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FURTHER COMMENT ON UNITED STATES V. DONRUSS

In an attempt to avoid personal income tax liability, taxpayers have often resorted to unique and complex individual income-reduction ploys. One such scheme involves the unreasonable accumulation of corporate earnings. Under the Internal Revenue Code, such earnings "are not taxed to the shareholder when they accrue to the corporation, but instead are taxed when they are passed to shareholders individually through dividends."[1] Thus, as a result "of the disparity between corporate tax rates and the higher graduations of individual income tax rates, a corporation — particularly a closely-held one — can significantly reduce shareholder tax liability by accumulating its earnings beyond the amount needed to operate the business."[2] In order to preclude utilization of this device, the Code imposes a penalty surtax, commonly termed the accumulated earnings tax, upon every corporation formed or availed of for the purpose of avoiding personal income tax liability on shareholders through the accumulation of earnings. The increasing applicability of this tax has rendered it a critical factor in the formulation of corporate tax planning,[3] and in this regard, a discussion of the recent Supreme Court case, *United States v. Donruss*,[4] is particularly relevant.

The Operative Sections of the Accumulated Earnings Tax

The accumulated earnings tax, initiated in 1913,[5] has undergone several significant changes since its inception. As the various sections which comprise the total taxing apparatus are presently constructed, the tax[6] applies to all corporations which shelter their stockholders from individual tax liability by accumulating, rather than distributing, earnings.[7] However, reflecting the congressional belief that one could

1 Commissioner v. Gordon, 391 U.S. 83, 90 n.5 (1968).

2 Brief for Petitioner at 6, United States v. Donruss, 393 U.S. 297 (1969).

3 *See* Altman, *Improper Accumulation of Earned Surplus*, N.Y.U. 24TH INST. ON FED. TAX. 805 (1966).

4 393 U.S. 297 (1969).

5 Tariff Act of 1913, ch. 16, § II G(a), 38 Stat. 172. The original penalty applied exclusively to "fraudulently" formed corporations. The difficulty in interpreting this word led to its deletion in the Revenue Act of 1918, ch. 18, § 220, 40 Stat. 1057. Personal holding companies became subject to the tax under the Revenue Act of 1934, ch. 277, § 102(a), 48 Stat. 702 (now INT. REV. CODE of 1954, § 532). The evolution of the tax reached its full cycle with the imposition upon the taxpayer of the burden of overcoming a presumption of tax avoidance. Revenue Act of 1938, ch. 289, § 102(b), 52 Stat. 482 (now INT. REV. CODE of 1954, § 533(a)).

6 INT. REV. CODE of 1954, §§ 531-37.

7 *Id.* § 531:

In addition to other taxes imposed by this chapter, there is hereby imposed for

not justly impose a penalty surtax upon earnings retained for reasonable business needs, the Code authorizes a credit for all accumulations which are reasonable in regard to the taxpayer's business.[8] Moreover, the Code has adopted a liberal interpretation in determining what constitutes a reasonable accumulation, expressly providing that consideration may also be accorded to "reasonably anticipated" needs.[9] The Code further prescribes that in no case is such credit to be less than the amount by which $100,000 exceeds the accumulated profits of the corporation as of the end of the preceding taxable year.[10]

Prior to 1954, the burden of proof as to the reasonableness of an accumulation had been upon the taxpayer. However, in that year the Senate Finance Committee noted that this imposition led to several undesirable consequences:

> The poor record of the Government in the litigated cases in this area indicates that deficiencies have been asserted in many cases which were not adequately screened or analyzed. At the same time taxpayers were put to substantial expense and effort in proving that the accumulation *was for the reasonable needs of the business.*[11]

In an attempt to remedy this situation, Congress enacted section 534 of the Code, which allows the taxpayer, upon receipt of notification of a proposed notice of deficiency, to file a statement of the grounds on which the corporation relies to establish the reasonableness of the ac-

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each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of —

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

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

[8] *Id.* § 535(c)(1). *See* Canty, *The Accumulated Earnings Tax, 1954 Reforms: An Appraisal*, 2 U. SAN FRAN. L. REV. 242, 258-62 (1968).

[9] INT. REV. CODE of 1954, § 537. The 1939 Code was less liberal in this regard. INT. REV. CODE of 1939, § 102(a)(c). *See, e.g.*, World Publ. Co. v. United States, 169 F.2d 186 (10th Cir. 1948), *cert. denied*, 335 U.S. 911 (1949), which held that a present need for the accumulation must exist. The Code was subsequently amended in 1954. *See* S. REP. No. 1622, 83d Cong., 2d Sess. (1954). The Finance Committee reported that there must be an indication that the future needs of the business require such accumulation, and that the corporation have specific, definite, and feasible plans for the use of such accumulation.

