UNC SCHOOL OF LAW

NORTH CAROLINA LAW REVIEW

Volume 47 | Number 4 Article 17

6-1-1969

Federal Taxation -- Unreasonable Corporate Accumulation and the "Any Purpose" Test

James R. Carpenter

Follow this and additional works at: http://scholarship.law.unc.edu/nclr

Part of the Law Commons

Recommended Citation

James R. Carpenter, *Federal Taxation -- Unreasonable Corporate Accumulation and the "Any Purpose" Test*, 47 N.C. L. Rev. 933 (1969).
Available at: http://scholarship.law.unc.edu/nclr/vol47/iss4/17

This Note is brought to you for free and open access by Carolina Law Scholarship Repository. It has been accepted for inclusion in North Carolina Law Review by an authorized editor of Carolina Law Scholarship Repository. For more information, please contact law_repository@unc.edu.

sentative is different from the citizenship of the infant, incompetent, or decedent, the citizenship of the one being represented automatically controls. Also, the rewording of the assignment clause to deprive the district court of jurisdiction over the parties whenever *an object* of the transaction is to invoke or to defeat federal jurisdiction is more stringent than the present statute.[52]

Thus, in view of the increasing criticism and study of the concept of manufactured diversity jurisdiction, the result of *McSparren v. Weist* was not unexpected. Although *McSparren* is a move in the right direction, the decision leaves several questions unanswered. The court held where the *sole* purpose of the appointment of a foreign representative is to create diversity the action is "improper" and therefore "offends against § 1359."[53] This leaves open to litigation the question whether the appointment has as its (1) *sole* purpose (2) its *principal* purpose or (3) *one* of its purposes the manufacture of diversity.[54] Although barred by prior Supreme Court decisions,[55] it seems that the better test would be to look to the citizenship of the deceased, minor, or incompetent for purposes of deciding jurisdiction.

MICKEY A. HERRIN

Federal Taxation—Unreasonable Corporate Accumulation and the "Any Purpose" Test

"It can be contended that every corporation, when organized, has as one of its purposes, the avoidance of surtax."[1] Though this may be true

[52] *Id.* at 102. "Ordinarily, the absolute transfer of property for valuable consideration would negative any conclusion that an object of the transfer was to create diversity." *Id.* The proposed statute would certainly change the result in *City of Eufaula.*

[53] 402 F.2d at 876. Apparently the holding would not include the situation where the original administrator resigns, because in this instance someone must be appointed before the suit can be brought.

[54] Amalgamated Clothing Workers v. Curlee Clothing Co., 19 F.2d 439 (8th Cir. 1927). A corporation's reincorporation in another state, though defective, was interpreted to be permanent. Acquiring federal jurisdiction was only one consideration, and probably a minor one, for the change. Federal jurisdiction was upheld. *Id.* at 440. If attorneys begin to choose as foreign representatives out-of-state relatives with a legitimate interest in the litigation, then the question would be squarely presented to the court.

[55] Mexican Cent. Ry. v. Eckman, 187 U.S. 429 (1903); Rice v. Houston, 80 U.S. (13 Wall.) 66 (1871); Chappedelaine v. Dechenaux, 8 U.S. (4 Cranch.) 306 (1808).

[1] Halperin, *The Surtax on Corporations Improperly Accumulating Surplus,* 18 TAXES 72, 76 (1940).

in a theoretical sense, Congress has not sought to penalize such a purpose when it is merely a normal incident of the use of the corporate form. When, however, the corporation is "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,"[2] Congress has imposed virtually a confiscatory surtax on these accumulated earnings.[3] The purpose of the tax is to compel the company to distribute any profits not needed for the conduct of its business so that shareholders may be taxed on the dividends received.[4]

Before the tax is imposed, it must first be shown that the accumulation is unreasonable;[5] this is a relatively objective test and most of the cases under the statute have been concerned with its determination.[6] A basic issue, however, remains whether or not the tax avoidance purpose is present in the decision to accumulate.[7] This proof—that the corporation was "formed or availed of for the purpose of tax avoidance"[8]—is necessarily subjective in nature.[9] Congress, therefore, has provided that

---

[2] INT. REV. CODE OF 1954, § 532(a). The basic provisions of the accumulated earnings tax, now found in INT. REV. CODE of 1954, §§ 531-37, have been in existence since 1921 and remain substantially unchanged. See Revenue Act of 1921, § 220, 42 Stat. 247.

