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BURDEN OF PROOF IN ACCUMULATED EARNINGS TAX CASES AND ITS DEVELOPMENT IN THE SECOND CIRCUIT COURT OF APPEALS

DONALD J. HOLZMAN*

INTRODUCTION

ALTHOUGH it has been said that "every student of the law fully understands the exact import of the phrase 'burden of proof,' "[1] this statement has been described as a "singular" remark in view of the precedents on the subject which spell confusion for the topic,[2] and it is far more accurate to say that much ambiguity and complication surrounds the "burden."[3] This is unquestionably true when one considers the development of the meaning and significance of the "burden of proof" in the area of the penalty tax on the improper accumulation of corporate surplus.

However, in spite of the confusion, a few things are very clear. One, the government does not want any part of the burden of proof; another, the Tax Court prefers not to make any decisions concerning it. This, coupled with what at one time seemed to be a straightforward statement of Congressional intent, has resulted in a frustration of the law in the Section 531 area.[4] Fortunately, the trend manifested by the Second Circuit Court of Appeals is a bulwark against heavy odds—and this is encouraging.

EXPLANATION OF SECTIONS 531-537

In order to give more meaning to this discussion, it will be well to make brief reference to the history and statutory provisions of the Section 531 tax on accumulated earnings.

This tax has had a lengthy period of development, sometimes being traced as far back as 1864 and the Civil War Tax Act.[5] However, nothing followed from that Act, but in the Revenue Act of 1913 a surtax on individual net income was related to undistributed corporate profits,[6] and, in 1921, a modification caused the tax to be imposed on the corporation instead of on the in-

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1. State v. Thornton, 10 S.D. 349, 356, 73 N.W. 196, 199 (1897).
2. 9 Wigmore, Evidence § 2485, at n. 2 (3d ed. 1940).
3. See 9 Wigmore, op. cit. supra note 2 at § 2485.
4. See Barker, Penalty Tax on Corporations Improperly Accumulating Surplus, 35 Taxes 949 (1957); Wagman, Taxation of Accumulated Earnings and Profits: A Procedural Wrangle, 37 Taxes 573 (1959); Holzman, R. S., Why Taxmen are Sore at "534," 39 Taxes 777 (1961); Forman, The Burden of Proof, 39 Taxes 737 (1961); Altman, Corporate Accumulation of Earnings, 36 Taxes 933 (1958); Hall, The Accumulated Earnings Tax, 38 Taxes 849 (1960); and Kopperud & Donaldson, The Burden of Proof in Accumulated Surtax Cases, 35 Taxes 827 (1957).
5. See Wagman, supra note 4 at 574.
6. Revenue Act of 1913, ch. 16 § II(A)(2), 38 Stat. 454.

dividual.[7] Since that time there has been a gradual development along the lines then established, with much of the emphasis being placed on phases of evidence. Although now statutorily designated as the Section 531 tax,[8] it was formerly prescribed by Section 102 in the Internal Revenue Code of 1939, and references to Section 531 and Section 102 are often made in an interchangeable sense, but, as we shall see, the sections are not identical.

The statutory provisions themselves can be summarized as follows:[9]

Section 531 is the section which imposes the accumulated earnings tax, and that tax is imposed on what is called accumulated taxable income of certain corporations.

Section 532 sets forth the corporations subject to the accumulated earnings tax, i.e., any corporation[10] which is formed or availed of for the purpose of avoiding the income tax with respect to its shareholders, or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

Section 533 deals with the evidence of purpose to avoid income tax and states that for the purposes of Section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of its 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.[11]

Section 534 deals with the burden of proof and establishes that in any proceeding before the Tax Court involving a notice of deficiency based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, the burden of proof with respect to such allegation is to be on the Commissioner (1) if he has not sent out a certain notification,[12] or, (2) if the notification is sent out and the taxpayer submits a statement[13] which sets forth the grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business.

Section 535 then defines accumulated taxable income as being taxable in-

7. Revenue Act of 1921, ch. 136, § 220, 42 Stat. 227. This change resulted from the doubt existing as to the constitutionality of taxing the stockholders. See H.R. Rep. No. 350, 77th Cong., 1st Sess. (1921) at 1939-1 (part 2) C.B. 192.

