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LEGISLATION

SECTION 102 AND THE FORBIDDEN PURPOSE

Introduction

The authors of the first modern income tax law,[1] conscious of forbidding practical difficulties and perhaps influenced by the existing English law, never considered taxing corporate income directly to the stockholders.[2] Thus, as if by default, the doctrine that corporations are taxable entities, separate and distinct from their shareholders, found its way into the federal tax structure. With but a few notable exceptions,[3] this doctrine has survived until the present time.[4] Accordingly, it has been the theory of the income tax laws to tax corporate profits immediately to the corporation, and their receipt to the stockholders only upon distribution as dividends.[5] Under such a system, when higher rates of tax are imposed on individuals than on corporations,[6] it is obviously advantageous for the individual to use the corporate personality to collect his income. The retention, rather than the distribution, of earnings by the corporation would enable the investor to avoid personal income taxes on the accumulated profits which he may neither presently need nor desire.[7] This initial postponement of the receipt of income is not the only benefit gained by the stockholder; he is also free to select less tax-burdensome methods [8]

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[1] Revenue Act of 1913, § IIA, 38 STAT. 114, 166 (1913).

[2] Ballantine, *Corporate Personality in Income Taxation*, 34 HARV. L. REV. 573, 574 (1921).

[3] Prominent among the corporations meriting special tax treatment are personal service corporations, INT. REV. CODE §§ 391-396, and personal holding corporations, *id.* §§ 500-511.

[4] Stickells, *Corporate Entity and Taxation*, 29 B. U. L. REV. 486 (1949); see Finkelstein, *The Corporate Entity and the Income Tax*, 44 YALE L. J. 436 (1935).

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

[6] *Compare* INT. REV. CODE §§ 11 and 12 (tax on individuals), *with* §§ 13, 15 and 430 (tax on corporations). The imposition of the excess profits tax and higher normal and surtax rates on corporations has reduced the usual disparity between the tax rates.

[7] Rudick, *Section 102 and Personal Holding Company Provisions of the Internal Revenue Code*, 49 YALE L. J. 171 (1939).

[8] The sale of the now more valuable shares enables the stockholder to realize these profits, subject only to the smaller capital gains tax. INT. REV. CODE § 117. If the shares are held and transmitted on the stockholder's death, their basis for capital gains purposes in the hands of the heirs is the fair market value of the stock at time of death. *Id.* § 113(a)(5).

or occasions [9] to receive these earnings. The judicious use of such a plan could conceivably result in a substantial reduction in the investor's tax burden.

The Congressional desire for an administratively simple tax statute did not blind its members to the possible misuse of the corporate presence. The threat presented to the taxing power and to the governmental fiscal policy has always been recognized.[10] As a result, provisions designed to prevent the improper retention of corporate earnings have been included in all the Revenue Acts.[11] Section 102 of the Internal Revenue Code is the present contraceptive provision which imposes a deterring penalty tax on corporations whose use as a convenient storehouse for unwanted earnings was prompted by the shareholders' desire for smaller personal taxes. The statute [12] declares any accumulation of earnings by a corporation to be wrongful, and therefore subject to a penalty,[13] when made with the intention of preventing the imposition of surtaxes upon its shareholders. The assessment of the penalty tax against the corporation [14] acts to reduce or eliminate the disparity between the individual tax rate and that of the corporation. Once the opportunity to reduce tax expense is lost, the incentive for the wrongful use of the corporate entity is removed and the effectiveness of the Revenue Act thereby restored.

After a lifetime of almost forty years, it seems reasonable to expect that Section 102 would provide a satisfactory solution to the corporate entity "loophole." Unfortunately, however, its administra-

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[9] Dividends may be declared in years when the stockholder's other income has declined, when personal needs are greater or when individual tax rates are lower.

[10] Rudick, *supra* note 7, at 172.

[11] Buck and Shackelford, *Retention of Earnings by Corporations Under the Income Tax Laws*, 36 Va. L. Rev. 141 (1950). This article contains an excellent summary of the legislative and administrative history of Section 102.

[12] "There shall be levied, collected and paid for each taxable year [a surtax] . . . upon the net income of every corporation . . . if such corporation . . . is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation through the medium of permitting earnings or profits to accumulate instead of being divided or distributed . . . ." Int. Rev. Code § 102(a). While the tax is placed on corporations "formed" as well as "availed of" for the wrongful purpose, cases seldom arise where the formation of the corporation has been sufficient to sustain the penalty. *See* Nipoch Corp. v. Commissioner, 36 B. T. A. 662, 668 (1937). This discussion is therefore limited to corporations "availed of" for the forbidden use.

[13] The penalty surtax is levied against the undistributed "section 102 net income" as defined by § 102(d). The present surtax rates are 27½% and 38½%. Int. Rev. Code § 102(a).

