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Federal Taxation - Accumulated Earnings Tax - The Quantum of Tax Avoidance Purpose Required - United States v. Donruss, 89 S. Ct. 501 (1969)

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CURRENT DECISIONS

Federal Taxation—ACCUMULATED EARNINGS TAX—THE QUANTUM OF TAX AVOIDANCE PURPOSE REQUIRED. *United States v. Donruss Co.*, 89 S. Ct. 501 (1969).

The Commissioner of Internal Revenue assessed and the respondent corporation paid accumulated earnings taxes for the years 1960 and 1961.[1] In a refund suit, the jury found that Donruss had accumulated earnings beyond the reasonable needs of its business, but not for the purpose of avoiding income tax for its sole stockholder;[2] accordingly, the district court held for respondent corporation.[3] The Government requested, but the court refused to give the following instruction:

> [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.[4]

Instead, the court instructed the jury in terms of the statute—that the corporation must have been ". . . availed of for the purpose of avoiding the income tax. . . ." [5]

On appeal, the Court of Appeals for the Sixth Circuit reversed, holding 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 . . ." and that it was prejudicial error not to clarify the statutory language.[6] The court stated that the jury should have been instructed that the tax avoidance purpose had to be the dominant, controlling, or impelling motive for the accumu-

1. 89 S. Ct. 501 (1969).

2. The corporation had profitable operations, increasing its undistributed earnings from $1,021,288.58 to $1,679,315.37, from 1955 through 1961. Wiener, the sole stockholder, cited inventory requirements, increasing costs, business risks, and a general desire to expand as reasons for the accumulation policy. More specifically, he asserted his desire to invest in respondent's major distributor, the Tom Huston Peanut Company. Respondent had no definite plans with regard to this investment during the tax years in question, but did purchase stock in Tom Huston at a cost of $380,000 in 1964. *Id.* at 502.

3. *Id.*

4. *Id.*

5. *Id.*

6. Donruss Co. v. United States, 384 F.2d 292, 298 (6th Cir. 1967), *rev'd*, 89 S. Ct. 501 (1969).

lation.[7] The Supreme Court granted certiorari to resolve the conflict among the circuits, and held that tax avoidance need be only *one* purpose for accumulation in order for the accumulated earnings tax to be exacted.

The Internal Revenue Code of 1954 imposes an accumulated earnings tax of significant proportions[8] on

> . . . every 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.[9]

The taxpayer usually has the burden of disproving such a purpose because of the statutory presumption in the Government's favor.[10] The narrow issue presented in *Donruss* concerned the quantum of purpose which the taxpayer had to show to defeat the imposition of the accumulated earnings tax.[11]

Although courts have used various words to describe the quantum of purpose required (*e.g.*, sole, dominant, determining, aiding), the real issue has been whether only "a" purpose of tax avoidance sufficed or whether a greater degree of tax avoidance purpose was required in order for the accumulated earnings tax to be imposed on the accumulation.

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7. *Id.*, 384 F.2d at 297-98.

8. INT. REV. CODE of 1954, § 531.

9. *Id.* § 532(a).

10. Section 533 provides for a rebuttable presumption in favor of the government whenever the earnings and profits have been permitted to accumulate beyond the "reasonable needs" of the company. As Judge Learned Hand said:

> "[A] statute which stands on the footing of the participants' [sic] state of mind may need the support of presumption, indeed be practically unenforceable without it, but the test remains the state of mind itself, and the presumption does no more than make the taxpayer show his hand. United Business Corp. of America v. Commissioner, 62 F.2d 754, 755 (2d Cir.), *cert. denied*, 290 U.S. 635 (1933).

Since section 535(c) provides for a computation credit in an amount equal to the earnings and profits retained for the "reasonable needs" of the business, almost all cases involve an "unreasonable" accumulation and the presumption is made against the taxpayer. Prior to the enactment of that section in 1954, some cases did arise in which the accumulations were not unreasonable, but the taxpayer still usually had to prove absence of tax avoidance purpose. Section 534 provides for shifting the burden of proof (but possibly not the burden of proof of purpose) to the Government in certain very limited situations. *See generally, e.g.*, Pye, *Section 534 and the Shiftless Burden of Proof*, 51 A.B.A.J. 784 (1965); Comment, *Accumulated Earnings Tax: Burdens of Proof of Reasonableness and Purpose*, 54 CALIF. L. REV. 1050 (1966).