8. Int. Rev. Code of 1954, § 531.

9. The immediate discussion is with reference to the Int. Rev. Code of 1954, §§ 531-37.

10. Other than a personal holding company, foreign personal holding company, or certain exempt organizations. See Int. Rev. Code of 1954, § 532(b).

11. Substantially the same language appears in Section 102(c) of the Int. Rev. Code of 1939 except that there the reference is to the "clear" preponderance of the evidence. Note that Section 533(b) provides that if a corporation is a mere holding or investment company, that fact shall be prima facie evidence of the purpose to avoid the income tax with respect to shareholders.

12. See Int. Rev. Code of 1954, § 534(b).

13. See Int. Rev. Code of 1954, § 534(c).

come with certain adjustments,[14] less the sum of the dividends paid deduction[15] and the accumulated earnings credit.[16] This accumulated earnings credit has two parts. One is a minimum credit equal to the amount by which $100,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year. The other is an amount equal to such part of the earnings and profits for the taxable year as are retained for reasonable business needs. The existence of the minimum credit means that a corporation can accumulate up to $100,000 without any concern about the Section 531 penalty tax. However, once the corporation has accumulated an amount in excess of $100,000, it becomes incumbent upon the corporation to be able to justify the accumulation based on the reasonable needs of the business, because once the $100,000 is exceeded, the minimum credit, by definition, will become zero, and the only credit available to the corporation will be the second part, the amount which is considered as being retained for the reasonable needs of the business.[17]

This, generally, explains the inter-relationship of the accumulated earnings tax sections. Our later discussion will center around the significance of Section 534 and the burden of proof. However, as a prelude to this, the following aspects of the burden of proof itself should be outlined.

SUMMARY OF BURDEN OF PROOF IN GENERAL

The burden of proof may be considered as having two aspects, each one of which may itself be thought of in terms of a "burden." One aspect is the burden of persuasion; the other is the burden of producing evidence. This breakdown of the burden of proof has been described by Professor Wigmore as the first meaning (risk of non-persuasion) and the second meaning (duty of producing evidence to the judge).[18] These elements have at times been thought of as two separate and distinct things—and the "important practical distinction" between them is that "*the risk of non-persuasion* operates when the case has come *into the hands of the jury,* while the *duty of producing evidence* implies a liability to a *ruling by the judge* disposing of the issue without leaving the question open to the jury's deliberations."[19] Further, the first burden, being established by the substantive law, will never shift, "since no fixed rule of law can be said to shift."[20] Whenever engaging in a controversy, each party thereto has attributed to him, at that time, from the rules of law, certain facts which he must prove if he is to prevail. The burden in this sense will not shift. The burden of producing evidence, however, does have a "shifting" characteristic. It will first

14. For the details of these adjustments, which have no significant bearing on this discussion, see Int. Rev. Code of 1954, § 535(b).
15. See Int. Rev. Code of 1954, § 561.
16. See Int. Rev. Code of 1954, § 535(c).
17. See also Treas. Reg. § 1.535-3(b)(2) (1959) and S. Rep. No. 1622, 83d. Cong., 2d Sess. 317 (1954). Note, too, that Section 537 provides that the term "reasonable needs of the business" includes the reasonably anticipated needs of the business.
18. See 9 Wigmore, op. cit. supra note 2 at §§ 2485, 2487.
19. Id. § 2487 at 284.
20. Id. § 2489 at 285.

evolve upon the proponent having the burden of proof in the sense of persuasion and thereafter may alternate from one party to the other. However, this burden of producing the evidence lacks definiteness in that neither party will know for certain when the burden is his, how much evidence must be adduced, or the effect his evidence has.[21] For this reason, the significance of this aspect of the burden of proof becomes so closely inter-related with the ultimate burden of persuasion that perhaps it is not always well to attempt to analyze the burden of proof in terms of two separate and distinct elements and with regard to shifting. Rather, it might generate a better understanding to consider the burden of producing evidence as something inherent in the burden of persuasion.

