171 (1965). There the Tax Court said:

> [W]ithout getting into the argument whether the tax avoidance purpose must be the sole purpose, the dominant purpose, or only one of the purposes . . . we find . . . that tax avoidance to its shareholders was not a sufficient consideration, if any, in the determination of petitioner's dividend policy . . . to make petitioner liable for the accumulated earnings tax.

89. Trico Products Corp. v. Commissioner, 137 F.2d 424 (2d Cir.), *cert. denied,* 320

dominant purpose was not sufficient. Conversely, the courts did not require the corporation to show a total absence of an intent to avoid taxes.[90] Still other courts required that the corporation prove that tax avoidance was not the primary or dominant motive for the earnings accumulation.[91]

The dispute was resolved by the Supreme Court in *Donruss*.[92] Donruss was a corporation engaged in profitable business activities, and all of its stock was owned by a single shareholder. The company had, during 1955-1961, increased its undistributed earnings by over $658,000, but had not paid any dividends. Several reasons were advanced to justify the accumulation, including the need for capital and inventory, increasing costs, and general economic and business risks. The sole shareholder also expressed a desire to expand and invest in the company's major distributor, but no concrete steps had been taken in this direction.

In the district court, the jury found that the corporation had accumulated earnings beyond the reasonable needs of its business but that it had not retained such earnings for the purpose of avoiding income tax on its sole shareholder.[93] Among the instructions requested by the Government was the following:

> [I]t is not necessary that avoidance of shareholder's tax be the sole purpose for the unreasonable accumulation of earnings; it is sufficient if it is one of the purposes for the company's accumulation policy.[94]

U.S. 799 (1943); Chicago Stock Yards Co. v. Commissioner, 129 F.2d 937 (1st Cir. 1942), *rev'd on other grounds*, 318 U.S. 693 (1943).

90. The second circuit in Trico Products Corp. v. Commissioner, 137 F.2d 424 (2d Cir.), *cert. denied*, 320 U.S. 799 (1943) and in United States v. Duke Laboratories, Inc., 337 F.2d 280 (2d Cir. 1964), and the fifth circuit in Barrow Mfg. Co. v. Commissioner, 294 F.2d 79 (5th Cir. 1961) held that the prohibited purpose need be only one of the reasons for the accumulation. A district court in Fenco, Inc. v. United States, 234 F. Supp. 317 (D. Md. 1964), *aff'd per curiam*, 348 F.2d 456 (4th Cir. 1965), interpreted Semagraph Co. v. Commissioner, 152 F.2d 62 (4th Cir. 1945) and Smoot Sand & Gravel Corp. v. Commissioner, 241 F.2d 197 (4th Cir. 1957) and 274 F.2d 495 (4th Cir. 1960) to the same effect. Courts in Kerr-Cochran, Inc. v. Commissioner, 253 F.2d 121 (8th Cir. 1958) and World Publishing Co. v United States, 169 F.2d 186 (10th Cir. 1948) stated that the prohibited motive had to be the "determining" purpose.

91. Young Motor Co. v. Commissioner, 281 F.2d 488 (1st Cir. 1960), 316 F.2d 267 (1st Cir. 1963), 339 F.2d 481 (1st Cir. 1964); Donruss Co. v. United States, 384 F.2d 292 (6th Cir. 1967). *Donruss* was subsequently reversed. 393 U.S. 297 (1969).

92. United States v. Donruss Co., 393 U.S. 297 (1969).

93. Donruss Co. v. United States, 65-1 U.S. Tax Cas. ¶9292 (W.D. Tenn. 1965).

94. Donruss Co. v United States, 384 F.2d 292 (6th Cir. 1967).

The court refused this request and simply instructed the jury that tax avoidance had to be "the purpose" of the accumulations.[95]

The appellate court reversed the verdict in favor of the taxpayer, saying that "the jury might well have been led to believe that tax avoidance must be the sole purpose behind an accumulation in order to impose the accumulated earnings tax." [96] This court rejected the government's proposed instruction, however, and held that the tax applied only where tax avoidance was the "dominant, controlling, or impelling motive" for the accumulation.[97]

