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Jerome M. Hesch

TAXATION—TAX AVOIDANCE NEED ONLY BE ONE OF THE PURPOSES FOR IMPOSITION OF THE ACCUMULATED EARNINGS TAX

Respondent, The Donruss Co., hereinafter referred to as Donruss, is engaged in the manufacture and sale of bubble gum and candy and in the operation of a farm. Donruss was owned by a single stockholder since 1954. In each year from 1955 to 1961 Donruss operated profitably, increasing its undistributed earnings from $1,021,288.58 to $1,679,315.37. During this period the sole stockholder, Don Weiner, received no benefits other than a salary. Donruss made no investments unrelated to its business and no dividends were declared. Weiner gave several reasons for Donruss' accumulation policy: capital and inventory requirements, increasing costs, the risks inherent in the particular business and in the general economy, and a general desire to invest in Donruss' major distributor. The Internal Revenue Service assessed accumulated earnings taxes for the years 1960 and 1961 under sections 531-537 of the Internal Revenue Code of 1954.[1] Donruss paid the tax and brought a refund suit. At the trial, the Government specifically requested that the jury be instructed that:

> [I]t is not necessary that avoidance of shareholder's tax be the sole purpose for the unreasonable accumulation; it is sufficient if it is one of the purposes for the company's accumulation policy.[2]

The district court refused and instructed the jury to determine whether the earnings and profits of Donruss were accumulated beyond its reasonable business needs, and whether the corporation was formed or availed of for the purpose of avoiding tax with respect to its shareholders. Judgment was entered for Donruss. The Court of Appeals reversed and remanded,[3] 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."[4] The Court of Appeals rejected the Government's proposed instruction and held that the tax applied only if tax avoidance was the "dominant, controlling, or impelling" motive for the accumulation.[5] On certiorari to the Supreme Court, *held*: Reversed and remanded. The Supreme

1. INT. REV. CODE of 1954, § 532(a) provides in part:
> The accumulated earnings tax imposed by section 531 shall apply to every corporation . . . formed or availed of for the purpose of avoiding the income tax with respect to its shareholders . . . , by permitting earnings and profits to accumulate instead of being divided or distributed.

INT. REV. CODE of 1954, § 533(a) reads:
> 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.

2. United States v. Donruss Co., 393 U.S. 297, 298 (1969).
3. Donruss Co. v. United States, 384 F.2d 292 (6th Cir. 1967).
4. *Id.* at 298.
5. *Id.*

Court adopted the Government's test and ordered a new trial to determine if tax avoidance was one of the purposes for the accumulation. *United States v. The Donruss Company*, 393 U.S. 297 (1969).

The chief tax advantage of a closely held corporation is that its shareholders are insulated from high personal income taxes in a year of abnormal earnings or in a year which a shareholder has considerable other income.[6] The purpose of the accumulated earnings tax is to compel the company to distribute any profits not needed for the conduct of its business so that, when distributed, individual stockholders will become liable for taxes on the dividends received.[7] This tax, therefore, discourages the use of the corporate form as an accumulation vehicle sheltering individual stockholders from personal income taxes on corporate earnings.[8] The tax was part of the original income tax statute following the ratification of the sixteenth amendment.[9] That Act imposed a tax on the shareholders of any corporation "formed or fraudulently availed of for the purpose of" tax avoidance.[10] The section provided that accumulation beyond the reasonable needs "shall be prima facie evidence of a fraudulent purpose to escape such tax. . . ."[11] The difficulties in proving a fraudulent purpose made the tax largely ineffective, so Congress deleted the word "fraudulently."[12] In addition, the incidence of the tax was shifted from the stockholders to the corporation itself.[13] Nevertheless, these changes were not sufficient to make the tax effective.[14] In 1934, Congress closed a significant loophole by exempting personal holding companies from the accumulated earnings tax provisions and subjecting them to a tax on undistributed earnings under separate Code provisions, regardless of the purpose for the accumulation.[15] Congress made this change to alleviate the difficulty of proving "purpose" in cases where there were partial distributions of excess earnings and a showing of some need for retaining the remainder.[16] Still, the problem of ineffective enforcement continued.[17] In 1938, the Senate Finance Committee proposed "to strengthen this section by requiring the

6. 2 J. RABKIN & M. JOHNSON, FEDERAL INCOME GIFT AND ESTATE TAXATION § 11.07 (1969).