This has been well handled by one writer who contends that "the duty of bringing forward evidence, or burden of production of evidence, is a derivative function of the burden of persuasion of a jury" and that, contrary to the earlier pronouncements, the burden of producing evidence is "not so very different" from the burden of persuasion.[22]

Nevertheless, the burden of proof is often referred to without a detailed distinction of its elements since this is not always necessary—particularly where, as in most tax cases, the same party bears the burden in its entirety.[23]

Thus, for general understanding, we may note the burden of proof as having two parts and point this out as the basis for some of the complications which seem to surround it. Our most direct concern with the burden of proof, however, will revolve around its meaning in the Tax Court.

Burden of Proof in the Tax Court

Rule 32 of the Rules of Practice of the Tax Court of the United States, entitled Burden of Proof, states bluntly that the burden of proof shall be upon the petitioner (taxpayer), except as otherwise provided by statute, and except that if the respondent (government) pleads new matter in his answer, the burden of proof with regard thereto is on the respondent.[24]

Rule 31, entitled Evidence and the Submission of Evidence, in part (g) relating to failure of proof states that the failure to adduce evidence in support of the material facts alleged by the party having the burden of proof and denied by his adversary may be ground for dismissal. In addition, it points out that the party having the burden of proof must properly produce evidence in support of issues joined on questions of fact.

Thus, in the usual tax case, the taxpayer will have to produce sufficient evidence to prove the Commissioner's determination incorrect. Related to this

21. See generally, 9 Wigmore, op. cit. supra note 2 at § 2489.
22. McNaughton, Burden of Producing Evidence: A Function of a Burden of Persuasion, 68 Harv. L. Rev. 1382 (1955).
23. See Ness, The Role of Statutory Presumptions in Determining Federal Tax Liability, 12 Tax L. Rev. 321, 332 (1957).
24. Dill Manufacturing Company, 39 B.T.A. 1023 (1939), is an example of an accumulated earnings tax case where the Commissioner had the burden of proof because that issue constituted new matter in his answer.

is the presumption of correctness of the Commissioner's determination.[25] It is this presumption which requires the taxpayer to present legally sufficient evidence negating the Commissioner's determination. If this is not done, i.e., if no evidence is produced by the taxpayer, the Court will be required to accept the Commissioner's determination.[26] However, once the evidence is produced to support the taxpayer's position, the decision must be made on the evidence alone; in other words, that produced by the taxpayer and by the government, the presumption itself not being evidence.[27]

Of course, if the burden of proof is on the Commissioner, there is no presumption of correctness of his determination, and he must assume both the burden of producing evidence and the burden of persuasion.[28]

A numerical analysis of the burden of proof may be significant from a point of view of understanding the importance placed upon where the burden of proof falls. If proponent has the burden of proof and he adduces evidence which in view of all the evidence presented causes the court to feel he has proven only a 25% case, proponent will fail. He will not have sustained his burden. The same thing will be true even if proponent proves a 50% case. Conversely, this means that opponent can have a 50% case and win; but proponent cannot win with a 50% case because he has the burden of proof, and this necessarily means he must go beyond the 50% point.

Thus, in a close case, the location of the burden of proof expresses itself in importance. If both sides have a 50% case, the side with the burden of proof must fail, even though the side of his opponent is no better. It is this fact which, perhaps, tends to explain why the Commissioner of Internal Revenue, who normally is involved in cases where the burden of proof is upon the taxpayer,

25. See generally, Ness, supra note 23 at 331-33, and Copelon, Practical Problems on Burden of Proof in Civil Trials, N.Y.U. 10th Inst. on Fed. Tax. 865, 867-70 (1952). See also Welch v. Helvering, 290 U.S. 111, 115 (1933) and Treas. Reg. § 1.533-1(b) (1959).

26. Hemphill Schools v. Commissioner, 137 F.2d 961 (9th Cir. 1943); J. M. Lyon, 1 B.T.A. 378 (1925).

27. Hemphill Schools v. Commissioner, supra note 26, explains this as follows:

> Evidence having been so produced, the presumption ceased, and thenceforth the issue depended 'wholly upon the evidence.' It thus became the duty of the Board to find from the evidence, and from it alone, whether petitioner's gains and profits were permitted to accumulate beyond the reasonable needs of its business. No such finding was made. Instead, the Board treated the presumption (which no longer existed) as if it were evidence, weighed it against petitioner's evidence and concluded that petitioner's evidence did not 'overcome' it. (Footnote omitted.)