[10] INT. REV. CODE of 1954, § 535(c)(2). The credit is specifically denied to holding and investment companies. *See id.* § 535(c)(3). Moreover, if a corporation declares a dividend within a seventy-five day grace period commencing at the end of the fiscal year, surtax liability will be avoided. *See id.* §§ 535(c)(4), 563(a).

[11] S. REP. No. 1522, 83d Cong., 2d Sess. 3 (1954) (emphasis added). The Finance Committee report continued:

> The complaints of taxpayers that the tax is used as a threat by revenue agents to induce settlement on other issues appear to have a connection with the burden of proof which the taxpayer is required to assume. It also appears probable that many small taxpayers may have yielded to a proposed deficiency because of the expense and difficulty of litigating their case under the present rules.

Id.

cumulation, together with facts sufficient to show the basis thereof. The submission of such a statement will shift the burden of proof as to reasonableness to the Government. However, if the Government fails to provide the necessary notification of the proposed deficiency, it must bear the burden of proof even though no statement is filed by the taxpayer.[12] Once the accumulation is found to exceed the corporation's reasonable needs, it is, in all cases, deemed to be for the purposes of tax avoidance, unless the taxpayer can, by a preponderance of the evidence, establish otherwise.[13]

THE STATUTORY PRESUMPTION

In order to facilitate the effective implementation of the accumulated earnings tax, the incidence of which is dependent upon the taxpayer's state of mind, Congress recognized the utility of a presumption that the retained earnings were accumulated for the purpose of tax avoidance. Since this presumption was not commensurate with guilt, it did not de jure render one liable for tax evasion.[14] Rather, it merely compelled the taxpayer to come forth and rebut the alleged illegal intent:

> A statute which stands on the footing of the participant's state of mind may need the support of presumption . . . but the test remains the state of mind itself, and the presumption does no more than make the taxpayer show his hand.[15]

Thus, an unreasonable accumulation created the rebuttable presumption of tax evasion, thereby placing the ultimate burden of proof upon the taxpayer. Initially, such an unreasonable accumulation was considered "prima facie evidence" of the unlawful purpose. Subsequently,

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12 INT. REV. CODE of 1954, § 534.

13 *Id.* § 533(a). If the defendant is a holding or investment corporation, this fact alone supplies prima facie evidence of tax avoidance, *id.* § 533(b). Specifically exempted from tax liability are corporations controlled by subchapter F of the Code. *See id.* §§ 501, 526.

For a general discussion of the accumulated earnings tax complex, see S. WEITHORN & R. NOALL, PENALTY TAXES AND PERSONAL HOLDING COMPANIES (1963).

14 *See, e.g.*, United States v. R. C. Tway Coal Sales Co., 75 F.2d 336 (6th Cir. 1935), wherein the taxpayer successfully avoided the penalty surtax. Although the *Tway* court found the imposition of the statutory presumption valid, it held that no reversible error existed; the defendant corporation had not been availed of for the purpose of shielding its shareholders from individual tax liability. *But see* National Grocery Co. v. Helvering, 92 F.2d 931 (3d Cir. 1937), *rev'd on other grounds*, 304 U.S. 282 (1938), holding that the presumption applies only when accumulations are unreasonable.

15 United Business Corp. v. Commissioner, 62 F.2d 754, 755 (2d Cir.), *cert. denied*, 290 U.S. 635 (1933). This decision, the first to pass upon the statutory presumption, was not concerned with the reasonableness of the accumulation. Liability was predicated solely upon a determination of the taxpayer's state of mind, irrespective of the reasonableness of the accumulation.

however, in an attempt to enhance the efficacy of the tax,[16] Congress amended section 533 to provide:

> [T]he fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be *determinative* of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.[17]

It was this statutory presumption of tax avoidance which, to a great extent, was determinative of whether or not the accumulated earning surtax was to be levied. However, the imposition of the presumption also compelled the judiciary to determine the manner in which it could be successfully overcome by a taxpayer-corporation. The differing standards applied by the various federal courts of appeals in this regard have resulted in rulings which were often discordant and irreconcilable. The Court of Appeals for the Second Circuit, adhering to a strict interpretation of the statute, held that the accumulated earnings tax applied whenever tax avoidance was *one* of the purposes for which coporate earnings were unreasonably accumulated:

> The Board's conclusion may justifiably have been reached in the view that, *whatever* the motive when the practice of accumulation was adopted, the purpose of avoiding the surtax *induced, or aided in inducing,* the continuance of the practice.[18]