[14] The Revenue Acts from 1913 to 1918 imposed the penalty directly on the stockholder by adding to his income his aliquot share of the corporation's net earnings. The decision in Eisner v. Macomber, 252 U. S. 189 (1920), created doubt as to the constitutionality of this method and the penalty thereafter was shifted to the corporation. Buck and Shackelford, *supra* note 11, at 159-161. There is some support for the belief that a return to the original method of taxing would be constitutional. Rudick, *supra* note 7, at 218.

tive history has been filled with uncertainty [15] and the problems raised by its presence are many and deep-rooted.[16] But in spite of these difficulties, the courts have interpreted its provisions, and have outlined its applicability to particular fact situations in a manner which permits a general, yet definite, analysis. It is the purpose here to examine the statute, in the light of these interpretations, with emphasis on the statutory test for determining corporate liability and the methods devised to enable the section to effectively fulfill its vital function.

The Touchstone of Liability

The touchstone of liability under Section 102 is the *purpose* behind the accumulation of the income and *not* the *consequences* of the accumulation.[17] It must be the intention of the stockholders to evade the payment of personal income taxes,[18] and this aim must be accomplished by permitting the earnings to lie in the corporate treasury instead of being distributed to the stockholders.[19] It is not enough that earnings have accumulated and that, as a result, the stockholders' tax burden has been lessened.[20] Before the corporation can be subject to the statutory penalty, the court must find as a matter of fact that the condemned intention existed.[21] As aids in determining the state of mind of the stockholder-director, the courts have properly relied on the circumstantial factors surrounding, and arising out of, the taxpayer's actions.[22] Care has been taken to distinguish between "purpose" and "effect"; yet the inference that the ". . . effect of a voluntary act is among the purposes of the actor. . . ." [23] has been correctly considered.

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[15] Cary, *Accumulations Beyond the Reasonable Needs of the Business: The Dilemma of Section 102(C)*, 60 HARV. L. REV. 1282 (1947).

[16] The theory of Section 102, *viz.*, to force dividend distributions, conflicts with some well founded theories. Among these may be included the following: the acknowledged right of every business to grow. *See* William C. De Mille Productions, Inc. v. Commissioner, 30 B. T. A. 826, 830 (1934); the discretionary power of management to determine whether dividends are to be declared, and the economic importance of "ploughed back" earnings. Discussions of these points, which are not covered herein, may be found in Heninger, *Federal Taxation of Corporate Surpluses*, 28 IOWA L. REV. 639 (1943); Lasser and Holzman, *The 102 Cases*, 3 TAX L. REV. 119 (1947); and 57 YALE L. J. 474 (1948).

[17] 7 MERTENS, LAW OF FEDERAL INCOME TAXATION § 40.08 (1943).

[18] Heninger, *supra* note 16, at 639, 640.

[19] INT. REV. CODE § 102(a).

[20] R. L. Blaffer & Co. v. Commissioner, 37 B. T. A. 851 (1938), *aff'd*, 103 F. 2d 487 (5th Cir.), *cert. denied*, 308 U. S. 576 (1939).

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

[22] See Rudick, *supra* note 7, at 189.

[23] R. L. Blaffer & Co. v. Commissioner, 37 B. T. A. 851, 856 (1938).

The corporation has the burden of coming forward with the proof [24] and of overcoming the inference of forbidden purpose which arises from a reduction in its stockholders' tax burden.[25] Here, as in tax cases generally, a determination by the Commissioner that the corporation possessed the interdicted purpose is presumed to be correct and must be disproven by competent evidence.[26] First the taxpayer, and then the Commissioner, offer evidence which is usually circumstantial in nature since it seeks to prove a state of mind. While these circumstantial factors vary in every case and those which are important in one situation may be unimportant in another, all of the cases have shown that the corporation involved was closely-held or closely-controlled.[27] The other circumstantial factors may be generally grouped into three classifications: first, those which help prove the presence of the wrongful intent; second, those establishing lack of intent; and third, those with little or no evidentiary value.

Among those factors which help prove the wrongful intent have been: loans to shareholders or the expenditure of corporate funds for their personal benefit; [28] investment of undistributed earnings in assets having no reasonable connection with the business; [29] and a showing that the stockholders, who saved the income tax,[30] had no

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[24] U. S. Treas. Reg. 111, § 29.102-2 (1943).

[25] Since the statute was designed to prevent tax savings by stockholders through the withholding of corporate dividends, it seems patently inapplicable when no tax saving is accomplished. *See* A. D. Saenger, Inc. v. Commissioner, 84 F. 2d 23, 24 (5th Cir.), *cert. denied,* 299 U. S. 577 (1936).

[26] See note 24 *supra.*

[27] See chart of decisions, Buck and Shackelford, *supra* note 11, at 353 (appendix).