137 F.2d at 964.

Similarly, the opinion in Redfield v. Eaton, 53 F.2d 693 (D. Conn. 1931), notes that to say "the Commissioner's decision, resting on evidence not presented to the court—in this case the defendant offered not a single witness—has the quality of probative evidence in determining the preponderance of evidence, is a proposition supported neither by authority nor reason." 53 F.2d at 696.

28.

> We are unable to conceive that the presumption of the correctness of a deficiency notice, which in the ordinary case the petitioner must meet, was intended by Congress to be used as a substitute for evidence in a case where the respondent has the burden of proof . . . . To adopt a classic to the case, the deficiency notice is a shield, not a sword. It is a defense where the petitioner has the onus of proof, not a weapon where the respondent has the burden.

C. A. Reis, 1 T.C. 9, 13 (1942). See also Ellwood M. Rabenold, 6 T.C.M. 1001 (1947).

is reluctant to have the burden of proof fall upon him, even in the few cases where such is provided by specific statutory enactment.[29]

EVOLVEMENT OF SECTION 534 BURDEN OF PROOF

The current burden of proof element which appears in Section 534 came about with the general revamping of the Internal Revenue Code of 1954. It was not the only change brought about in the accumulated earnings tax area by the 1954 revisions, but it appeared to be one of the most significant as manifested by the committee reports.

Recognizing that Section 102 imposed a "special tax" and that it made provision for the fact of earnings and profits being permitted to accumulate beyond the reasonable needs of the business to be determinative of the purpose to avoid tax unless the corporation proved otherwise by the clear preponderance of the evidence, the House Ways and Means Committee stated its predication to the modification of the section as follows:

> Your committee has received numerous complaints that this provision is prejudicial to small business, that it has been applied in an arbitrary manner in many cases, and that it is a constant threat to expanding business enterprises. Fear of the penalty tax is said to result frequently in distribution of funds needed by the corporation for expansion or other valid purposes.
>
> Your committee believes it is necessary to retain the penalty tax on unreasonable accumulations as a safeguard against tax avoidance. However, several amendments have been adopted to minimize the threat to corporations accumulating funds for legitimate business purposes and to restrict the application of the provision in the case of small companies.[30]

Dealing specifically with the burden of proof, the committee proceeded to explain that under the then existing law, if the Commissioner were to propose a deficiency on the ground that the taxpayer has accumulated earnings and profits in excess of the reasonable needs of the business, the burden of proof as to the reasonableness of the accumulation would be upon the taxpayer. Furthermore, if the excess exists, the accumulation is deemed to be for the prohibited purpose unless the taxpayer proves otherwise by the clear preponderance of the evidence.[31]

Such an imposition of the burden of proof on the taxpayer was thought by the committee to have "several undesirable consequences" expressed as follows:

29. An example of how far the government goes to avoid the burden of proof is noted in Forman, supra note 4, where mention is made of an Internal Revenue Service announcement that it will no longer contest the rule standing for the proposition that the government has the burden of proving fraud in suits for refund. The comment made in the article is that "no court has ever held otherwise, nor is there anything in the statutes or regulations to suggest a contrary rule. Yet, only now has the Internal Revenue Service agreed to submit." (Footnote omitted.) Forman, supra note 4 at 737.

30. H.R. Rep. No. 1337, 83d Cong., 2d Sess. 52 (1954). Substantially the same language appears at S. Rep. No. 1622, 83d Cong., 2d Sess. 68 (1954).

31. H.R. Rep., supra note 30 at 52; S. Rep., supra note 30 at 70.

> 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. Moreover, 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.[32]

Thus, under the committee's bill, provision was made for the burden of proof to be upon the government as to whether the accumulation is in excess of the reasonable needs of the business. The procedure established, now set forth in Section 534, is as follows:

The Commissioner is given an opportunity, before mailing the notice of deficiency based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, to send by certified mail or registered mail a notification informing the taxpayer that the proposed notice of deficiency includes an amount with respect to the accumulated earnings tax. If this notification is not sent out, the burden of proof with respect to the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business shall be upon the Commissioner.