Although this interpretation is admittedly stringent, the presumption was successfully rebutted by the taxpayer in *United States v. Duke Laboratories, Inc.*[19] The Commissioner had appealed from a jury verdict which found the accumulations to be unreasonable, but did not find the proscribed intent of tax evasion. Noting that "[t]he jury was told that [the purpose to avoid taxation] 'need not be the sole or dom-

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16 Revenue Act of 1938, ch. 289, § 102(c), 52 Stat. 483. An even more stringent application of the section had been proposed by the House Ways and Means Committee, *i.e.*, the imposition of a surtax upon *all* closely held corporations. *See* H.R. REP. NO. 1850, 75th Cong., 3d Sess. (1938).

Although the 1938 Act required a taxpayer to prevail by a "clear preponderance of the evidence," this burden of proof was made somewhat more lenient for the taxpayer by deletion of the word "clear" in 1954. However, at least one commentator has observed this deletion to be one merely of form, rather than substance. *See* 7 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 39.34 n.2 (rev. ed. 1966).

17 INT. REV. CODE of 1954, § 533(a) (emphasis added).

18 Trico Prods. Corp. v. Commissioner, 137 F.2d 424, 426 (2d Cir.), *cert. denied*, 321 U.S. 801 (1943), *citing* Helvering v. Chicago Stock Yards, 318 U.S. 693, 699 (1943) (emphasis added). It has been suggested that the *Trico* court's reliance upon *Helvering* is misplaced, since the latter decision concerned itself with a tax avoidance scheme which was initiated before legislative imposition of the surtax and subsequently maintained *solely* to avoid the tax. *See* Brief for Respondent at 14-15, United States v. Donruss, 393 U.S. 297 (1969).

19 337 F.2d 280 (2d Cir. 1964).

inant intent',"[20] the Second Circuit, affirming, held that there existed sufficient evidence upon which the triers of fact could have formed an honest belief in the credibility of the taxpayer. Conceding that such an instance of credibility would indeed be rare, the court regarded it as clearly permissible under the statute.

A similar standard was applied by the Court of Appeals for the Fifth Circuit in *Barrow Manufacturing Co. v. Commissioner*,[21] wherein the court stated:

> 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 the requirement of proof of 'primary or dominant purpose' of the accumulation.[22]

On the other hand, the Eighth[23] and Tenth[24] Circuits, rejecting this interpretation and opting instead for a more liberal standard, required the taxpayer to establish that tax avoidance was not the "determinative" factor in the decision to accumulate.[25] But the last and most liberal promulgation in this regard, often categorized as the "primary or dominant" purpose test, came from the Court of Appeals for the First Circuit: "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."[26]

In order to resolve this conflict, the United States Supreme Court granted certiorari in *United States v. Donruss*.[27]

UNITED STATES V. DONRUSS

In *Donruss*, the respondent corporation had operated profitably a confectionary business in each of the taxable years 1955 through

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[20] *Id.* at 283.

[21] 294 F.2d 79 (5th Cir. 1961), *cert. denied*, 359 U.S. 817 (1962). *See also* E-Z Sew Enterprises, Inc. v. United States, 260 F. Supp. 100 (E.D. Mich. 1966).

[22] 294 F.2d at 82.

[23] *See, e.g.*, American Metal Prod. Corp. v. Commissioner, 287 F.2d 860 (8th Cir. 1961); Kerr-Cochran, Inc. v. Commissioner, 253 F.2d 121 (8th Cir. 1958).

[24] *See, e.g.*, World Publ. Co. v. United States, 169 F.2d 186 (10th Cir. 1948), *cert. denied*, 335 U.S. 911 (1949). It should be noted that, at present, few courts articulate their rationale for selecting a particular test. *See* Comment, *Donruss v. United States*, 43 NOTRE DAME LAW. 566, 569 (1968). In fact, many courts have attempted to completely avoid the issue of imposition of a particular test by simply repeating the Code sections. *See* Faber, *Practitioner's Guide to Defending a 531 Case — Theory and Practice*, 27 J. TAX. 274, 277 (1967).

[25] Kerr-Cochran, Inc. v. Commissioner, 253 F.2d 121, 123 (8th Cir. 1958). Nevertheless, the *Kerr-Cochran* court cited Trico Prods. Corp. v. Commissioner, 320 U.S. 799 (1943) (*see* note 18 *supra* and accompanying text as valid authority).

[26] Young Motor Co. v. Commissioner, 281 F.2d 488, 491 (1st Cir. 1960).

[27] 393 U.S. 297 (1969).