[28] Helvering v. National Grocery Co., 304 U. S. 282 (1938); Whitney Chain & Manufacturing Co. v. Commissioner, 149 F. 2d 936 (2d Cir. 1945); J. M. Perry & Co. v. Commissioner, 120 F. 2d 123 (9th Cir. 1941); United Business Corp. of America v. Commissioner, 62 F. 2d 754 (2d Cir. 1933); Christmann Veneer & Lumber Co., 4 CCH 1945 TC MEM. DEC. 529 (1945); U. S. Treas. Reg. 111, § 29.102-2 (1943).

[29] Helvering v. National Grocery Co., *supra* note 28; Whitney Chain & Manufacturing Co. v. Commissioner, *supra* note 28; Becton, Dickinson & Co. v. Commissioner, CCH 1942 BTA MEM. DEC. ¶ 12,800-A (1942), *aff'd,* 134 F. 2d 354 (3d Cir. 1943); Eastern Railway & Lumber Co., 12 T. C. 869 (1949); U. S. Treas. Reg. 111, § 29.102-2 (1943).

[30] INT. REV. CODE § 148(c) requires that the Commissioner, on request, be provided with a statement of accumulated corporate earnings and the names of shareholders entitled to the same on distribution, together with the amount payable to each. This information enables the Commissioner to compute and offer as evidence the tax saving produced. Courts have considered the tax saving as evidence of the wrongful intent. Helvering v. National Grocery Co., 304 U. S. 282 (1938); World Publishing Co. v. United States, 72 F. Supp. 886 (N. D. Okla. 1947), *aff'd,* 169 F. 2d 186 (10th Cir. 1948), *cert. denied,* 335 U. S. 911 (1949); McCutchin Drilling Co. v. Commissioner, 143 F. 2d 480 (5th Cir. 1944); Trico Products Corp. v. Commissioner, 46 B. T. A. 346 (1942), *aff'd,* 137 F. 2d 424 (2d Cir. 1943), *cert. denied,* 320 U. S. 799 (1943). *But cf.* Wean Engineering Co., 2 CCH 1943 TC MEM. DEC. 510 (1943); Dietze & Co., 1 CCH 1942 TC MEM. DEC. 93 (1942). See note 25 *supra.*

need for additional income by way of dividends.[31] The source of earnings,[32] a change to a conservative dividend policy when individual tax rates increase[33] and a radical change in the business enterprise after profits have been accumulated[34] have also been said to evidence the objectionable design.

The mere absence of the items proving intent,[35] the retention of a surplus reasonably necessary for business needs,[36] and the setting of the dividend policy by a minority stockholder or by one who benefits but little from the failure to distribute,[37] constitute the factors showing lack of intent. The group of relatively unimportant elements includes the categorical denial of the illegal objective by a managing stockholder,[38] and the distribution by the corporation of a "large portion" of its earnings for the year in question.[39]

Even though the test of liability is the intention motivating the corporate course of action,[40] the aim of avoiding surtaxes need not be the only or even predominant reason for withholding dividends.[41] "It is sufficient if it is one of the determining purposes. . . ."; [42] indeed it has been said that the taxpayer must prove a complete lack of the condemned intent.[43] Even a valid, demonstrated purpose for the

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[31] World Publishing Co. v. United States, *supra* note 30; Trico Products Corp. v. Commissioner, *supra* note 30.

[32] R. & L., Inc. v. Commissioner, 84 F. 2d 721 (5th Cir. 1936); *see* California Motor Transport Co. Ltd., 1 CCH 1943 TC MEM. DEC. 974, 979 (1943).

[33] *See* United Business Corp. of America v. Commissioner, 62 F. 2d 754, 755 (2d Cir. 1933).

[34] U. S. Treas. Reg. 111, § 29.102-3 (1943).

[35] Lane Drug Co., 3 CCH 1944 TC MEM. DEC. 394 (1944); Metal Mouldings Corp., 1 CCH 1943 TC MEM. DEC. 616 (1943); Flint Ink Co., CCH 1942 BTA MEM. DEC. ¶ 12,591-B (1942).

[36] United States v. R. C. Tway Coal Sales Co., 75 F. 2d 336 (6th Cir. 1935); William C. Atwater & Co., 10 T. C. 218 (1948).

[37] Universal Steel Co., 5 T. C. 627 (1945); Smokeless Fuel Co., 2 CCH 1943 TC MEM. DEC. 794 (1943).

