Accumulated Earnings Tax - Taxpayer's Purpose in Accumulating Income

T. Winston Weeks

NOTES

Accumulated Earnings Tax — Taxpayer's Purpose in Accumulating Income

The Commissioner of Internal Revenue assessed and collected an accumulated earnings tax from the Donruss Company for the tax years 1960 and 1961. Donruss filed an action for refund in the District Court for the Western District of Tennessee. In response to two special interrogatories, the jury found (1) Donruss had accumulated its earnings beyond the reasonable needs of the business, and (2) Donruss had *not* so accumulated its earnings for the purpose of avoiding income tax with respect to its shareholders. On the basis of these answers the court rendered judgment for Donruss. The government appealed, alleging that the trial court's charge[1] erroneously led the jury to believe that to answer the second interrogatory in the affirmative they must find that Donruss had accumulated its earnings for the *sole* purpose of avoiding personal income taxes on its shareholders. The government contended that the proper test was less stringent: whether in accumulating its earnings Donruss had as *a* purpose or one of its purposes the avoidance of income taxes on its shareholders. *Held, reversed*: The proper test in accumulated earnings tax cases is whether the corporate taxpayer in accumulating its earnings has a dominant, controlling, or impelling purpose of avoiding income taxes with respect to dividend distributions to its shareholders.[2] *Donruss Co. v. United States*, 384 F.2d 292 (6th Cir. 1967), *cert. granted*, 37 U.S.L.W. 3001 (U.S. July 2, 1968).

I. The Accumulated Earnings Tax

The accumulated earnings tax provisions, first enacted in 1913,[3] establish two methods for determining whether a corporation has wrongfully accumulated its earnings. Section 532[4] sets out a subjective, "purpose" test, placing a penalty tax on a corporation "formed or availed of" for the purpose of avoiding income tax with respect to its shareholders.[5] In addition

[1] The trial judge charged the jury, *inter alia*: "If . . . the earnings here in question for the two years under consideration, were accumulated for *the purpose* of meeting the reasonable business needs . . . rather than for *the purpose* of avoiding taxes with respect to its sole shareholder, Mr. Weiner, you will find for the plaintiff . . . ." Donruss Co. v. United States, 384 F.2d 292, 295 (6th Cir. 1967), *cert. granted*, 37 U.S.L.W. 3001 (U.S. July 2, 1968) (emphasis added).

[2] The result of this decision is that the taxpayer will have the burden of proving by the preponderance of the evidence that it had a dominant, controlling, or impelling purpose other than to avoid personal income taxes on its shareholders. Int. Rev. Code of 1954, § 533.

[3] Revenue Act of 1913, 38 Stat. 114.

[4] Int. Rev. Code of 1954, § 532.

[5] Although the original accumulated earnings provision provided that the corporation had to be *fraudulently* formed or availed of, Congress dropped the word "fraudulently" in its 1916 revision. Revenue Act of 1916, 39 Stat. 756.

The original accumulated earnings tax provision also placed the penalty tax directly on the shareholders. Due to the constitutional problem involving the taxing of shareholders on undistributed profits, the Act as revised in 1921 placed the tax on the corporation itself rather than on the individual shareholders. Revenue Act of 1921, 42 Stat. 227; *see* Eisner v. Macomber, 252 U.S. 189 (1920). However, the Supreme Court subsequently held that for one-man and closely-held corporations Congress could constitutionally levy the tax on the individual owners rather than the corporation. Helvering v. National Grocery Co., 304 U.S. 282 (1938).

Int. Rev. Code of 1954, § 532 now reads: "The accumulated earnings tax . . . shall apply to

to the subjective test, section 533(a)[6] establishes an objective standard for determining a corporation's purpose in accumulating its income: if the government proves that the corporation has accumulated its earnings beyond the reasonable needs of the business, this is "determinative" of the corporation's purpose to avoid the income tax with respect to its shareholders,[7] and the burden is on the corporate taxpayer to prove otherwise.[8]

A jury finding that the corporate taxpayer accumulated its earnings beyond the reasonable needs of the business generally is the controlling factor in an accumulated earnings tax case. The taxpayer's burden to rebut the presumption of improper purpose which results from such a finding is, as Congress intended,[9] a heavy one. Moreover, corporate taxpayers often submit evidence only on the issue of the reasonableness of the accumulations, ignoring the possibility of proving that the corporation's purpose in accumulating income does not violate section 532.[10] This is usually a mistake, because even if the government proves that the accumulation of

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."