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

8. United States v. Donruss Co., 393 U.S. 297, 303 (1969) [hereinafter referred to as *Donruss*]. B. BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, § 6.01, p. 211 (2nd ed. 1966).

9. Tariff Act of 1913, 38 Stat. 114.

10. *Id.* § II(A)(2) at 166.

11. *Id.* at 167.

12. Rev. Act of 1918, § 220, 40 Stat. 1072; *see* S. REP. No. 617, 65th Cong., 3d Sess. 5 (1918).

13. Rev. Act of 1921, § 220, 42 Stat. 227. The change was prompted by the decision in Eisner v. Macomber, 252 U.S. 189 (1920). *See* H.R. REP. No. 360, 67th Cong., 1st Sess. 12-13 (1921).

14. United States v. Donruss Co., 393 U.S. 297, 304 (1969).

15. Rev. Act of 1934, §§ 102, 351, 48 Stat. 702, 751. The present Code sections are §§ 541-47.

16. H.R. REP. No. 704, 73rd Cong., 2d Sess. 11 (1934).

17. United States v. Donruss Co., 393 U.S. 297, 305 (1969).

taxpayer by a clear preponderance of the evidence to prove the absence of any purpose to avoid surtaxes upon shareholders after it has been determined that the earnings and profits have been unreasonably accumulated."[18] The change was thought to make it clear that the burden of proving intent was to be on the taxpayer.[19] More recent changes in this area have been generally favorable to the taxpayer,[20] but no language has been added concerning the degree of tax avoidance purpose necessary for the imposition of the tax.[21] The accumulated earnings tax does not automatically attach to undistributed income; rather, a prerequisite to imposing the tax is that the accumulation be for the purpose of tax avoidance.[22] However, the Code assists the Government in proving purpose by creating a presumption of that purpose which the taxpayer is required to rebut once the unreasonableness of the accumulation is established.[23]

A conflict developed among the circuit courts as to the degree of a tax avoidance purpose necessary for the imposition of the tax on the unreasonable accumulation. The First Circuit, in *Young Motor Company v. Commissioner*,[24] held that tax avoidance must be the primary or dominant purpose, rejecting the view that tax avoidance need be only one of the purposes.[25] The court based its decision on the wording of section 532(a) of the Code, pointing out that "the statute does not say 'a' purpose, but 'the' purpose."[26] The Court concluded that tax avoidance had to be dominant, otherwise "a" would have been used. The Fifth Circuit, in *Barrow Manufacturing Company v. Commissioner*,[27] held that the prohibited purpose need only be "one" of the purposes for the failure to distribute excess earnings, rejecting outright the dominance test.[28] The court, with reference to the pre-