[3] Section 531 imposes a tax of 27½ percent of the accumulated taxable income not in excess of 100,000 dollars, plus 38½ percent of the accumulated taxable income in excess of 100,000 dollars. INT. REV. CODE of 1954, § 531.

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

[5] INT. REV. CODE of 1954, § 533(a). It is interesting to note that in this regard Congress has provided one of those rare instances in which the taxpayer can shift the burden of proof to the government. INT. REV. CODE of 1954, § 534. The value of this shift, however, is not so great as it might first appear. As it has been pointed out, "[t]he reasonable needs of the business is really a subsidiary question . . . The burden of proof as to the ultimate question, whether the taxpayer corporation has been availed of for the purpose of avoiding tax on its stockholders, always remains with the taxpayer." Hammond & Victor, *The Accumulated Earnings Tax*, 9 PRAC. LAW. No. 8, 1963, at 92.

[6] *E.g.*, Pelton Steel Casting Co. v. Commissioner, 251 F.2d 278 (7th Cir.), *cert. denied*, 356 U.S. 958 (1958). Discussion of what factors are relevant in determining the reasonableness of the accumulation is beyond the scope of this note. See generally Treas. Reg. § 1.533-1(a)(2) (1959); Carey, *Accumulations Beyond the Reasonable Needs of the Business: The Dilemma of Section 102(c)*, 60 HARV. L. REV. 1282 (1947); Hernitz, *Stock Redemptions and the Accumulated Earnings Tax*, 74 HARV. L. REV. 866 (1961); Note, *Accumulated Earnings and the Reasonableness Test of Section 537*, 43 TUL. L. REV. 129 (1968).

[7] See Shaw-Walker Co. v. Commissioner, 390 F.2d 205, 214 (6th Cir. 1968), *vacated and remanded*, 89 S. Ct. 707 (1969) (per curiam).

[8] INT. REV. CODE of 1954, § 532(a).

[9] See Casey v. Commissioner, 267 F.2d 26, 32 (2d Cir. 1959) (concurring opinion). One writer has pointed out that

proof of state of mind is always fraught with difficulty. Direct evidence is

the fact that the corporation's profits and earnings are allowed to accumulate beyond the reasonable needs of the business shall be determinative of the proscribed purpose unless the contrary is proven by the preponderance of the evidence.[10]

If there is an unreasonable accumulation of income, what must the taxpayer do to show by a "preponderance of the evidence" that the tax avoidance motive was absent? Prior to the Supreme Court's recent decision in *United States v. Donruss Company*,[11] the courts were divided over the issue. Three distinct tests were applied in deciding when there was sufficient tax avoidance purpose to impose the surtax: (1) tax avoidance must be the "dominant, controlling, or impelling" motive,[12] (2) it must be one of the "determinating purposes" in the decision to accumulate,[13] and (3) it is sufficient if "any purpose" is tax avoidance.[14] In resolving this conflict, the Supreme Court adopted the "any purpose" test, *i.e.*, the government's contention that "it is sufficient if [tax avoidance] is one of the purposes for the company's accumulation policy."[15]

The Donruss Company had increased its accumulated earnings over a six year period from 1.02 to 1.67 million dollars. During this period the sole shareholder had received no income from the business other than his normal salary. In a suit for refund of the penalty tax, the jury found that although the accumulation was beyond the reasonable needs of the business, there had been no tax avoidance purpose present.[16] The court of appeals reversed the judgment entered on the verdict because the charge

> usually unavailable, and reliance must be placed on inferences from the surrounding circumstances. In addition, the taxpayer here is always a corporation, and resort must therefore be had to the motives of the individuals in control of the corporation since, of course, it can have no independent state of mind.

Herwitz, *Stock Redemptions and the Accumulated Earnings Tax*, 74 HARV. L. REV. 866, 869 (1961).

[10] INT. REV. CODE of 1954, § 533(a).