On the other hand, if the notification is sent to the taxpayer, the taxpayer is given the opportunity to submit a statement of the grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business. If the statement is submitted, the burden of proof will again be on the Commissioner with respect to the grounds set forth in the statement. However, if the statement is not submitted, then the burden of proof is on the taxpayer just as it would have been without the benefit of Section 534.

Note that the statement submitted by the taxpayer is of the grounds, together with facts sufficient to show the basis thereof.[33] As this was first set forth in the House bill the statement to be submitted was required to include facts sufficient to apprise the Secretary or his delegate of the basis thereof. The Senate Finance Committee, believing this requirement to be somewhat too rigid, substituted the language now in the section, "facts sufficient to show the basis thereof."[34]

Related to the attack on the burden of proof was the lack of adequate standards as to what constituted reasonable needs of the business. As a result,

32. Ibid.
33. Int. Rev. Code of 1954, § 534(c).
34. S. Rep., supra note 30 at 71.

noted both the House and Senate committees, erroneous or irrelevant standards have been employed, and, "more often, in the absence of adequate guidance, revenue agents in examining cases have applied their individual concepts as to business needs."[35]

The over-all implication was that the change in the burden of proof would have a favorable effect on this aspect of the confusion as to the application of the tax.

CASE DEVELOPMENT OF SECTION 534

Effective August 11, 1955, Section 534 of the Internal Revenue Code of 1954 was amended to make it retroactive and applicable in proceedings tried on the merits after that date.[36] Therefore, even though most of the taxable years in the cases to date have been prior to 1954, there has been opportunity for court review of the new provision. However, there is one very important difference between a 1939 Code case and a 1954 Code case in this area, and that difference revolves around the accumulated earnings credit.[37] This credit was non-existent in Section 102.

The prohibited purpose of Section 102 is a corporation's being formed or availed of to prevent the imposition of a 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. The prohibited purpose in Section 531, now set forth in Section 532, continues to be having a corporation formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed. However, the 1954 Code provisions also establish a $100,000 limit up to which point earnings and profits may accumulate without having the corporation fear the accumulated earnings tax.[38] In addition, the accumulated taxable income, the base against which the tax rate is applied, is computed by reducing what it would otherwise be by the amount of earnings and profits which are accumulated for the reasonable needs of the business. Thus, by definition, the existence of accumulations for reasonable business needs equal to the total accumulation will eliminate any accumulated taxable income against which the tax can be applied.[39] As we will see later, this factor may bear a very close relation to the burden of proof.

In considering the burden of proof question as it becomes involved in accumulated earnings tax matters, the courts have produced opinions and explanations falling into one or more of a variety of categories. The major ones are outlined below.

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35. H.R. Rep., supra note 30 at 53; S. Rep., supra note 30 at 69.
36. This amendment was enacted on August 11, 1955. See ch. 805, §§ 4, 5, 69 Stat. 690, 691 (1955).
37. Int. Rev. Code of 1954, § 535(c).
38. Int. Rev. Code of 1954, § 535(c)(2).
39. Int. Rev. Code of 1954, § 535(c)(1).

Category 1: REASONABLE NEEDS OF THE BUSINESS ARE NOT IN ISSUE, AND, THEREFORE, THERE CAN BE NO SHIFTING OF THE BURDEN OF PROOF.

To understand this we must note that Section 534(a) provides that its general rule concerning the burden of proof will apply only in a proceeding before the Tax Court which involves a *notice of deficiency* based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business. Also, Section 534(b) provides for a notification from the Commissioner informing the taxpayer that *the proposed notice of deficiency includes an amount with respect to the accumulated earnings tax* proposed by Section 531.[40]

In a 1954 Code case, neither the notification nor the notice of deficiency need specifically refer to the reasonable needs of the business for Section 534 to be applicable since, as we have seen previously, by definition, in order for there to be any accumulated taxable income against which the accumulated earnings tax can apply, the determination must be made that the earnings and profits have accumulated beyond the reasonable needs of the business. Therefore, it cannot properly be said in any 1954 Code case that the notice of deficiency is not based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business. Such an allegation must necessarily be a part of any determination of a deficiency.[41]