1961. Throughout this period all outstanding stock of the corporation was owned by one individual, but no dividend was declared despite the fact that retained earnings had increased from $1,021,288.58 to $1,679,315.37. When the Commissioner assessed accumulated earnings taxes against the respondent corporation for the tax years 1960 and 1961, it paid the required sum and subsequently brought a refund suit in the District Court for the Western District of Tennessee. At the trial, the Government specifically requested that the jury be instructed:

> [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.[28]

This request was denied by the district court, which, instead, utilizing only the statutory language, instructed that tax avoidance had to be "*the* purpose" of the accumulation. In response to interrogatories, the jury found that the retained earnings were beyond the reasonable needs of the business.[29] However, it also found that the corporation had not accumulated its profits for "the purpose" of avoiding income tax liability. Accordingly, judgment was rendered for the respondent. On appeal, the Court of Appeals for the Sixth Circuit reversed and remanded, holding that the district court instruction might well have led the jury "to believe that tax avoidance must be the sole purpose behind an accumulation in order to impose the accumulated earnings tax."[30] Additionally, however, the court rejected the Government's proposed instruction and ruled that the tax could be imposed only if tax avoidance was found to be the "dominant, controlling or impelling motive" for the accumulations.[31]

Upon writ of certiorari, the United States Supreme Court took a narrow view of the question before it, *i.e.*, whether application of the accumulated earnings tax requires that the corporation have as its "dominant, controlling or impelling" motive the avoidance of income tax liability, or whether it is sufficient that such avoidance is but one of the purposes of the accumulation.[32] Mr. Justice Marshall, writing for

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[28] Donruss v. Commissioner, 384 F.2d 292, 296 (6th Cir. 1967) (emphasis added).

[29] Respondent had offered several explanations concerning the reasonableness of the accumulations, including capital and inventory requirements; increasing costs; risk in the particular business and the general economy; and a desire to invest in his major supplier. Nevertheless, Donruss never challenged the jury's determination that the accumulations were unreasonable. 393 U.S. at 298.

[30] 384 F.2d at 298.

[31] *Id.*

[32] The Court specifically excluded any consideration of the second part of the statutory test, *i.e.*, those factors which constitute reasonable business needs. 393 U.S. at 301.

the majority, adopted the latter position, noting that the dominant motive test would permit taxpayers to escape imposition of the tax whenever it could be established that at least one other motive was equal to tax avoidance purpose. The Court doubted that such a determination could be made with any degree of accuracy, since it would depend almost entirely upon testimony of the corporate management involved. This realization on the part of the Court reflected its complete acceptance of the Government position:

> Rarely has a corporation but a single purpose for particular conduct. Any given corporation will be "availed of" for a variety of "purposes." Tax avoidance seldom will appear as the sole or even the most readily discernible motive, whether the focus of attention be an accumulation of earnings or any other corporate act. Accumulated-earnings cases invariably involve a surplus, usually held in cash or other quick or investment assets, which has a broad variety of potential uses and has been accumulated by a series of acts. Almost certainly, the purpose of tax avoidance, when present, will arguably be intermixed with other objectives. Attempts to apply the accumulated earnings tax are particularly likely to invoke assertions of multiple corporate purposes. The potential variations — of degree as well as kind — are endless.[33]

The Court of Appeals for the Sixth Circuit, in support of its "dominant motive" test, had adopted the rationale of the First Circuit in *Young Motor Co. v. Commissioner*,[34] wherein it noted that the statute did not require "a" purpose, but "the" purpose. The Supreme Court, however, refused to attach any significance to this use of the definite article in section 533(a).[35] In addition to characterizing it as "inherently vague," the Court found not only that Congress had failed to import any significance to its inclusion in that section, but also that adoption of the Commissioner's test would more fully effectuate congressional intent.[36]

With the imposition of a test in which virtually any degree of tax avoidance intent on the part of the taxpayer triggers the penalty surtax, the Court was confronted by the objection that it was eliminating any possibility of overcoming the presumption imposed by section

[33] Brief for Petitioner at 12, United States v. Donruss, 393 U.S. 297 (1969).

[34] 281 F.2d 488 (1st Cir. 1960).

[35] The Code provides that unreasonable accumulations "shall be determinative of *the* purpose to avoid the income tax. . . ." INT. REV. CODE of 1954, § 533 (emphasis added). Neither litigant proposed that "*the* purpose" of the accumulation be solely an intent to avoid the surtax. The Commissioner argued that if *one* of the purposes of the accumulation was tax avoidance, liability should be imposed, while the respondent asserted that tax avoidance be the "dominant" purpose. *See* 393 U.S. at 301. *See also* Canty, *supra* note 8, at 252.