[6] INT. REV. CODE of 1954, § 533(a), provides: "[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."

[7] INT. REV. CODE of 1954, § 533(a).

[8] *Id.* The government need not attempt to prove that taxpayer accumulated its earnings beyond the reasonable needs of the business and may elect to try the case solely on the purpose test in § 532. *See* Young Motor Co. v. Commissioner, 316 F.2d 267 (1st Cir. 1963); Pelton Steel Casting Co. v. Commissioner, 251 F.2d 278 (7th Cir.), *cert. denied*, 356 U.S. 958 (1958).

Under INT. REV. CODE of 1954, § 533(a) the taxpayer has the burden of disproving by the preponderance of the evidence that it had an improper purpose in accumulating its earnings. However, some courts have held that by proving the unreasonableness of the accumulations, the government forces the taxpayer to disprove by a *clear* preponderance of the evidence that no improper purpose existed. *See, e.g.*, Young Motor Co. v. Commissioner, 316 F.2d 267 (1st Cir. 1963).

[9] The original accumulated earnings tax provisions used the term "prima facie evidence" in the "reasonableness" section. In the 1938 revision of the provisions, the "reasonableness" section was strengthened by replacing the term "prima facie evidence" with the word "determinative." Congress noted that "the proposal is to strengthen this Section by requiring the taxpayer . . . 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." *See* S. REP. No. 1567, 75th Cong., 3d Sess. (1938) as quoted in Palmer, *Tax Court Renews Its Pelton Error On No Need for Accumulated Earnings*, 12 J. TAXATION 74 (1960) (emphasis added). The Supreme Court has also pointed out that "the purpose of the legislation is to compel the company to distribute any profits not needed for the conduct of the business . . . ." Helvering v. Chicago Stock Yards Co., 318 U.S. 693, 699 (1940). In 1954 Congress again showed a desire that the "reasonableness of the accumulations" have significance by enacting a tax credit under INT. REV. CODE of 1954, § 535(c). Under section 531 the accumulated earnings tax is levied only on the accumulated taxable income for the year, and section 535(c) provides that the taxpayer may deduct from the accumulated taxable income those earnings and profits for the year "retained for the reasonable needs of the business," minus long-term capital gains. Thus, applying section 535(c), if the jury decides that the accumulation of earnings was reasonable, a determination that the taxpayer had an improper purpose in accumulating its earnings is meaningless. *See* Palmer, *supra*. Notwithstanding the improper purpose, the basis on which the tax would be levied could be zero, so that no accumulated earnings tax would have to be paid.

From the testimony developed at a post-trial hearing it appears that the reason the jury answered the second interrogatory in the negative was that the jurors had the mistaken belief that the government would win the case if the first interrogatory were answered in the affirmative, and that answering the second interrogatory in the affirmative might result in a prison sentence for the sole shareholder of Donruss. This would explain why the instant case seems to be one of those rare cases where the government succeeds in proving unreasonableness and then loses the case. *See also* Bremerton Sun Publishing Co., 44 T.C. 53 (1965), where the court found the accumulated earnings of the taxpayer unreasonable, but relieved the taxpayer from liability on the basis that taxpayer had no purpose to avoid personal income taxes on its shareholders.