[11] 89 S. Ct. 501 (1969).

[12] Donruss Co. v. United States, 384 F.2d 292, 296 (6th Cir. 1967); *accord*, Young Mtr. Co. v. Commissioner, 281 F.2d 488 (1st Cir. 1960).

[13] Kerr-Cochran, Inc. v. Commissioner, 253 F.2d 121 (8th Cir. 1958); *accord*, World Publ. Co. v. United States, 169 F.2d 186 (10th Cir. 1948), *cert. denied*, 335 U.S. 911 (1949).

[14] R.L. Blaffer & Co. v. Commissioner, 37 B.T.A. 851 (1937), *aff'd*, 103 F.2d 487 (5th Cir.), *cert. denied*, 308 U.S. 576 (1939); *accord*, Barrow Mfg. Co. v. Commissioner, 294 F.2d 79 (5th Cir. 1961), *cert. denied*, 369 U.S. 817 (1962); Pelton Steel Casting Co. v. Commissioner, 251 F.2d 278 (7th Cir.), *cert. denied*, 356 U.S. 958 (1958).

[15] 89 S. Ct. at 502.

[16] *Id.*

to the jury implied that the proscribed motive had to be the sole determining factor in the decision to accumulate.[17] On remand the court instructed that the correct test was that tax avoidance must be the "dominant, controlling, or impelling" motive.[18]

On certiorari to the Supreme Court, the major argument of the parties dealt with the construction of the words "formed or availed of for the purpose of tax avoidance" in section 532(a). Taxpayer argued that the use of the word "the" instead of "a" supported the "dominant purpose" test applied by the court of appeals.[19] The government asserted that the phrase, when read as a whole, supported its proposed "any purpose" test.[20] Discounting both arguments as inconclusive and referring to the statutory language as "inherently vague,"[21] the Court concentrated on the factor of congressional intent to find support for the government's position. In examining the history of the accumulated earnings tax, the Court noted that Congress had consistently maintained a firm position against this type of tax avoidance.[22] The Court interpreted the 1954 additions[23] to the accumulated earnings tax provisions as congressional recognition of "the tremendous difficulty of ascertaining the purpose for corporate accumulations"[24] and concluded that the "congressional response to these facts has been to emphasize unreasonable accumulation as the most significant factor in the incidence of the tax."[25] Since Congress intended to emphasize the relatively objective inquiry into the reasonableness of the accumulation, reasoned the Court, it would be inconsistent with this intent to allow a taxpayer, once the objective criterion is satisfied, to escape the tax when the proscribed purpose was present to any degree.[26] Thus, the Court concluded that Congress intended to impose the surtax if any tax avoidance motive is present when there is an accumulation beyond the reasonable needs of the business.

---

[17] Donruss Co. v. United States, 384 F.2d 292, 298 (6th Cir. 1967).
[18] *Id.*
[19] 89 S. Ct. at 504. See Young Mtr. Co. v. Commissioner, 281 F.2d 488 (1st Cir. 1960).
[20] 89 S. Ct. at 504.
[21] *Id.*
[22] *Id.* at 505-07.
[23] Section 535(c) allows a minimum credit of 100,000 dollars to the corporation. INT. REV. CODE of 1954, § 535(c). Section 537 provides that the term "reasonable needs of the business" shall include the "reasonably anticipated needs of the business." INT. REV. CODE of 1954, § 537.
[24] 89 S. Ct. at 507.
[25] *Id.*
[26] *Id.*