[36] 393 U.S. at 307.

533(a). Indeed, it was readily acknowledged that cases in which no tax avoidance design was present would be "isolated." Yet, the Court also emphasized that "purpose means more than mere knowledge, undoubtedly present in nearly every case."[37] Thus, it remains "open for the taxpayer to show that even though knowledge of the tax consequences was present, that knowledge did not contribute to the decision to accumulate earnings."[38]

COMMENTARY

The *Donruss* decision represents the culminant development in the continuing attempt to strengthen the Commissioner's posture in a section 533(a) presumption dispute.[39] The subjective intent of the taxpayer has diminished in relevance, and the surtax is now imposed with little regard for the purposes underlying the accumulation — as long as the accumulation is deemed unreasonable. Although the courts previously were permitted to determine intent even if the accumulation under scrutiny was regarded as reasonable,[40] reasonableness is now, in effect, the sole determinant in the accumulated earnings tax complex. In the course of its opinion, the *Donruss* Court noted:

> The reasonableness of an accumulation, while subject to honest difference of opinion, is a much more objective inquiry, and is susceptible of more effective scrutiny, than are the vagaries of corporate motive.[41]

Nevertheless, it is clear that the Supreme Court has yet to delineate the proper standard to be utilized in arriving at a final determination of "reasonableness." At present, "reasonableness" is defined in terms

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[37] *Id.* at 309. Mr. Justice Harlan, dissenting in part, felt the majority's test removed from the taxpayer a "last clear chance." He favored a test which would impose liability if:

> [the jury] finds that the taxpayer would not have accumulated earnings *but for* its knowledge that a tax saving would result.

Id. at 313 (emphasis added).

[38] 393 U.S. at 309.

[39] This process began more than thirty years ago. *See* S. REP. No. 1567, 75th Cong., 3d Sess. (1938):

> The proposal is to strengthen the evidentiary section by requiring the taxpayer by a clear preponderance of the evidence to prove the absence of any purpose to avoid surtaxes upon shareholders. . .

Id. at 5 (emphasis added). *See also supra* note 16 and accompanying text.

[40] *See* Appollo Indus., Inc. v. Commissioner, 358 F.2d 867 (1st Cir. 1966), holding that in spite of the reasonableness of the taxpayer's accumulations, inquiry into his state of mind was still permissible. *See also* Carolina Rubber Hose Co. v. Commissioner, 24 CCH Tax Ct. Mem. 1159, 1171 (1965):

> After determining reasonable needs we must still determine whether petitioner was availed of during these years to avoid tax on its stockholders by permitting its earnings and profits to accumulate instead of being divided or distributed. . . .

[41] 393 U.S. at 307.

of the "reasonably prudent businessman,"[42] a standard which, despite obvious difficulties, has found favor in other areas of tax law.[43] In determining the reasonable needs of a particular business, the judiciary has variously emphasized several key factors, including objective need[44] and utilization of the retained earnings in the business of the corporation[45] within a reasonable time, with definite plans set forth for future use.[46] In addition, great latitude has generally been permitted in both the purchase of an asset and the replacement of capital.[47] It has been rather difficult, however, to delineate adequate standards for the accumulation of working capital.[48] One attempted solution, providing that earnings retained as working capital could equal one year's operating expenses, has proven inadequate simply because the individual need for liquid assets varies greatly from one corporation to another.[49] An attempt to establish a ratio of current assets to liabilities has also been deemed unsatisfactory.[50] In *Dixie, Inc. v. Commissioner*,[51] the

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42 *See* Mr. Justice Harlan's dissent in *Donruss*. In discussing the concept of foreseeability, the standard applied in the law of torts, *i.e.*, the "last clear chance," is applied to the law of tax. 393 U.S. at 310. *See also* 7 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 39.37(a), at 69 (rev. ed. 1966).

43 *See, e.g.*, Treas. Reg. § 1.537-1 (1968). Under the "reasonably prudent businessman" test, the Commissioner will disallow surtax credit for an initially unreasonable accumulation which later, due to unforeseeable circumstances, becomes reasonable.

44 *See id.* § 1.537-2, which sets forth various objective tests. *See also* Bardahl Mfg. Corp. v. Commissioner, 24 CCH Tax Ct. Mem. 1030 (1965). *Cf.* Trethewey, *Effective Use of Statistical Analysis to Fend Off 531 Attack*, 30 J. TAX. 80 (1969).