[10] *See* text accompanying notes 3 through 8 *supra*.

earnings was unreasonable, the taxpayer can rebut the presumption of improper purpose and win its case by proving that the purpose in accumulating earnings was not violative of section 532. Although there has been some question of whether a corporation which accumulates its earnings because of a good faith mistake in judgment can escape liability for the accumulated earnings tax,[11] it has been held that a mistake based on an honest belief that the accumulation was no greater than was reasonably necessary will relieve the corporation from liability.[12] Spite, miserliness and stupidity may also be grounds for rebutting the presumption of improper purpose which arises when the government proves that the corporation's accumulation of income was greater than the reasonable needs of the business demanded.[13]

II. The Purpose Test—Conflicting Constructions

In the majority of cases decided under section 532 the courts have not concerned themselves with defining what Congress meant by "the purpose of avoiding the income tax with respect to its [the corporation's] shareholders."[14] Most courts have simply quoted from section 532, weighed the evidence presented, and determined that the taxpayer had failed to establish that tax avoidance was not "the purpose" behind the accumulations.[15] However, a few courts have attempted to construe the meaning of the term "the purpose,"[16] resulting in three conflicting conclusions.

In *Barrow Manufacturing Co. v. Commissioner*,[17] the Fifth Circuit concluded that all the trial court need find is that the taxpayer had *a* purpose to avoid individual income taxes on its shareholders.[18] Thus, a corporation which had several purposes in accumulating its income, one of which was to avoid tax on its shareholders, would be liable for the accumulated earnings tax. The Tenth Circuit came to the same conclusion in *World Publishing Co. v. United States*,[19] a case arising under the Internal Revenue Code of 1939.[20]

[11] Casey v. Commissioner, 267 F.2d 26 (2d Cir. 1959) (concurring opinion); B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders § 6.02 (2d ed. 1966).

[12] *Id.*

[13] *See* B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders § 6.02 (2d ed. 1966). *But cf.* Smoot Sand & Gravel Corp. v. Commissioner, 274 F.2d 495 (4th Cir. 1960) (reasonable purpose required).

[14] *See, e.g.*, James H. Pierce Corp. v. Commissioner, 326 F.2d 67 (8th Cir. 1964); R. Gsell & Co. v. Commissioner, 294 F.2d 321 (2d Cir. 1961); Smoot Sand & Gravel Corp. v. Commissioner, 274 F.2d 495 (4th Cir. 1960); Pelton Steel Casting Co. v. Commissioner, 251 F.2d 278 (7th Cir.), *cert. denied*, 356 U.S. 958 (1958); Trico Products v. McGowan, 169 F.2d 343 (2d Cir. 1948); Zeigler, *The New Accumulated Earnings Tax: A Survey of Recent Decisions*, 22 Tax L. Rev. 77 (1966).

[15] *Id.*

[16] *See, e.g.*, United States v. Duke Laboratories, Inc., 337 F.2d 280 (2d Cir. 1964); Young Motor Co. v. Commissioner, 316 F.2d 267 (1st Cir. 1963); Barrow Mfg. Co. v. Commissioner, 294 F.2d 79 (5th Cir.), *cert. denied*, 369 U.S. 817 (1961); World Publishing Co. v. United States, 169 F.2d 186 (10th Cir.), *cert. denied*, 335 U.S. 911 (1948).

[17] 294 F.2d 79 (5th Cir.), *cert. denied*, 369 U.S. 817 (1961).

[18] The court reasoned that the badly-needed presumption raised when the government proves that accumulations were beyond the reasonable needs of the business would be destroyed if a primary or dominant purpose test were used. 294 F.2d at 82.

[19] 169 F.2d 186 (10th Cir.), *cert. denied*, 335 U.S. 911 (1948).

[20] Int. Rev. Code of 1939, § 102(a).

In a recent decision, *United States v. Duke Laboratories*,[21] the Second Circuit placed a narrower interpretation on the wording of section 532. The court reasoned that because section 532 requires the corporation to be "formed or availed of for the purpose of avoiding" income tax on its shareholders, Congress must have intended that shareholder tax avoidance be the *sole* purpose of the corporation in accumulating its earnings.[22] According to the court, if Congress had meant for the courts to use the term "primary" or even "a," it would have used one of those terms in its many revisions of the tax provision.