18. S. REP. No. 1567, 75th Cong., 3d Sess. 5 (1938).
19. *Id.* at 16. The Senate's proposal was enacted. Rev. Act of 1938, § 102, 52 Stat. 483.
20. INT. REV. CODE of 1954, § 535 provided credits for those earnings which had a valid business purpose. In addition, a minimum accumulation was allowed for which no tax avoidance presumption could arise. *Id.* at § 535(c).
21. United States v. Donruss Co., 393 U.S. 297, 306 (1969).
22. INT. REV. CODE of 1954, § 532(a). Treas. Regs. § 1.532-1(a)(1) (1959).
23. INT. REV. CODE of 1954, § 533(a). Treas. Regs. § 1.533-1(a)(1) (1959). However, without the benefit of the presumption, an immediate inference as to the forbidden purpose may be drawn from the facts of the case. *See* Helvering v. Chicago Stock Yards Co., 318 U.S. 693 (1943). The Regulations give circumstances which may be considered: loans or other dealings with stockholders, lack of dividend distributions, and investments having no connection with the business. Treas. Regs. § 1.533-1(a)(2) (1959).
24. 281 F.2d 488 (1st Cir. 1960).
25. *Id.* at 491.
26. *Id.*
27. 294 F.2d 79 (5th Cir. 1961); *cert. denied*, 369 U.S. 817 (1962).
28. The Second Circuit in Trico Products Corporation v. Commissioner, 137 F.2d 424 (2d Cir. 1943), *cert. denied*, 320 U.S. 799 (1943), reached the same conclusion by different reasoning. A year before *Trico* the Supreme Court had ruled that "a corporate practice adopted for [non-tax avoidance] reasons may have been continued with the additional motive of [tax avoidance]." Helvering v. Chicago Stock Yards, 318 U.S. 693, 696 (1943). After veiwing the tax imposed in this case, the court in *Trico* saw that tax avoidance was not a dominant purpose in *Chicago Stock Yards* and thereby inferred that dominance is unnecessary.

sumption raised by the Code, based its decision on what Judge Learned Hand said of the much weaker presumption contained in the Revenue Act of 1921:[29] "[a] statute which stands on the footing of the participants' state of mind may need the support of presumption, indeed may be practically unenforceable without it. . . ."[30] The court in *Barrow* concluded: "[t]he utility of the badly needed presumption . . . is well nigh destroyed if that presumption in turn is saddled with the requirement of proof of 'the primary or dominant purpose' of the accumulation."[31] An intermediate position was adopted in the Eighth and Tenth Circuits,[32] which would impose the tax only if tax avoidance is one of the determining purposes. These cases seem to indicate that tax avoidance had to be more than a minor, incidental purpose, but not as great as dominant or controlling. The tax would not be imposed if tax avoidance was only an "incidental" reason for the accumulation.

The majority opinion recognized that the Government's test was the proper standard to apply, because it would eliminate most of the subjectiveness from the area and, therefore, the accumulated earnings tax would be simpler to enforce. The majority did not aprove of a test which would allow a corporation to escape all penalties merely because it could convince a jury that at least one other motive was equal to tax avoidance.[33] The Court held that to adopt taxpayer's position "would [compound] the problems that Congress was trying to avoid" as there is seldom one motive or even a dominant motive for any corporate decision.[34] The Court felt that weighing of corporate motives was purely subjective, could not be done with any accuracy, and that Congress was dissatisfied with the emphasis on intent. Therefore, such a test should be entirely avoided. The Court concluded that the dominant-motive test would effectively destroy the presumption Congress created in section 533(a) to meet the problem of proof on motive.[35] The Court, unimpressed with the arguments as to the meaning of the language of the statute,[36] examined the relevant legislative history. That history led the

29. Rev. Act of 1921, 42 Stat. 247.

30. United Business Corporation of America v. Commissioner, 62 F.2d 754, 755 (2d Cir. 1933).

31. 294 F.2d at 82.

32. Kerr-Cochran Inc. v. Commissioner, 253 F.2d 121, 123 (8th Cir. 1958); World Publishing Company v. United States, 169 F.2d 186, 189 (10th Cir. 1948).

33. United States v. Donruss Co., 393 U.S. 297, 308 (1969).

34. *Id.* at 307-08.

35. *Id.* at 308. To support this conclusion the Court relied on the effect which Judge Learned Hand predicted for the presumption if a dominant motive test were used, and the reasoning of the *Barrow* case.