Mr. Justice Harlan, concurring in part and dissenting in part, agreed that the congressional intent was to rely more heavily on the objective test.[27] He concluded, however, that the words of section 533(a) reveal an intention to give the taxpayer a "last clear chance" to prove the absence of the avoidance motive. Mr. Justice Harlan took issue with the majority's instruction on remand, which he felt would "effectively deny to the taxpayer the 'last clear chance' which Congress clearly meant to afford and substitute a very fuzzy chance indeed."[28] While arguing that the "any purpose" test of the majority might in reality make the jury believe it must impose the tax whenever it finds the accumulation unreasonable,[29] Harlan agreed that the "dominant, controlling, or impelling" motive test is also inappropriate since it would apparently require proof that tax avoidance was the strongest of all purposes.[30] Instead, he reasoned, the jury should be instructed "to impose the tax if it finds that the taxpayer would not have accumulated earnings but for its knowledge that a tax saving would result."[31] It is arguable that this proposed "but for" test is the same as the "dominant purpose" standard since if taxpayer would not have accumulated earnings but for the tax factor, then the tax factor must have been the "dominant purpose." In light of his specific rejection of the "dominant purpose" test, however, it would seem that Justice Harlan intends his "but for" test to be analogous to the "determinating purpose" test. Under this standard the jury must find that tax avoidance was one of the principle reasons for the accumulation, though it need not be the "dominant, controlling, or impelling" motive.[32]

It is questionable whether the test of the majority carries out the true intentions of Congress. While there is little doubt that the 1954 additions[33] to the tax provisions place more emphasis on the reasonableness of corporate accumulation, it is important to note that both new provisions are designed to alleviate the burden on the taxpayer.[34] Indeed, as the Court itself concluded, the amendments were a congressional recognition of "the tremendous difficulty of ascertaining the purpose for corporate accumulations."[35] It would appear to be inconsistent with this con-

[27] *Id.* at 508-10.
[28] *Id.* at 508.
[29] *Id.* at 509.
[30] *Id.* at 510.
[31] *Id.*
[32] See note 13 *supra.*
[33] See note 23 *supra.*
[34] See S. Rep. No. 1622, 83d Cong., 2d Sess. (1954).
[35] 89 S. Ct. at 507.

gressional attitude to require imposition of the tax where the jury, judging in retrospect,[36] finds the business reasons for accumulation without merit but further finds only some slight avoidance motive.[37] The argument for a less strict congressional intent gains further support from the fact that the 1954 recodification of section 533(a) deleted the adjective "clear" from the phrase "clear preponderance of the evidence"—the burden that the taxpayer must meet to show insufficient tax avoidance motive. While it may have been a mere change in phraseology, logically the deletion indicates an intent to reduce the taxpayer's burden of proof.

In answer to the Harlan criticism that the "any purpose" test effectively denies the taxpayer a "last clear chance" to escape the tax,[38] the majority pointed out that the taxpayer may "show that even though knowledge of the tax consequences was present, that knowledge did not contribute to the decision to accumulate earnings."[39] This chance, however, is quite slim. As one writer has argued: "Since the issue of whether to pay a dividend involves a balancing of the needs of the corporation and the desires of the stockholders for a cash return on their investment, the potential taxes on such dividends would necessarily play some part in a decision to have the corporation accumulate its earnings . . . ."[40] Thus, corporate knowledge of the tax consequences normally does influence the decision to accumulate, and, of course, there is always a chance that the accumulation might be found to be unreasonable. It has been suggested that "the only corporations that could safely accumulate income would be those having stockholders with substantial net losses,"[41] thus having little interest in dividend tax consequences. It is doubtful that Congress intended such a result.

Perhaps the sounder view is the "determinating purposes" test promulgated in *Kerr-Cochran, Inc. v. Commissioner*[42] and ostensibly

[36] Although the rule is that the reasonableness is to be judged as of the time of the accumulation, normally several years have elapsed between the decision to accumulate and the trial, and subsequent events realistically do influence the jury's determination. See Smoot Sand & Gravel Corp. v. Commissioner, 241 F.2d 197 (4th Cir. 1957).

[37] See Note, *Federal Income Taxation—Accumulated Earnings Tax—Tax Avoidance Must Be the Dominant Purpose For the Accumulation of Earnings and Profits By a Corporation Before the Accumulated Earnings Tax May Be Imposed,* 43 NOTRE DAME LAW. 566 (1968).

[38] 89 S. Ct. at 508.

[39] *Id.*

[40] Herwitz, *supra* note 9, at 875.