[38] "The testimony of interested witnesses . . . must be given consideration and accorded the weight to which it is entitled but it may be less persuasive than the surrounding circumstances." World Publishing Co. v. United States, 72 F. Supp. 886, 889 (N. D. Okla. 1947), *aff'd*, 169 F. 2d 186 (10th Cir. 1948), *cert. denied*, 335 U. S. 911 (1949). *Accord*, Gibbs & Cox, Inc. v. Commissioner, 2 CCH 1943 TC MEM. DEC. 688 (1943), *aff'd*, 147 F. 2d 60 (2d Cir. 1945). See Hanovia Chemical & Manufacturing Co., 2 CCH 1943 TC MEM. DEC. 822 (1943); Florida Iron & Metal Co. of Jacksonville, CCH 1942 BTA MEM. DEC. ¶ 12,585-B (1942).

[39] See note 24 *supra*.

[40] Cecil B. De Mille Productions, Inc. v. Commissioner, 31 B. T. A. 1161 (1935), *aff'd*, 90 F. 2d 12 (9th Cir.), *cert. denied*, 302 U. S. 713 (1937).

[41] Trico Products Corp. v. McGowan, 67 F. Supp. 311 (W. D. N. Y. 1946), *aff'd*, 169 F. 2d 343 (2d Cir.), *cert. denied*, 335 U. S. 899 (1948).

[42] World Publishing Co. v. United States, 169 F. 2d 186, 189 (10th Cir. 1948).

[43] R. L. Blaffer & Co. v. Commissioner, 37 B. T. A. 851, 856 (1938), *aff'd*, 103 F. 2d 487 (5th Cir.), *cert. denied*, 308 U. S. 576 (1939). See Whitney Chain & Manufacturing Co. v. Commissioner, 3 T. C. 1109 (1944), *aff'd*, 149 F. 2d 936 (2d Cir. 1945).

retention of earnings might be ". . . not inconsistent with another purpose to reduce income taxes. . . ."[44]

Statutory Aids for Proving Intent

The nebulous nature of the test of liability and the almost complete reliance upon circumstantial proof convinced Congress that the Commissioner needed additional aid in enforcing Section 102.[45] The assistance provided consisted of two statutory presumptions in the Commissioner's favor which relate to the forbidden purpose and by which guilt is imputed to the corporation.[46] The effect of both presumptions has been to ease greatly the Commissioner's burden of proof while concomitantly increasing that of the taxpayer; the effect of the second inference frequently has been to change the question of fact to be litigated.

The first of these presumptions is limited to mere "holding"[47] or "investment"[48] companies and makes the nature of these corporations ". . . prima facie evidence of a purpose to avoid surtax upon shareholders."[49] Such a provision gives ". . . further weight to the presumption of correctness already arising from the Commissioner's determination. . . ."[50] of the illegal purpose and is in the nature of an "additional presumption."[51] To overcome its force, the taxpayer must show by clear and convincing evidence that the corporation was not used to avoid personal surtaxes.[52]

The second, and more important, of these presumptions applies to all corporations,[53] including operating companies. It declares that the accumulation of corporate earnings or profits, beyond reasonable business needs, shall be "determinative" of the purpose to avoid surtax unless, by a clear preponderance of the evidence, the corporation

[44] Nipoch Corp. v. Commissioner, 36 B. T. A. 662, 668 (1937).

[45] See Rudick, *supra* note 7, at 185.

[46] *Ibid.*

[47] "A corporation having practically no activities except holding property and collecting the income therefrom or investing therein . . . ." U. S. Treas. Reg. 111, § 29.102-2 (1943).

[48] A corporation whose ". . . activities further include, or consist substantially of, buying and selling stocks, securities, real estate, or other investment property . . . so that the income is derived not only from the investment yield but also from profits upon market fluctuations . . . ." U. S. Treas. Reg. 111, § 29.102-2 (1943).

[49] INT. REV. CODE § 102-b. "[T]here has been no current objection to subsection (b), which provides that the fact that any corporation is merely a holding or investment company shall be prima facie evidence of the purpose to avoid surtax. This subsection strikes at the most obvious technique of avoidance." Cary, *supra* note 15, at 1283.

[50] U. S. Treas. Reg. 111, § 29.102-2 (1943).

[51] *Ibid.*

[52] *Ibid.*

[53] The statute expressly fails to cover personal holding companies or foreign personal holding companies. INT. REV. CODE § 102(a). It also fails to apply to corporations exempt from ordinary corporate tax and those corporations formed to avoid imposition of surtaxes in a way other than by accumulating earnings. 7 MERTENS, *op. cit. supra* note 17, § 40.01.

proves that no such purpose exists.[54] This does not mean that an excessive accumulation of profits will automatically subject the corporation to the penalty. Under the proper conditions, that is, when the improper objective is missing, no tax will apply.[55] The statute does mean, however, that when the Commissioner has proven an unreasonable [56] retention of earnings, a heavy and frequently unbearable burden of proof [57] is placed on the accused taxpayer.