45 *See* Treas. Reg. § 1.537-3 (1968). To receive a credit for an investment in another corporation, the taxpayer-corporation must establish that the corporation in which it has invested is a "mere instrumentality," or that the taxpayer-corporation own a minimum of 80 percent of the voting stock of the corporation in which it has invested. Personal holding and investment companies are specifically excluded from this provision.

46 *See id.* § 1.537-1. *Accord*, Fenco, Inc. v. United States, 234 F. Supp. 317, 323-24 (D. Md. 1964).

Several other factors, including the prior policy of the corporation in regard to retention of earnings and dividends, business expansion, the percentage of earnings distributed, and possible tax savings have been considered relevant. *See* J. MERTENS, *supra* note 42, § 39.32 at 72. In addition, anticipated business competition, United States v. Duke Laboratories, Inc., 337 F.2d 280 (2d Cir. 1964), and expansion of business activities, J. MERTENS, *supra* note 42, § 39.38 at 62, have been held to justify accumulations of earnings. On the other hand, a corporate loan to a shareholder is viewed as an indication that the corporation has excess capital. *Id.* § 39.36 at 80. *See also* Treas. Reg. § 1.533(a)(2)(ii) (1968). It is also clear that a fund for unanticipated emergencies will not be regarded as a reasonable business need. Bardahl Mfg. Corp. v. Commissioner, 34 P-H Tax Ct. Mem. ¶ 65,200 (1965). *See generally* S. WEITHORN & R. NOALL, *supra* note 13, at 21-41.

47 *See, e.g.*, Electric Regulator Corp. v. Commissioner, 336 F.2d 339, 346-47 (2d Cir. 1964); Casey v. Commissioner, 267 F.2d 26 (2d Cir. 1959).

48 *See, e.g.*, F. E. Watkins Motor Co. v. Commissioner, 31 T.C. 288, 299 (1958); J. L. Goodman Furniture Co. v. Commissioner, 11 T.C. 530 (1948).

49 *See, e.g.*, Harry A. Koch Co. v. Vinal, 228 F. Supp. 782, 785 (D. Neb. 1964); Bremerton Sun Publ. Co. v. Commissioner, 44 T.C. 566 (1965).

50 *See, e.g.*, United States v. R. C. Tway Coal Sales Co., 75 F.2d 336 (6th Cir. 1935).

51 277 F.2d 526 (2d Cir. 1960).

Court of Appeals for the Second Circuit noted that while such a "rule of thumb" may be proper for administrative convenience, the limits of its utility should be recognized.[52] As inordinate reliance upon such touchstones is to be avoided, "the search must always be concerned with the needs of a particular business as they existed during the particular year."[53] The difficulty in establishing the "reasonableness" of an accumulation is thus apparent. It is submitted that since neither test has proven adequate, a new standard, possibly relating to custom and usage within the industry, must be developed. One might also question whether it will still be possible to introduce subjective evidence tending to establish that different corporations within the same or a related industry may have greatly different needs which are not readily ascertainable. Additionally, assuming that an objective standard is adopted, will it be possible for a corporation to accumulate earnings with an intent to evade taxes and yet remain within the boundaries of "reasonable need"?[54]

The Supreme Court has seriously weakened section 533(a)'s rebuttable presumption of tax avoidance, placing a virtually irrebuttable one in its stead. Clearly such a result is contrary to the intent of a Congress which had expressly rejected a proposed irrebuttable presumption.[55] Yet *Donruss* establishes that a corporation is "availed of" for the purpose of tax avoidance whenever that purpose is one of several objectives, irrespective of whether it is the impelling or dominant purpose. Accordingly, although a taxpayer may still rebut the presumption of tax avoidance, the countervailing evidence must effectively negate all aspects of intent. Thus, the *Donruss* interpretation actually discourages knowledge and understanding of the law. Judge Learned Hand noted in *Helvering v. Gregory*[56] that "anyone may so arrange his affairs that his taxes shall be as low as possible; he is not

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[52] *Id.* at 528.

[53] *Id.* The need for a sound method of determining reasonability has been demanded for:

> [a] clear disclosure of the method by which the Court computed the working capital required would not only go a long way to dispose of the issues . . . but could be useful to the legal and accounting professions. . . .

Smoot Sand & Gravel Corp. v. Commissioner, 241 F.2d 197, 207 (4th Cir. 1957).

A method of determining reasonableness which has yet to be thoroughly examined by the courts is the "operating cycle formula." *See* Bardahl Mfg. Corp. v. Commissioner, 25 CCH Tax Ct. Mem. 935 (1966); Bardahl Int'l Corp. v. Commissioner, 24 CCH Tax Ct. Mem. 1030 (1965).