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

[42] 253 F.2d 121 (8th Cir. 1958).

adopted in Mr. Justice Harlan's "but for" test. As noted above this test would require a jury finding that tax avoidance was a major consideration in the decision to accumulate before imposing the surtax. This would require more than the mere existence of an avoidance factor but less than a conclusion that the proscribed purpose was the "dominant, controlling, or compelling" motive. Arguably this would be consistent with the burden of proof as set forth in section 533(a) since the test, while placing emphasis on the unreasonable accumulation, would give the taxpayer a realistic "last clear chance" to escape the tax. Clearly Congress intended such a result since the statute provides that even though the objective criterion of unreasonableness be satisfied, the taxpayer can avoid imposition of the surtax by proving by a "preponderance" of the evidence the absence of the proscribed purpose.

It is interesting to speculate as to the actual impact of the "any purpose" test. Keeping in mind the fact that any test of taxpayer motive is subjective in nature, it would seem reasonable to expect an average jury to engage in a "balancing of the equities." For example, if the jury, after making the basically objective determination that the accumulation was unreasonable, found that on a scale of ten motivation factors only one of the factors was tax avoidance, it might well render its verdict that no tax avoidance purpose was present. Indeed one might argue that the average jury is invited to engage in a balancing practice under the "any purpose" instruction, thus finding no tax avoidance purpose where it might otherwise have found a slight avoidance purpose present. Since the existence of the tax avoidance purpose is a factual determination, appellate courts might be hard pressed to find grounds for overturning such verdicts.

While in reality the average jury might engage in a balancing practice, corporate planners must anticipate a literal interpretation of the "any purpose" instruction. The effect,[43] then, of the *Donruss* decision may be far-reaching, especially in areas such as corporate diversification.[44] Since the Court's instruction is based upon a questionable interpretation of

[43] The effect of the decision will fall primarily on closely held corporations. As one writer pointed out, "although there is nothing in the Code of Regulations so stating, publicly held corporations can be said not to fall within the scope of the accumulated earnings tax." Note, *The Accumulated Earnings Tax as a Deterrent to Business Diversification of Close Corporations*, 16 U. KAN. L. REV. 98, 103 (1967).

[44] For discussion of the problems presented corporations by the accumulated earnings tax see *Id.*; Note, *The Accumulated Earnings Tax and the Problem of Diversification*, 64 MICH. L. REV. 1135 (1966).

congressional intent, it is submitted that Congress should act to restate the amount of avoidance motive it feels should be present before imposition of the surtax.

JAMES R. CARPENTER

Income Tax—Deductibility of Losses Suffered in Intra-Family Transfers

In *Merritt v. Commissioner*,[1] the Court of Appeals for the Fifth Circuit held that section 267 of the Internal Revenue Code of 1954 precluded deduction of a loss suffered by a husband when his stock in a family corporation was sold to his wife in an involuntary sale. The sale had been forced by the Internal Revenue Service to obtain funds for the payment of taxes from previous years, and the wife's 25,000 dollar bid was in sharp contrast to the 135,000 dollar basis at which the husband had been carrying the property. But the court of appeals affirmed the decision of the Tax Court[2] and disallowed the 110,000 dollar deduction.

The broad terms of section 267 disallow any deduction claimed for losses suffered in transactions between certain related taxpayers, generally family members.[3] The provisions of this present section originated in section 24(a)(6)(A) and (B) of the Revenue Act of 1934.[4] Prior to 1934, the rule was that the deductibilty of all sales, regardless of the identity of the vendor and vendee, depended on the presence of a bona

---

[1] 400 F.2d 417 (5th Cir. 1968).

[2] James H. Merritt, Sr., 47 T.C. 519 (1967).

[3] Section 267 provides:

(a) Deductions Disallowed.—No deduction shall be allowed—

(1) Losses.—In respect of loses from sales or exchanges of property (other than losses in cases of distributions in corporate liquidations), directly or *indirectly*, between persons specified within any one of the paragraphs of subsection (b).

. . . .

(b) Relationships.—The persons referred to in subsection (a) are:

(1) Members of a family, as defined in subsection (c)(4)

. . . .

(c) Constructive Ownership of Stock—For purposes of determining, in applying subsection (b), the ownership of stock—

. . . .

(4) The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants. . . .

INT. REV. CODE of 1954, § 267 (emphasis added).

[4] 48 Stat. 680, 691 (1934).