Before this burden can pass to the corporation, the court must solve a new question of fact, *viz.*, "Were earnings accumulated beyond business needs?" In the solution of this problem, courts have realized that there is no rigid formula nor set standards of measurement to be relied upon.[58] Each case must turn on its own facts. Therefore, because the statute makes the determination of possible excess retention a judicial question,[59] judges have cast themselves in the roles of corporate managers and, acting in said roles, have carefully weighed the individual corporate resources and earnings against the corporate needs.

In the judicial evaluation of resources and earnings, reliance has been placed upon the size of the corporate surplus,[60] and the amount of cash and other "quick assets" available.[61] The nature of the business,[62] earnings [63] and their predictability,[64] especially in face of

[54] INT. REV. CODE § 102(c). This language was incorporated into the law in 1938. Revenue Act of 1938, § 102(c), 52 STAT. 483 (1938). Prior to that time, the law provided that the accumulation of earnings beyond reasonable business needs created only a prima facie presumption of the prohibited purpose. Although the change was dismissed lightly at the time (Rudick, *supra* note 7, at 179) the rationale of the great majority of decisions now emphasizes unreasonable accumulation rather than intent. 57 YALE L. J. 474, 477 (1948).

[55] World Publishing Co. v. United States, 72 F. Supp. 886 (N. D. Okla. 1947).

[56] U. S. Treas. Reg. 111, § 29.102-3 (1943), expressly permits the proper accumulation of income, if ". . . retained for working capital needed by the business; or if invested in additions to plant reasonably required by the business; or if in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation."

[57] See note 24 *supra*.

[58] Universal Steel Co., 5 T. C. 627 (1945).

[59] World Publishing Co. v. United States, 72 F. Supp. 886 (N. D. Okla. 1947), *aff'd*, 169 F. 2d 186 (10th Cir. 1948), *cert. denied*, 335 U. S. 911 (1949).

[60] World Publishing Co. v. United States, *supra* note 59; United States v. R. C. Tway Coal Sales Co., 75 F. 2d 336 (6th Cir. 1935); Hanovia Chemical & Manufacturing Co., 2 CCH 1943 TC MEM. DEC. 822 (1943); Metal Mouldings Corp., 1 CCH 1943 TC MEM. DEC. 616 (1943).

[61] Helvering v. National Grocery Co., 304 U. S. 282 (1938); United Block Co. v. Helvering, 123 F. 2d 704 (2d Cir. 1941), *cert. denied*, 315 U. S. 812 (1942); J. M. Perry & Co. v. Commissioner, 120 F. 2d 123 (9th Cir. 1941); Syracuse Stamping Co., 4 CCH 1945 TC MEM. DEC. 371 (1945); John F. Boyle Co., 3 CCH 1944 TC MEM. DEC. 1335 (1944).

[62] See note 34 *supra*.

[63] Beim Co. v. Landy, 113 F. 2d 897 (8th Cir. 1940); Plant Shipping Co., CCH 1942 BTA MEM. DEC. ¶ 12,500-E (1942).

[64] Wean Engineering Co., 2 CCH 1943 TC MEM. DEC. 510 (1943); Becton, Dickinson & Co. v. Commissioner, CCH 1942 BTA MEM. DEC. ¶ 12,800-A (1942), *aff'd*, 134 F. 2d 354 (3d Cir. 1943).

hazardous business [65] or world conditions,[66] have been considered. The inclusion among the assets of investments in unrelated enterprises [67] or accounts receivable arising from loans to or on behalf of stockholders [68] have been treated as indicative of unwarranted accumulations which served no lawful business purpose.[69]

Estimates of business needs have similarly been based on sound management principles. The importance of a good financial position [70] to fulfill expansion needs,[71] the necessity of modernizing and improving plant facilities,[72] and the providing of adequate reserves against possibly injurious litigation,[73] unfavorable legislation,[74] or other hazards [75] have been properly weighed by the courts. Business has been given a right to grow,[76] but its needs must be immediate,[77] definite,[78] rather than nebulous,[79] and within the reasonable pursuit

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[65] Universal Steel Co., 5 T. C. 627 (1945); T. Smith & Son, Inc., 2 CCH 1943 TC MEM. DEC. 740 (1943); Millane Nurseries & Tree Experts, Inc., 1 CCH 1942 TC MEM. DEC. 228 (1942).

[66] Dietze & Co., 1 CCH 1942 TC MEM. DEC. 93 (1942); see Lion Clothing Co., 8 T. C. 1181 (1947).

[67] Helvering v. National Grocery Co., 304 U. S. 282 (1938); Olin Corp. v. Commissioner, 128 F. 2d 185 (7th Cir. 1942); J. M. Perry & Co. v. Commissioner, 120 F. 2d 123 (9th Cir. 1941); Eastern Railway & Lumber Co., 12 T. C. 869 (1949).