[54] *See, e.g.*, United Business Corp. v. Commissioner, 62 F.2d 754 (2d Cir.), *cert. denied*, 290 U.S. 635 (1933), wherein the accumulation was reasonable, but the taxpayer's evasive state of mind permitted the imposition of tax liability. *See also* note 40 *supra* and accompanying text.

[55] *See* S. REP. No. 1567, 75th Cong., 3d Sess. 5 (1935).

[56] 59 F.2d 809 (2d Cir. 1934).

bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."[57] *Donruss*, on the other hand, compels the imposition of the penalty surtax where the corporation fails to establish shareholder ignorance of possible tax savings. Indeed, it is clear that a "jury is very likely to believe that it must find the forbidden purpose and impose the tax whenever the Government shows that the taxpayer has accumulated earnings with knowledge of the resultant tax saving. . . ."[58] Although the Supreme Court indicated that "purpose" means more than mere knowledge, it never clearly delineated that distinction, and on a practical level, the two concepts remain indistinguishable.

Significantly, the Code's presumption of tax avoidance is not triggered until the unreasonableness of an accumulation is established. Accordingly, *Donruss* exaggerates the functional value of the taxpayer's ability to shift the burden of proof as to the reasonableness of the accumulation to the Commissioner.[59] Yet many commentators have expressed doubt that this procedural device renders any real assistance to the taxpayer.[60] Indeed, the statement procedure is available only at the Tax Court level. In sum, then, the *Donruss* interpretation merely aggravates the abuses which Congress attempted to remedy in the 1954 Code. The impact of *Donruss* upon the intended function of the accumulated earnings tax further thwarts legislative intent. If the penalty

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[57] *Id.* at 810.

[58] 393 U.S. at 311 (Harlan, J., dissenting in part).

[59] *See* INT. REV. CODE of 1954, § 534. *See also* note 12 *supra* and accompanying text. In deciding a section 534 pre-trial motion, the court does not adjudicate the truthfulness of the allegations, but merely shifts the burden of proof to the Government. Raymond P. Smith, Inc. v. Commissioner, 292 F.2d 470 (9th Cir. 1961); Chatham Corp. v. Commissioner, 48 T.C. 145 (1967).

[60] One commentator has labeled any protection afforded a taxpayer by section 535 "illusory." *See* Pye, *Section 535 and the Shiftless Burden of Proof*, 51 A.B.A.J. 784 (1965). *See also* Nelson, *Recent Trends Regarding Unreasonable Accumulations of Surplus*, 43 TAXES 857 (1965). The author contends the Congress underestimated the "ingenuity" of the Service in "emasculating" the procedural advantages this provision provides for the taxpayer. *Id.* at 862. The Service merely denies the allegations of the corporation, *id.*, or alternatively contends that the statement is not sufficiently clear and specific. *See, e.g.*, Shaw-Walker Co. v. Commissioner, 34 P-H Tax Ct. Mem. ¶ 65,308 (1965). These practices, coupled with a court's refusal to adjudicate the sufficiency issue prior to trial, compel the taxpayer to proceed under the assumption that the burden of proof must be borne by the corporation. *Compare* Carolina Rubber Hose Co. v. Commissioner, 34 P-H Tax Ct. Mem. ¶ 65,229 (1965) *and* Barrow Mfg. Co. v. Commissioner, 294 F.2d 79 (5th Cir. 1961) *with* Chatham Corp. v. Commissioner, 48 T.C. 145 (1967). *See also* Grossman, *Section 531 Problems Including One Bardahl Formula*, 45 TAXES 913, 919 (1967); Simons, *The Gathering Storm of Section 531 of Our Tax Laws*, 44 TAXES 528, 535 (1966). In addition, this development deprives the corporation of the advantage it would ordinarily possess in pre-trial proceedings with the Service. *See generally* Note, *The Accumulated Earnings Tax — Sections 531-37 of the 1954 Code*, 64 NW.U.L. REV. 239, 242-43 (1969).

concept is to be preserved,[61] the burden should not be one of proving reasonableness but rather should focus upon whether there has been a conscious effort to avoid payment of the tax — even though the questioned accumulation may be reasonable.[62]

Since the requisite motive is unlikely to appear in the context of public ownership, the effect of the accumulated earnings tax has been confined principally to closely-held corporations.[63] Accordingly, one commentator has questioned whether the surtax inhibits the growth of small corporations or precludes companies from growing as they otherwise might.[64] Under the *Donruss* interpretation, the penalty surtax will, in the absence of exceptional circumstances, be levied upon *all* unreasonable accumulations. Thus, in order to avoid imposition of the

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61 One commentator has suggested that the tax was never an effective penalty. *See* Rudick, *Effect of the Corporation Income Tax on Management Policies*, 2 How. L.J. 232, 285-86 (1956).