11. This is to be distinguished from the quantum of proof necessary to show purpose or reasonableness of accumulation.

Decisions in the second,[12] fourth,[13] and fifth[14] circuits required that tax avoidance be only "one" purpose or "a" purpose of retaining earnings and profits. The second circuit in a 1943[15] decision, *Trico Products Corp. v. Commissioner*,[16] relied on a Supreme Court decision[17] in stating that the tax avoidance purpose must have "aided in inducing" the accumulation. While emphasis on the Supreme Court decision might have been misplaced,[18] the result appears to be in accord with the fourth and fifth circuit opinions,[19] which asserted that this interpretation was the best way to implement the congressional attempt to deter use of the corporate entity as an "umbrella" to avoid personal income taxes. One court stated further that:

> The utility of the badly needed presumption arising from the accumulation of earnings or profits beyond the reasonable needs of the business is well nigh destroyed if that presumption in turn is saddled with requirement of proof of "the primary or dominant purpose" of the accumulation.[20]

The eighth[21] and tenth[22] circuits purportedly occupied an intermediate ground, requiring that tax avoidance be "one of the determining" purposes. However, since almost any true *purpose* will have a

12. Trico Prods. Corp. v. Commissioner, 137 F.2d 424, 426 (2d Cir.), *cert. denied*, 320 U.S. 799 (1943). *See also* United States v. Duke Laboratories, Inc., 337 F.2d 280, 282 (2d Cir. 1964).

13. Semagraph Co. v. Commissioner, 152 F.2d 62 (4th Cir. 1945)

14. Barrow Mfg. Co. v. Commissioner, 294 F.2d 79, 82 (5th Cir. 1961), *cert. denied*, 369 U.S. 817 (1962).

15. While the holdings discussed here date from the early 1940's, the accumulated earnings tax itself dates back to 1913, when the tax was imposed directly on the shareholders. Tariff Act of 1913, ch. 16, § II-A(2), 38 Stat. 114, 166. In 1921, the law was changed to provide for assessment against the corporation. Revenue Act of 1921, ch. 136, § 220, 42 Stat. 227, 247.

16. 137 F.2d 424, 426 (2d Cir.), *cert. denied*, 320 U.S. 779 (1943).

17. Helvering v. Chicago Stock Yards Co., 318 U.S. 693, 699 (1943).

18. The Supreme Court while actually discussing another issue said, "[W]hatever the motive when the practice of accumulation was adopted, the purpose of avoiding surtax induced, or *aided in inducing*, the continuance of the practice." [Emphasis added.] *Id.* The court, in *Trico*, admitted the facts were different. 137 F.2d at 426. in *Trico*, admitted the facts were different. 137 F.2d at 426.

19. The opinion stated that tax avoidance need not be the dominant purpose. 137 F.2d at 426.

20. Barrow Mfg. Co. v. Commissioner, 294 F.2d 79, 82 (5th Cir. 1961), *cert. denied*, 369 U.S. 817 (1962).

21. Kerr-Cochran, Inc. v. Commissioner, 253 F.2d 121, 123 (8th Cir. 1958).

22. World Publishing Co. v. United States, 169 F.2d 186, 189-90 (10th Cir. 1948), *cert. denied*, 335 U.S. 911 (1949).

determining effect, little difference can be seen between "a" purpose and "one of the determining" purposes.[23]

In recent cases, the first[24] and sixth[25] circuits have held that tax avoidance had to be the "primary, dominant or impelling" motive behind an accumulation. In *Young Motor Co. v. Commissioner*,[26] the court stated that an individual having mere knowledge of possible tax savings could hardly assert that tax savings was not "a" purpose under the other tests.[27] The court stated:

> If knowledge of such a result is to be the test of purpose, then the only corporations that could safely accumulate income would be those having stockholders with substantial net losses.[28]

In short, these two jurisdictions took a view much more favorable to the taxpayer.[29]

No courts have held that tax avoidance must be the sole motive for accumulation before the tax would apply.[30]

The Supreme Court in *United States v. Donruss Co.*[31] reversed the

23. Kerr-Cochran, Inc. v. Commissioner, 253 F.2d 121, 123 (8th Cir. 1958), even cites the *Trico* decision in support of its conclusion. The following illustrates the close semantic distinction by contrast: if these courts had said "the determining" purpose, then the test would have been nearly indistinguishable from the "dominant or controlling" purpose test (discussed *infra*). *See* E-Z Sew Enterprises, Inc. v. United States, 260 F. Supp. 100 (E.D. Mich. 1966); Fenco, Inc. v. United States, 234 F. Supp. 317 (D. Md. 1964), *aff'd per curiam*, 348 F.2d 456 (4th Cir. 1965).