However, since no accumulated earnings credit exists with regard to the 1939 Code years, it is possible for the Commissioner's notification, notice of deficiency, and even his answer all to make reference to the proscribed purpose without necessarily involving the question of reasonable business needs. If this is the case, it is possible to have a situation where the Section 534 burden of proof has no significance at all. An example is *Pelton Steel*.[42] There the notice of deficiency and the notification (which in this case came after the notice of deficiency because of the timing of the statutory enactments)[43] made no specific reference to the reasonable needs of the business, except that the latter

40. Of course, for a 1939 Code year, the section proposing the tax would be Section 102, and, from a technical standpoint, there seems to be a statutory defect in regard to the section to which reference is directed to be made in the Commissioner's notification.

41. Any other view would disregard the accumulated earnings credit in the amount equal to the accumulations which have been made for reasonable business needs. See Barker, Penalty Tax on Corporations Improperly Accumulating Surplus, 35 Taxes 949, 953-55 (1957), and Wagman, Taxation of Accumulated Earnings and Profits: A Procedural Wrangle, 37 Taxes 573, 579-80 (1959).

42. Pelton Steel Casting Co. v. Commissioner, 251 F.2d 278 (7th Cir. 1958), cert. denied, 356 U.S. 958 (1958), affirming 28 T.C. 153 (1957).

43. The unusual circumstances are pointed out in the opinion. The notice of deficiency was dated August 24, 1953, and the taxpayer's petition to the Tax Court was filed September 8, 1954. The amendment to Section 534 was made August 11, 1955, and shortly thereafter, on September 7, 1955, the Commissioner's notification was mailed. The taxpayer's statement was submitted on October 6, 1955, less than two months before the time the case was heard on December 1st and 2nd, 1955.

also included language putting the taxpayer on notice of his rights concerning his statement.[44]

As a prelude to discussing the burden of proof, the Tax Court's opinion in *Pelton Steel* stated that the statute (Section 102) may be found inapplicable in some cases where accumulations are unreasonable and, conversely, may be found to apply where they are reasonable. In other words, the position advanced was that the prohibited purpose may or may not exist regardless of the reasonableness or unreasonableness of the accumulations, the latter merely being a factor useful in arriving at the ultimate determination.

With regard to the burden itself, the court thought it clear that the ultimate burden of proof of error is upon the taxpayer where, "*as in the instant case*, the statutory notice of deficiency is based upon the premise that petitioner was availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting earnings or profits to accumulate instead of being divided or distributed. . . ." (Emphasis added.)[45] Also, in a footnote at this point of the decision, the court stated it assumes a shift of the burden to the Commissioner "to the extent, *if any*, that his determination is based upon the theory that earnings and profits were accumulated beyond the reasonable needs of the business, and upon the presumption (section 102(c) of the Code of 1939) arising therefrom." (Emphasis added.)[46] This language points out the court's awareness that the notice of deficiency was not necessarily concerned with the reasonable needs of the business.[47] In addition, the Tax Court did not consider this factor essential to its decision. Nevertheless, it took the view that in any event, upon consideration of the whole record, the Commissioner met his burden.

At a later part of the opinion, the court noted the "retroactive impact" of Section 534 upon the instant proceedings came just before the hearings, and

44. Portions of the notice of deficiency and notification appear in Pelton Steel Casting Co., 28 T.C. 153, 154-55 (1957).

45. Pelton Steel Casting Co., supra note 44 at 174.

46. Id. at 174 n. 6.

47. Further indications that the Tax Court was aware of this appear through the manner in which it italicized various portions of the quotations from the reports of the Senate Finance Committee. For example, quoting from S. Rep., supra note 30, at 70, the following appears at page 181 of the opinion:

> 'At the present time if the Commissioner of Internal Revenue proposes a deficiency *on the ground that taxpayer has accumulated earnings and profits in excess of the reasonable needs of the business*, the taxpayer has the burden of proof as to the reasonableness of the accumulation.'