[68] KOMA, Inc. v. Commissioner, 189 F. 2d 390 (10th Cir. 1951); McCutchin Drilling Co. v. Commissioner, 143 F. 2d 480 (5th Cir. 1944); Wilkerson Daily Corp. v. Commissioner, 125 F. 2d 998 (9th Cir. 1942); Hut Neckwear Co., 10 CCH 1951 TC MEM. DEC. 801 (1951); Southland Industries, Inc., 5 CCH 1946 TC MEM. DEC. 950 (1946); William C. De Mille Productions, Inc. v. Commissioner, 30 B. T. A. 826 (1934).

[69] Whitney Chain & Manufacturing Co. v. Commissioner, 3 T. C. 1109 (1944), *aff'd*, 149 F. 2d 936 (2d Cir. 1945).

[70] W. S. Farish & Co. v. Commissioner, 104 F. 2d 833 (5th Cir. 1939), *affirming* 38 B. T. A. 150 (1938).

[71] J. L. Goodman Furniture Co., 11 T. C. 530 (1948); Syracuse Stamping Co., 4 CCH 1945 TC MEM. DEC. 371 (1945); General Smelting Co., 4 T. C. 313 (1944).

[72] John F. Boyle Co., 3 CCH 1944 TC MEM. DEC. 1335 (1944); T. Smith & Son, Inc., 2 CCH 1943 TC MEM. DEC. 740 (1943); Metal Mouldings Corp., 1 CCH 1943 TC MEM. DEC. 616 (1943).

[73] William C. Atwater & Co., 10 T. C. 218 (1948).

[74] Albert L. Allen Co., 3 CCH 1944 TC MEM. DEC. 1246 (1944); *see* World Publishing Co. v. United States, 72 F. Supp. 886, 894 (N. D. Okla. 1947).

[75] Lion Clothing Co., 8 T. C. 1181 (1947); Bosch Brewing Co., CCH 1942 BTA MEM. DEC. ¶ 12,592-M (1942).

[76] William C. De Mille Productions, Inc. v. Commissioner, 30 B. T. A. 826 (1934).

[77] World Publishing Co. v. United States, 169 F. 2d 186 (10th Cir. 1948).

[78] KOMA, Inc. v. Commissioner, 189 F. 2d 390 (10th Cir. 1951); Semagraph Co. v. Commissioner, 152 F. 2d 62 (4th Cir. 1945); Colonial Amusement Corp., 7 CCH 1948 TC MEM. DEC. 546 (1948).

[79] Becton, Dickinson & Co. v. Commissioner, CCH 1942 BTA MEM. DEC. ¶ 12,800-A (1942), *aff'd*, 134 F. 2d 354 (3d Cir. 1943).

of the corporate business.[80] Where the litigant corporation has had but one stockholder, courts have said that the need for capital could be as easily met by distributing earnings to its owner, to be returned when the need is pressing, as it could by leaving funds in the treasury.[81]

If, after an examination of all the evidence, the court finds that earnings were needlessly accumulated, the statute treats such finding as "determinative" of the forbidden purpose.[82] The taxpayer must then prove, by a clear preponderance of the evidence, that this unreasonable retention was not prompted by the illegal motive.[83] Treasury Department regulations declare that such proof must show that ". . . the absence of such a purpose is unmistakable." [84] While it has not been impossible for the corporation to sustain this burden,[85] the invocation of the "complete absence of purpose" rule makes the task a very difficult one. Director-stockholders have seemingly been charged with knowledge that the failure to distribute earnings resulted in smaller personal taxes.[86] The courts treat this knowledge as evidence of one of the purposes of the director-stockholder's failure to act,[87] and impute such possible purpose to the corporation. Since

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80 World Publishing Co. v. United States, 169 F. 2d 186 (10th Cir. 1948); U. S. Treas. Reg. 111, § 29.102-2 (1943).

81 Helvering v. National Grocery Co., 304 U. S. 282 (1938); Southland Industries, Inc., 5 CCH 1946 TC MEM. DEC. 950 (1946).

82 INT. REV. CODE § 102(c).

83 *Ibid.*

84 U. S. Treas. Reg. 111, § 29.102-2 (1943). "[T]he Treasury Department is really changing the statute to read that the taxpayer must clearly prove the absence of any surtax avoidance motive instead of merely proving its absence by a 'clear preponderance of the evidence.' There is a definite difference in degree betwen clear proof and a clear preponderance." Buck and Shackelford, *supra* note 11, at 327-328.