A middle-ground approach was taken in *Young Motor Co. v. Commissioner*,[23] where the First Circuit, basing its decision on *Commissioner v. Duberstein*,[24] came to the conclusion that the corporate taxpayer had to have a primary or dominant purpose to avoid the individual tax by its accumulations. The court noted that because corporate directors and officers will almost certainly realize the shareholder tax advantage which results from the corporation's accumulating the income rather than distributing it, application of the "a purpose" test would subject almost every corporation to this accumulated earnings tax. However, the court did not consider the possibility that Congress meant for the "sole purpose" test to be applied in determining wrongful accumulations of corporate income.

III. Donruss Co. v. United States

In *Donruss* the taxpayer corporation relied on the *Duke Laboratories* case, where the Second Circuit had placed a narrow interpretation on the wording in section 532. The corporation argued that because Congress used the terminology "the purpose," it must have meant exactly that, and the *Duke* "sole purpose" test should be applied. The government, on the other hand, contended that the question was well settled that only *a* purpose was necessary to impose the penalty tax,[25] relying primarily on *Barrow*.

After discussing the above cases and the "primary purpose" test used in the *Young Motor Co.* case, the *Donruss* court concluded that none of these precedents would be controlling. Instead, the court sought to analogize the "purpose" test of section 532 to the "motive" test used in determining whether a gift was made "in contemplation of death" under section 2035(a) of the Internal Revenue Code,[26] and concluded: "In our view there is no sound reason why the 'dominant, controlling, or impelling' motive test employed in connection with the gift in contemplation of

[21] 337 F.2d 280 (2d Cir. 1964).

[22] *Id.* at 282.

[23] 316 F.2d 267 (1st Cir. 1963).

[24] 363 U.S. 278 (1960). The case involved the exclusion of a business gift from gross income under Int. Rev. Code of 1954, § 102. The Supreme Court held that in deciding whether a taxpayer has a gift under § 102, the court must determine the primary intent of the alleged donor.

[25] The rule is definitely not well settled. *See* United States v. Duke Laboratories, 337 F.2d 280 (2d Cir. 1964); Young Motor Co. v. Commissioner, 316 F.2d 267 (1st Cir. 1963); Barrow Mfg. Co. v. Commissioner, 294 F.2d 79 (5th Cir.), *cert. denied*, 369 U.S. 817 (1961); World Publishing Co. v. United States, 169 F.2d 186 (10th Cir.), *cert. denied*, 335 U.S. 911 (1948).

[26] Int. Rev. Code of 1954, § 2035(a) provides that "the value of the gross estate shall include the value of all property to the extent of an interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, in contemplation of death."

death provision should not be applied to the accumulated earnings tax provision."[27] In comparing the two tax provisions, the court noted: "To hold that the dominant, controlling, or impelling motive criterion is inapplicable in the case of the accumulated earnings tax provision would require that we make a distinction where no material difference exists."[28]

IV. The Validity of the Donruss Analogy

Is the "motive" test used in the gift in contemplation of death provision properly analogous to the "purpose" test of section 532? The accumulated earnings tax was enacted to prevent persons from using the corporate form to reduce their individual income taxes by ultimately taking the corporate earnings at a capital gains rate.[29] The tax itself is a penalty tax.[30] It is levied at a set percentage of the amount of earnings found to have been unreasonably accumulated;[31] and although it is in addition to the taxes the corporation would otherwise have to pay, it is in lieu of the taxes the individual owners would have paid had the earnings been properly distributed in the form of dividends. The original accumulated earnings provision required fraudulent intent on the part of the persons responsible for the conduct of the corporation.[32] Although the word fraudulent was dropped from the provision, the purpose behind the tax is still to tax those persons who use the corporate form to avoid personal income taxes.

The inclusion in the gross estate, under section 2035(a), of the amount of a gift made in contemplation of death is meant to accomplish the same objective as the accumulated earnings tax; its purpose is to keep individuals from avoiding the higher estate tax rates by making gifts at the lower gift tax rate just prior to death.[33] Although the two provisions can be distinguished on the basis of the rate of taxation imposed,[34] this difference does not go to the purpose behind them. Both sections 533 and 2035(b) set out presumptions that take effect if the government is able to prove certain facts,[35] in which case the taxpayer must overcome the presumptions by the

[27] 384 F.2d at 297.