The issue presented to the Supreme Court was whether the taxpayer, in order to rebut the presumption contained in section 533(a),[98] must establish that tax avoidance was not "one of the purposes" for the unreasonable accumulation, or whether it need only establish that tax avoidance was not the "dominant, controlling, or impelling" reason for the accumulation. After examining the language, purposes, and legislative history of the statute, the Court concluded that the corporation must prove, by a preponderance of the evidence, that avoidance of tax on the shareholders was not "one of the purposes" of an accumulation which exceeds the reasonable needs of its business.[99] The Court believed that to adopt the test proferred by the taxpayer would "exacerbate the problems that Congress was trying to avoid," as there is rarely "one motive, or even one dominant motive, for corporate decisions." [100] The taxpayer's test would make it too easy for taxpayers to escape the tax by showing that at least one other motive was equal in importance to tax avoidance, since such a determination could not be made with any degree of accuracy and would depend almost entirely upon the interested testimony of the corporate management.[101] The Court maintained that the purpose test was still relevant since it would serve to isolate those cases where tax avoidance did not con-

95. Donruss Co. v. United States, 65-1 U.S. Tax Cas. ¶ 9292 (W.D. Tenn. 1965).

96. Donruss Co. v. United States, 384 F.2d 292 at 298 (6th Cir. 1967).

97. *Id.*

98. INT. REV. CODE of 1954, § 533(a) provides:

> For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.

99. United States v. Donruss Co., 393 U.S. 297, 301 (1969).

100. *Id.* at 307-08.

101. *Id.* at 308.

tribute to the decision to accumulate. The Court stated that "purpose" means more than mere knowledge, which is present in almost every case. Thus, it is still open to the taxpayer to show that, even though it had knowledge of the tax consequences, such knowledge did not contribute to its decision to accumulate earnings.[102]

The minority opinion argues that Congress chose to give the taxpayer a "last clear chance" to prove that, despite the unreasonableness of the accumulation, it was not due to a purpose of avoidance, and that if the majority's test were used, the taxpayer would be denied such a "last clear chance." [103] This argument rests on the probability that a jury, having been instructed that avoidance need be only one of the purposes for an accumulation, is quite likely to find that a purpose of avoidance exists whenever the government shows that the taxpayer has accumulated earnings knowing of the resultant tax savings even though there may be evidence establishing that avoidance played only a minor role.[104] The minority believed that the jury should be instructed to impose the tax only "if it finds that the taxpayer would not have accumulated earnings but for its knowledge that a tax saving would result." [105]

Although the decision in *Donruss* settled the conflict as to the quantum of avoidance needed for imposition of the tax once the presumption of tax avoidance has been invoked by an unreasonable accumulation of earnings, the decision has raised another question. What is meant by purpose? The Court states that knowledge alone is not enough, but that knowledge acted upon is. Where knowledge exists together with an accumulation, however, it is quite probable, as the minority in *Donruss* points out,[106] that the jury will equate this combination with a purpose to avoid. The "but for" test of the minority would not solve the problem either, if Congress meant for the tax to be imposed whenever the taxpayer would have distributed earnings absent the possibility of a tax saving. For under the very test of the minority, if the corporation accumulated the earnings for other reasons as well as for tax savings, the tax would not be imposed. These difficulties are inherent in the subjective intent requirement that a purpose of tax avoid-

102. *Id.* at 309.
103. *Id.* at 310.
104. *Id.* at 311.
105. *Id.* at 313.
106. *Id.* at 311-12.

ance be shown. The problem could be avoided by eliminating the requirement.