85 Gus Blass Co., 9 T. C. 15 (1947). Court found an unreasonable retention of earnings for the fiscal year ending January 31, 1941 but held there was no intention to avoid surtaxes on stockholders. Evidence showed (1) petitioner awaited final audit report in order to definitely ascertain net profits, (2) later distribution almost equalled net profits, and (3) such distribution was included in the stockholders' incomes for calendar year 1941, as would have been the case if the dividends had been declared during the corporation's fiscal period. It is submitted that the combination of fortuitous circumstances relied upon is indicative of the unusual evidence necessary to sustain the burden of proof.

86 "The stockholders knew that distributions would have increased their surtaxes. As petitioner's counsel state, 'Obviously they were not morons.'" Gibbs & Cox, Inc. v. Commissioner, 2 CCH 1943 TC MEM. DEC. 688, 698 (1943), *aff'd*, 147 F. 2d 60 (2d Cir. 1945).

87 "[B]y refraining from distributing any of the earnings the stockholders have avoided substantial surtaxes. That was the effect of their action, and an ordinary presumption is that the effect is among the purposes of the actor." Gibbs & Cox, Inc. v. Commissioner, *supra* note 86.

"The fact that the taxed surplus . . . was accumulated . . . and the further fact that plaintiff's six largest stockholders . . . saved a large federal income tax that would have been imposed upon them had the taxed surplus been distributed, is enough to uphold the taxes in question." Trico Products Corp. v.

any showing of the proscribed purpose, unless negated, is apparently sufficient to support the imposition of the penalty, the corporation's attempts to disprove both the statutory determination of purpose and the evidence of purpose, arising through knowledge,[88] must generally fail. It is submitted that, in the great majority of instances, the determination of purpose, arising from a finding of unreasonable accumulation, is not merely determinative until disproven, but is, for practical purposes, a conclusive finding.

Although the determination of an unreasonable accumulation is almost inevitably followed by a finding of the wrongful purpose,[89] an unreasonable accumulation is not, in itself, another touchstone of liability.[90] The proper test is, and has always been, the "purpose to avoid" surtaxes; the retention of profits is only proof of that purpose.[91] But the nearly irrefutable nature of this proof rescues the tax authorities from the difficulties of establishing a state of mind by circumstantial evidence. Confident that a corporation will but rarely [92] escape liability after an unnecessary accumulation, the Commissioner primarily seeks to prove that such an accumulation has occurred. This attempt makes the essential question to be litigated the more objective one of whether earnings were unnecessarily retained.[93] While this question is at best an abstraction,[94] its solution clearly involves less difficult evidentiary problems than those encountered in establishing a subjective intention.[95] Moreover, its adoption by the courts as a compelling criterion of liability [96] makes the question of an alleged unreasonable accumulation the problem usually [97] presented before the court for a corporate [98] answer.

McGowan, 67 F. Supp. 311, 325 (W. D. N. Y. 1946), *aff'd,* 169 F. 2d 343 (2d Cir.), *cert. denied,* 335 U. S. 899 (1948).

[88] "It seems to us that a naive and credulous tribunal would be required for the assumption that in the confirmed practice of methodical accumulation there was no taint of a purpose to procure so desirable a monetary result for the individuals responsible for the petitioner's decisions." Trico Products Corp. v. Commissioner, 46 B. T. A. 346, 380 (1942), *aff'd,* 137 F. 2d 424 (2d Cir.), *cert. denied,* 320 U. S. 799 (1943).

[89] See Buck and Shackelford, *Retention of Earnings by Corporations Under the Income Tax Laws,* 36 VA. L. REV. 141, 337 (1950).

[90] *Ibid.*

[91] See Cary, *supra* note 15, at 1289.

[92] "[B]ut none of these cases has concerned a corporation with its stock widely-held and its control widely diversified." Buck and Shackelford, *supra* note 89, at 337.

[93] Cary, *Section 102 May Not Be the Menace Some Tax Men Consider it to Be,* 89 J. ACCOUNTANCY 219 (1950).

[94] *Ibid.*

[95] "[T]he reasonable needs of a business . . . [are] . . . immediately within the ken of the managers, [and] the supposititious standard, though indeed objective, being as accessible as those for example of the prudent driving of a motor car . . . ." United Business Corp. of America v. Commissioner, 62 F. 2d 754, 756 (2d Cir.), *cert. denied,* 290 U. S. 635 (1933).

[96] 57 YALE L. J. 474, 478 (1948).