[28] *Id.* at 298.

[29] *See* J. Seidman, Legislative History of Federal Income Tax Laws, 1861-1938, at 983-87 (1939).

[30] *See* Casey v. Commissioner, 267 F.2d 26 (2d Cir. 1959); B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders § 6.01 (2d ed. 1966).

[31] The accumulated earnings tax is the sum of 27½% of the accumulated taxable income not in excess of $100,000 and 38½% of the accumlated taxable income in excess of $100,000. Int. Rev. Code of 1954, § 531.

[32] *See* note 5 *supra.*

[33] Denniston v. Commissioner, 106 F.2d 925 (3d Cir. 1939).

[34] Under Int. Rev. Code of 1954, § 2035(a) the value of the gift is taxed at the estate tax rates as if it had been transferred through the estate, whereas the accumulated earnings tax is at a set rate for all corporate taxpayers. However, the distinction is lost when it is considered that both taxes are levied in lieu of the tax that should have been paid if there had been no attempt at avoidance. The accumulated earnings tax is now at a set rate rather than at the personal income tax rate of each shareholder because of the constitutional problem regarding the taxing of shareholders on undistributed profits. *See* authorities cited note 5 *supra.*

[35] Int. Rev. Code of 1954, § 533(a), sets out that "[T]he fact that earnings and profits . . . are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax . . . ."

Int. Rev. Code of 1954, § 2035(b) sets out that "If the decedent within a period of 3 years ending with the date of his death . . . transfers an interest in property . . . such transfer . . . shall, unless shown to the contrary, be deemed to have been made in contemplation of death . . . ."

preponderance of the evidence.

In construing the applicability of the two tests, a court must look to the congressional intent behind the statutes as well as to the entire context of the acts.[36] Since the two provisions involve essentially the same subject matter, scope, and aim, it seems that the court properly read them together in construing their meaning.[37]

V. Conclusion

In addition to the validity of the analogy drawn by the *Donruss* court, the "dominant, controlling, or impelling purpose" test set out in *Donruss* should be preferred over the "a purpose" test of *Barrow* and the "sole purpose" *Duke Laboratories* test for practical reasons as well. First, it would be almost impossible for a taxpayer to prove that not even "a" purpose to avoid personal taxes was involved in the decision to accumulate earnings. Under the "a purpose" test the tax avoidance motive need only be one of taxpayer's motives,[38] and almost any corporate director realizes that by accumulating earnings the corporation will be saving personal income taxes for its shareholders. Mere realization of such an advantage would make the avoidance purpose one of the taxpayer's motives, notwithstanding the significance of this particular motive in the ultimate decision to accumulate earnings.

Similarly, if the "sole purpose" test were used, the taxpayer would not find it difficult to show that at least one other motive was involved in the decision to accumulate earnings. If the taxpayer need only show by the preponderance of the evidence that the tax avoidance purpose was not his only purpose, his burden of proof would be easily met, and the statute would fail to accomplish its designed objective.

T. Winston Weeks

Mechanics' Liens: Statutory Retainage Versus Holder in Due Course

Another conflict in the long struggle for priority among competing mechanics' lien claimants was recently waged in a Texas court. It has long been the practice for an owner to execute to his general contractor a negotiable note secured by a lien on his property, both of which the contractor

---

[36] Vermilya-Brown Co. v. Connell, 335 U.S. 377 (1948); United States v. Cooper, 312 U.S. 600 (1941).

[37] United States v. Korpan, 237 F.2d 676 (7th Cir. 1956), *rev'd on other grounds*, 354 U.S. 271 (1957); Northern Pac. Ry. v. United States, 156 F.2d 346 (7th Cir. 1946), *aff'd*, 330 U.S. 248 (1947).

[38] Barrow Mfg. Co. v. Commissioner, 294 F.2d 79 (2d Cir.), *cert. denied*, 369 U.S. 817 (1961); World Publishing Co. v. United States, 169 F.2d 186 (10th Cir.), *cert. denied*, 335 U.S. 911 (1948).