36. *Id.* at 302. The Court rejected taxpayer's reliance on *Young Motor Co. v. Commissioner, supra* note 24. The Court found nothing in the legislative history which attached any particular significance to the use of the article "the," nor did it find the change in the statute from "a" to "the" helpful since they felt it signified nothing more than a change in phraseology. The Court of Appeals in *Donruss*, 384 F.2d 292 (6th Cir. 1967) relied on certain cases from the gift and estate tax area. The Court rejected this reliance as those cases dealt with an entirely different situation where statutory language, history, and legislative purpose are different.

Court to conclude that the test proposed by the Government was consistent with the intent of Congress and necessary to effectuate the purpose of the tax. The history demonstrated Congressional concern with the use of the corporate form to avoid income tax on shareholders. From its examination the Court drew two conclusions: first, Congress recognized the tremendous difficulty of ascertaining the purpose for corporate accumulations; second, Congress saw that accumulation was often necessary for legitimate business purposes. Congressional response to this had been to emphasize unreasonable accumulation as the most significant factor in the incidence of the tax.[37] Hence, if the unreasonableness of the accumulation is established, a rebuttable presumption of tax avoidance arises without any proof on the matter. Finally, the Court contended that purpose is still relevant because their decision would isolate those cases in which tax avoidance motives did not contribute to the decision to accumulate.[38] The Court also noted that "knowledge" of tax consequences was not the same as "purpose," and that the taxpayer could show that its knowledge did not contribute to the decision to accumulate.[39] The concurring opinion agreed with the Court's analysis of legislative history and the need for relying on an objective criteria, but contended that Congress chose to give the taxpayer a "last clear chance" to disprove tax avoidance.[40] The minority deemed this chance precluded by the majority's framing of its instruction, for under the majority's test a jury is likely to believe that it must find tax avoidance if the Government shows the corporation accumulated earnings with knowledge of its tax consequences. The minority considered it merely wishful thinking to expect the jury to be convinced that this knowledge did not play some part in the decision to accumulate. They suggested a "but for" test where the jury would be instructed to impose the tax only if it finds that taxpayer would not have accumulated earnings "but for" its knowledge that a tax saving would result.[41]

The Court was justified in accepting the Government's test; otherwise parties whose purpose was tax avoidance could escape the tax if they had the foresight to establish another reason for the accumulation. The standard as it now stands will effectuate congressional intent. The test is so favorable to the Government that it may go far beyond what Congress intended.[42] A corporation with excess earnings, aware of the tax consequences of a dividend distribution, may want to retain that excess. Realizing it cannot keep the

37. United States v. Donruss Co., 393 U.S. 297, 307 (1969). This reliance is also due to the availability of objective criteria for evaluating reasonableness.
38. *Id.* at 309.
39. *Id.*
40. *Id.* at 310.
41. *Id.* at 313.
42. As the concurrence in *Donruss* pointed out, the lack of a cause and effect relationship between knowledge and purpose may be quite difficult to establish. It seems that the mere discussion of tax consequences may be an insuperable obstacle to a party attempting to show that tax awareness did not contribute to the decision to accumulate.

excess funds in the business, it may reinvest the accumulation in a valid business purpose. Even though the original purpose may have been tax avoidance, the threat of the accumulated earnings tax induced the corporation to adopt a valid business purpose. Under *Donruss*, since one reason for the accumulation was tax avoidance, the corporation may either have to pay the tax or distribute the accumulation. The Court made no provision for a legitimate change of purpose. The traditional method of capital investment has been through retained earnings. The *Donruss* decision tends to discourage this method of financing. There is nothing in the legislative history which indicates Congress intended the tax to have this effect. Generally, the Internal Revenue Service has assessed the tax in cases where the excess accumulations have existed for a number of years.[43] Now, armed with the *Donruss* decision, the Commissioner may start to assess the tax sooner. If prior practice continues, the corporation will have a "grace period" in which it can decide what to do with its excess earnings without encountering the tax or changing its time limit for such a decision. If the Commissioner starts to assess the tax sooner than he has in the past, it will tend to diminish the retention of earnings and result in hurried corporate decisions, two considerations the Court failed to consider in reaching its decision. Mr. Justice Harlan, in suggesting a "but for" test, failed to recognize that this could easily be interpreted as a dominance test. The practical effect of the *Donruss* decision[44] is that the corporation will have to emphasize the reasonableness of the accumulation of resources.[45] The area will become more important if the Commissioner initiates more cases in the area. Those marginal situations, formally bypassed, may now give rise to an accumulated earnings tax assessment. The corporation will continue to need sufficient, if not extensive, documentation to show compliance with the tests set forth in the Regulations[46] to prove reasonableness. Those atypical cases where reasonableness was proven will become increasingly important.[47] The Government must be convinced that tax avoidance never entered into the decision to accumulate. In the past, the determination of the purpose of an accumulation received little attention.