[97] See notes 54 and 93 *supra.*

[98] For a guide to the corporations which the Treasury Department will ex-

Section 102 Appraised

It is easy to recognize the need for Section 102 and to applaud the protection it provides for the tax revenues. The formulation of its test of liability as the "purpose to avoid" personal taxes and the establishment of the several presumptions as enforcement aids are, in light of its important function, both necessary and proper. But, while the statute discourages the misuse of the corporate entity, its imposition is necessarily uncertain [99] and often in conflict with the public policy of encouraging the growth and expansion of private enterprise.[100]

The imposition of the penalty in any particular situation is uncertain because the circumstantial factors which prove either the illegal purpose or the unreasonable accumulation will vary with every corporation.[101] Although the factors may be identified from prior decisions of the courts, no single factor nor combination thereof need always be sufficient to support the penalty.[102] Instead, their materiality, under a specific state of facts, cannot be conclusively determined until they are passed upon by the court.[103] Any determination at that time, if unfavorable, is too late to help the corporation.[104] In this way, director-stockholders, charged with setting a corporate dividend policy and who may conceivably incur personal liability,[105] cannot tell whether the corporation is subject to a tax until it is beyond their power to provide a remedy.[106]

Under these conditions, and with little basis for knowing what tests will be applied in deciding whether profits were needlessly retained,[107] the director-stockholder is forced to act. Whenever reasonable doubt arises as to the applicability of Section 102, dividend distributions will probably be forthcoming. While this is the effect that the statute was designed to produce, there is a very real danger

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amine closely for the possible application of Section 102, see T. D. 4914, 1939-2 CUM. BULL. 108, and T. D. 5398, 1944-1 CUM. BULL. 194.

[99] 57 YALE L. J. 474, 479, 480 (1948).

[100] Cary, *supra* note 15, at 1311.

[101] See note 99 *supra*. See Rudick, *supra* note 7, at 182.

[102] Buck and Shackelford, *supra* note 89, at 339-341.

[103] See note 99 *supra*. As to the question of the review of Tax Court decisions, it is provided: "The Courts of Appeals shall have exclusive jurisdiction to review the decisions of the Tax Court . . . in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury; and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari . . . ." INT. REV. CODE § 1141(a).

[104] See Heninger, *supra* note 16, at 640.

[105] This problem, which arises upon the payment by the corporation of a penalty tax under Section 102 is discussed in Note, 49 COL. L. REV. 394 (1949). See also Lasser and Holzman, *Personal Liability of Directors for Section 102 Surtaxes*, 16 THE CONTROLLER 342 (1948).

[106] See Heninger, *supra* note 16, at 640.

[107] See note 15 *supra*.

that funds which are actually needed for expansion or reserve purposes will be distributed. The loss to the corporation of the use of these funds must surely act to throttle business expansion and effect productive employment.[108]

Fortunately, however, the statute has been administered in an unusually tolerant manner.[109] Much of the fear created within the ranks of corporate managers by a strict reading of the statute has been dissipated by the temperate attitude of the courts and the Commissioner. The courts have adopted a generous interpretation of the "reasonable needs" of a business[110] and have been reluctant to substitute their judgment for that of the directors.[111] In addition, the decisions have carefully circumscribed the discretion of the tax authorities in their enforcement of the statute.[112] In a similarly moderate manner, the Commissioner has sought to apply the penalty only when ". . . a *common-sense view* of the whole picture makes it reasonably clear that there was a tax avoiding purpose, and that the reasons alleged for the accumulation are not reliable or sufficient."[113] The small number of deficiency letters issued annually under the section,[114] and the failure to bring before a court even one corporation whose stock and control were both widely dispersed,[115] point up the limited enforcement measures undertaken by the Commissioner. In short, a wise administrative policy has prevented Section 102 from becoming either a present threat to business or an insurmountable obstacle in the path of a growing enterprise.

Vindication of Family Partnerships

The definition of "partner," as amplified by a recent amendment to Section 3797(a)(2) of the Internal Revenue Code, now includes a person who ". . . owns a capital interest in a partnership in which

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[108] See note 93 *supra*.

[109] See Cary, *supra* note 93, at 220.

[110] See Cary, *supra* note 15, at 1306. For examples of generous interpretations of business needs, see J. L. Goodman Furniture Co., 11 T. C. 530 (1948); Lion Clothing Co., 8 T. C. 1181 (1947). A more restricted interpretation may be found in World Publishing Co. v. United States, 169 F. 2d 186 (10th Cir. 1948).

[111] R. C. Tway Coal Sales Co. v. United States, 3 F. Supp. 668 (W. D. Ky. 1933), *aff'd*, United States v. R. C. Tway Coal Sales, 75 F. 2d 336 (6th Cir. 1935); Lane Drug Co., 3 CCH 1944 TC Mem. Dec. 394 (1944).

[112] See Cary, *supra* note 15, at 1307.

[113] Miller, *Improper Accumulation of Surplus—(2) The Lawyer's Task of Giving Advice as to Current Dividend Policy, in View of Section 102 I.R.C.*, 1 Amer. Univ. Tax Inst. Lectures 103, 110 (1948).

[114] During the period from 1939 to 1947 less than 100 deficiency letters were issued annually under the section. *Id.* at 111.

[115] Covers the period from 1913 to 1950. See Buck and Shackelford, *supra* note 89, at 337.