24. Young Motor Co. v. Commissioner, 281 F.2d 488, 491-92 (1st Cir. 1960). *See also* Appollo Indus., Inc. v. Commissioner, 358 F.2d 867, 876 (1st Cir. 1966).

25. Shaw-Walker Co. v. Commissioner, 390 F.2d 205, 216 (6th Cir. 1968); Donruss Co. v. United States, 384 F.2d 292, 296-98 (6th Cir. 1967).

26. 281 F.2d 488 (1st Cir. 1960).

27. Tax savings alone is evidence of a purpose to avoid taxes. The jury could logically infer that one intended obvious and natural consequences. *See* 7 MERTENS LAW OF FEDERAL INCOME TAXATION (1967 rev.) § 39.26 at 45-46.

28. 281 F.2d at 491. The well-reasoned opinion goes on to say: "The issue is not what are the necessary, and to that extent contemplated consequences of the accumulation, but what was the primary or dominant purpose which led to the decision." *Id.*

29. This view is possibly more in accord with antitrust laws in that it enables individuals to incorporate more freely, and compete with larger corporations. Otherwise, individuals may be discouraged from incorporating and, instead, join with larger corporations. *See* Ziegler, *The "New" Accumulated Earnings Tax: A Survey of Recent Developments*, 22 TAX L. REV. 77, 120-21 (1966).

30. *E.g.*, Donruss Co. v. United States, 384 F.2d 292, 296 (6th Cir. 1967); Kerr-Cochran, Inc. v. Commissioner, 253 F.2d 121, 122-23 (8th Cir. 1958); World Publishing Co. v. United States, 169 F.2d 186, 189-90 (10th Cir. 1948), *cert. denied*, 335 U.S. 911 (1949).

31. 89 St. Ct. 501 (1969).

decision of the Court of Appeals for the Sixth Circuit,[32] and held that avoidance of shareholder tax need be only "one" purpose of accumulation for the accumulated earnings tax to apply.[33] Because the statutory language was unclear, the Court turned to the congressional intent.[34] It intimated that any other test would be inconsistent with that intent[35] and would unduly weaken the presumption of a purpose of avoidance.[36] The Court stated, "[O]ur holding would [not] make purpose totally irrelevant. It still serves to isolate those cases in which tax avoidance motives did not contribute to the decision to accumulate." [37]

On the basis of this decision the accumulated earnings tax, if otherwise applicable, will be assessed against a corporate taxpayer which accumulates earnings with "a" purpose of avoiding personal income taxes regardless of other purposes or motives. As the dissent in *Donruss* suggests,[38] if the jury does not carefully weigh subtleties, then accumulation of earnings together with mere knowledge of the tax savings may satisfy the "one" purpose quantum requirement of the Supreme Court. The taxpayer must disprove *any* tax avoidance purpose.

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Armed Services—THE RIGHT TO PRE-INDUCTION JUDICIAL REVIEW. *Oestereich v. Selective Service System*, 89 S. Ct. 414 (1968).

A divinity student, unconditionally entitled to exemption from military service by statute,[1] was reclassified as delinquent,[2] and subsequently

32. 384 F.2d 292 (6th Cir. 1967)

33. 89 S. Ct. at 504. The Court recognized *Young* as a strong case in the taxpayer's favor, but rejected it.

34. *Id.* at 504-07.

35. *Id.* at 505.

36. *Id.* at 507.

37. *Id.* at 508.

38. *Id.* at 508-10.

1. Universal Military Training and Service Act of 1948, ch. 625, § 6(g), 62 Stat. 611 (now Military Selective Service Act of 1967, 50 U.S.C.A. APP., § 456(g) (1967)). This provision grants students enrolled in a theological school an exemption from training and service.

2. Plaintiff returned his registration certificate to the Government in expressing his dissent from United States participation in the Vietnam war. Every person must have his registration certificate in his possession at all times. 32 C.F.R. § 1617.1 (1968). The local Selective Service board has the authority to declare a registrant to be delinquent whenever he fails to perform any duty required of him, apart from the duty to obey an order to report for induction. 32 C.F.R. § 1642.4(a) (1968).