62 In Casey v. Commissioner, 267 F.2d 26, 32 (2d Cir. 1959), Judge Learned Hand stated his belief "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." Thus, the penalty surtax could not be levied if a corporation honestly believed the unreasonable accumulation was in fact reasonable. However, it appears that the judiciary often utilizes an objective, rather than a subjective, standard of reasonable needs. For example, in many instances a plea of good faith is simply not a credible defense for a grossly unreasonable accumulation. And even when the accumulation is not obviously unreasonable, protestations of innocence by corporate officers are generally outweighed by the actual conduct of the corporation. *See* J. MERTENS, *supra* note 42, § 39.26, at 47-48.

63 *See* Canty, *supra* note 8, at 246. *See also* Rudick, *supra* note 61, at 244, in which the author states:

> So far as large publicly-owned corporations are concerned, the importance of the section as an economic factor can be dismissed. The managers of large corporations are sophisticated enough taxwise to know that they are immune from worry about the section.

Citing Kales v. Woodworth, 32 F.2d 37 (6th Cir. 1929). The author continues:

> With rare exceptions, they want to pay as high dividends as they feel they safely can, bearing in mind contemplated expansion and other business requirements, and they know that if they improperly accumulate the income, they will be brought to task by the stockholders perhaps faster than by the Government.

Id. See also Trico Prods. Corp. v. Commissioner, 137 F.2d 424 (2d Cir. 1943) discussed at note 18 *supra*.

A further inherently discriminatory effect of the tax lies in the fact that it is often advantageous for high income bracket shareholders to pay the penalty surtax at its static rates, rather than at the progressive rates levied upon individual income. Under the Code, personal income taxes range marginally from 14 to 70 percent, while the maximum tax rate for a corporation is 48 percent. *See* INT. REV. CODE of 1954, §§ 1, 11. *See also* Cummins Diesel Sales, Inc. v. United States, 207 F. Supp. 746 (D. Ore. 1962), *aff'd*, 321 F.2d 503 (9th Cir. 1963).

Several measures have been suggested as alternatives to declaration of a dividend. However, most involve basic corporate restructuring. *See* Sullivan, *Planning to Avoid the Section 531 Tax*, 17 W. RES. L. REV. 763 (1966). The possible alternatives include: (1) incorporation with substantial debt; (2) operation in unincorporated form; (3) subchapter S election; (4) additional minimum accumulated earnings credit; (5) personal holding or investment companies; (6) foreign subsidies; and (7) liquidation.

64 *See* Rudick, *supra* note 61, at 247.

tax, a corporation is encouraged to declare dividends it otherwise would not, rather than develop farsighted plans for future expansion. One might also contend that the resultant conservative accumulation policy precludes a corporation from retaining sufficient capital for use during a period of depression.[65] This development would, of course, have a deleterious effect upon the economy since it would tend to accentuate inflationary and deflationary trends.[66] In addition, it is possible that the surtax stimulates acquisitions, thereby tending to concentrate business enterprise.[67] On the other hand, adoption of the dominant motive test would enable the corporation to retain earnings as long as it could establish that one of its purposes was bona fide, and that this purpose was equal to or more than the tax avoidance motive.

The *Donruss* quest for certitude has, in fact, resulted in the perversion of the penalty surtax. Refusing to grapple with the nebuli of intent, the Court has established that a corporation is "availed of" for the purpose of tax avoidance whenever that purpose is one of several objectives, regardless of whether it is the impelling or the dominant motive. Indeed, the avoidance of the penalty surtax now mandates either corporate justification of retained earnings or a drastic alteration of the corporate structure.[68]

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[65] *Id.* at 238-39. The Second Circuit Court of Appeals noted in Electric Regulator Corp. v. Commissioner, 336 F.2d 339, 346 (2d Cir. 1964), that: "If the Tax Court's views . . . were to be accepted, they would give to the Treasury virtually absolute power to stifle or encourage economic growth."

[66] Rudick, *supra* note 61, at 246.

[67] *See* Hall, *Revision of the Internal Revenue Code and Section 102*, 8 NAT. TAX J. 275 (1955); THE TAXATION OF CORPORATE SURPLUS ACCUMULATIONS, A STUDY PREPARED FOR THE JOINT COMMITTEE ON THE ECONOMIC Rep. No. 1, 82d Cong., 2d Sess. (1952).

[68] *See* note 64 *supra.*