43. *But see* Belaire Management Corporation, 21 T.C. 881 (1954), where the tax was applied to a corporation in its first year of operation.

44. For a more technical evaluation *see*, Altman and Muchin, *Supreme Court's Donruss decision calls for a shift in tactics in 531 area*, 30 J. Taxation 202 (1969).

45. I use the term "resources" because it is possible that the Commissioner may impose the tax where he feels that the excess is hidden in other assets besides liquid resources.

46. Treas. Regs. § 1.533-1(a)(2) gives three factors to consider in determining reasonableness. They are: investments by the corporation unrelated to its business, loans or expenditures of funds by the corporation for the personal benefit of the shareholders, and evidence of a regular dividend policy in years past.

47. Pelton Steel Casting Co. v. Comm'r, 251 F.2d 278 (7th Cir. 1958), *cert. denied*, 356 U.S. 958 (1958) (it might be all right to accumulate for purpose of buying out minority shareholder). Gazette Publishing Co. v. Self, 103 F. Supp. 779 (D.C. Ark. 1952) (buying out of minority interest is valid business purpose since sale of minority's interest to outsiders could result in lack of harmony in management). *See also*, RESEARCH INSTITUTE OF AMERICA, INC., TAX COORDINATOR, Vol. 2, ¶ D-2800 (1966).

But today, once unreasonableness is established, the corporation can no longer rely on the dominance test. There are some decisions which indicate that the presumption of tax avoidance can be overcome.[48] In many, lengthy testimony and detailed facts were presented to indicate a thorough analysis of business needs and to demonstrate that the decision to accumulate was not for tax avoidance purposes.[49] As the law now stands a corporation will have to prove this beyond a doubt if there is a finding its accumulation is unreasonable.

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48. The Regulations acknowledge that the presumption of tax avoidance is not "absolutely conclusive," so that the taxpayer may prove that the purpose was not avoidance of income taxes on shareholders. Treas. Regs. § 1.533-1(a)(2) (1959).

49. *Compare* Casey v. Comm'r, 267 F.2d 261 (2d Cir. 1959) (deadlock on policy grounds between two equal shareholders as to whether or not to spend surplus is a legitimate business purpose) *with* Hedberg-Freidheim Contracting Co. v. Comm'r, 251 F.2d 839 (8th Cir. 1958). Mountain State Steel Foundaries, Inc. v. Comm'r, 284 F.2d 737 (4th Cir. 1960), (existence of substantial minority interest that would have objected to unreasonable accumulation might be sufficient to rebut presumption). T. C. Heyward & Co. v. United States, 18 A.F.T.R.2d 5775 (1966) (retention of large liquid reserve stemmed from controlling shareholder's obsession a depression was imminent not tax avoidance). Kowa, Inc. v. Comm'r, 189 F.2d 390 (10th Cir. 1951) (conservative decisions regarding accumulations will not be conclusive with respect to their legitimacy). The Court of Claims in Halby Chemical Co., 180 Ct. Cl. 584 (1967), accepted the corporation's showing that it needed a reserve to compete with the giant firms in its field. The corporation showed a need for the reserve because of the risks it assumed in concentrating on only two products.