A Proposal to Eliminate the Subjective Test in the Imposition of the Accumulated Earnings Tax

Prior to 1954, if the tax avoidance purpose was found to be at all present, the accumulated earnings tax could be imposed upon the corporation's entire undistributed earnings for the taxable year, even if all or a part of these earnings had been retained for the reasonable needs of the business.[107] This was altered by the enactment of the accumulated earnings credit in 1954.[108] Under this provision, no tax is to be imposed on that portion of an accumulation which is within the reasonable needs of the business, even if a tax avoidance purpose is present. Therefore, if only a part of the undistributed earnings for the taxable year is retained for the reasonable needs of the business, the tax will be applied only to the excess earnings retained.[109] The 1954 amendments thereby downgraded the subjective test by making it subordinate to the objective test. Recent court decisions have tended to reduce its importance even further. For example, the courts of appeal in both the first and second circuits have recently held that the objective test (the "reasonable business needs" test) is the single most important indicator in determining whether the tax avoidance purpose is present.[110] In contrast, some of the earlier decisions seemed to be as much concerned with the subjective intent of the corporate shareholders as with the corporate business needs.[111]

Even with a trend away from the subjective test, difficulties arise, as may be seen in the discussion of the *Donruss* case, in determining what is needed in addition to knowledge of tax savings to find that a purpose of tax avoidance exists. It would seem preferable to eliminate such

107. *See, e.g.*, R. Gsell & Co. v. Commissioner, 294 F.2d 321 (2d Cir. 1961); Young Motor Co. v. Commissioner, 281 F.2d 488 (1st Cir. 1960).

108. Int. Rev. Code of 1954, § 535(c).

109. *See, e.g.*, Bardahl Mfg. Corp., 24 CCH Tax Ct. Mem. 1030 (1965); Ted Bates & Co., 24 CCH Tax Ct. Mem. 1346 (1965).

110. United States v. Duke Laboratories, Inc., 337 F.2d 280 (2d Cir. 1964); Young Motor Co. v. Commissioner, 281 F.2d 488 (1st Cir. 1960), *on remand*, 21 CCH Tax Ct. Mem. 711 (1962), *rev'd and remanded*, 316 F.2d 267 (1st Cir. 1963), *on remand*, 23 CCH Tax Ct. Mem. 113, *aff'd*, 339 F.2d 481 (1st Cir. 1964).

111. *See, e.g.*, Cecil B. De Mille, 31 B.T.A. 1161 (1935), *aff'd*, 90 F.2d 12 (9th Cir.), *cert. denied*, 302 U.S. 713 (1937); Fisher & Fisher, Inc., 32 B.T.A. 211 (1935), *aff'd per curiam*, 84 F.2d 996 (2d Cir. 1936).

fruitless inquiries. To this end it is proposed that Congress amend the accumulated earnings tax provisions to delete the subjective test. The "reasonable business needs" test would then no longer be merely presumptive support of the presence of a tax avoidance purpose, but would serve as the only test of the accumulation's taxability. Section 532(a) might be amended as follows:

> (a) GENERAL RULE.—The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) accumulating earnings and profits beyond the reasonable needs of the business.

Section 532(b) would not be changed. Section 533 would be deleted from the Code. Section 537 might be amended to include further examples of reasonable needs of the business, but this does not appear necessary in view of the extensive case law presently in existence.

This amendment appears to be in accord with the recent trends noted above in progressively reducing the importance of the subjective test. Moreover, the inherent difficulty in determining the presence of a tax avoidance purpose for the imposition of the tax would be eliminated. The change would also serve to lessen the discrimination presently existing against closely held corporations in applying the tax. It would no longer matter that it is much easier to prove the existence of a purpose of tax avoidance in such a corporation.[112] Application of the tax would be dependent upon whether the accumulation served the reasonable needs of the corporation. If this were not thought to be a desirable result, an express exemption could be made for widely held corporations.

While this amendment would simplify imposition of the tax and probably eliminate more tax avoidance than does the present statute, it would not penalize the corporation which accumulates its earnings with a reasonable business objective in mind. Corporations which accumulate funds beyond their reasonable business needs without any tax avoidance purpose are rare and, in any event, ought not to be permitted such accumulation without incurring the tax.

112. *See* text accompanying notes 36-55 *supra*.