A similar use of italics, again at page 181 of the opinion, emphasizes that the burden of proof relates solely to the reasonable needs of the business and that the shift in the burden applies where the issue relates to such needs. Also, note the court's own statement as follows:

> There is no basis to presume that Congress intended to alter or reverse the rules of existing law regarding petitioner's *ultimate* [italics in original] burden of proving in an accumulated earnings tax case *such as that now before us* [italics added] that it was not availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting earnings or profits to accumulate instead of being divided or distributed except to the extent indicated below.

Pelton Steel Casting Co., supra note 44 at 183.

"the parties elected to go ahead with the trial in the traditional manner—petitioner being the first to go forward with the evidence—and to reserve to argument on brief their expression of views regarding the effect of the new statutory provision upon proceedings such as these."[48] It then proceeded to analyze the effect of Section 534 upon the law applicable to 1939 Code cases. After a detailed discussion, the conclusion was that there existed a lack of expression of intent in either the 1954 Code sections or the legislative history to alter any existing law relative to burden of proof except with regard to the accumulation of earnings and profits beyond the reasonable needs of the business, and then only "if the issue is essential to the decision."[49] Thus, in a 1939 Code case, the reasonable needs of the taxpayer are looked upon as constituting "only one factor to be weighed by the Court in reaching its ultimate determination with regard to the presence or absence of the interdicted purpose,"[50] which purpose can be established entirely apart from considerations as to reasonable business needs. Even though this element was not considered by the court to be essential to its decision, it did state that even if it were assumed to be a significant factor and that the burden were shifted to the Commissioner in this respect, the affirmative evidence demonstrated the earnings accumulated "were materially in excess of any reasonable, planned, or needed future capital expenditures or other reasonably anticipated exigencies or contingencies of the business."[51]

The Tax Court's opinion in the *Pelton Steel* case with regard to the burden of proof cannot easily be challenged.[52] It is in a technical sense a very accurate and thorough exploration and discussion of the effect the change in the Code provisions had on cases to which the 1939 Code is applicable. One must be wary, however, of generalizations with regard to the case and remember that it contains a peculiar element in that in *Pelton Steel* the Commissioner was not basing his contentions on the fact that the taxpayer was accumulating earnings and profits beyond the reasonable needs of the business. Rather, wholly apart from this aspect, the Commissioner's approach was that the prohibited purpose existed. This provides a basic distinction between *Pelton Steel* and other cases which have cited it with approval but in which the reasonable needs of the business did play an important part and this factor was overlooked.

Category 2: IT IS UNNECESSARY TO DETERMINE WHERE THE BURDEN OF PROOF LIES SINCE ON THE RECORD AS A WHOLE IT CAN BE DETERMINED THAT THE ACCUMULATION IS (IS NOT) BEYOND THE REASONABLE NEEDS OF THE BUSINESS.

This approach has been typical of the Tax Court in several instances. In

48. Pelton Steel Casting Co., supra note 44 at 180.
49. And, of course, if the requirements of Section 534 are met. Id. at 183.
50. Pelton Steel Casting Co., supra note 44 at 184.
51. Id. at 185.
52. Note that in Pelton Steel Casting Co. v. Commissioner, 251 F.2d 278 (7th Cir. 1958) no reference was made to the burden of proof.

Wellman Operating Corporation,[53] the taxpayer, prior to trial, filed a motion for a ruling that its statement complied with the requirements of Section 534(c) and that by reason of this compliance the burden was upon the Commissioner to prove that the earnings had been accumulated beyond the reasonable needs of the taxpayer's business. However, in order that it might be able to present its entire affirmative case first, the taxpayer did not press at the trial for a ruling thereon, stating it was refraining from doing so without waiving any rights under the motion.[54] Subsequently, though, the court found it unnecessary to rule upon the motion because of its satisfaction on the evidence that the taxpayer was availed of for the improper purpose regardless of whether there was any shifting of a "limited burden of proof."[55]

The determination "on the record as a whole" has not always been made in favor of the government's case. In fact, one of the decisions favoring the taxpayer, *Fotocrafters Inc.*,[56] presents one of the most lucid illustrations of a recognition of the distinction between Sections 102 and 531. This case involved fiscal years ending in 1954, 1955, and 1956. Section 102 was applicable to the first and Section 531 to the others. After concluding from all the facts that the petitioner did not permit its earnings to accumulate beyond the reasonable needs of its business, the court recognized that this holding does not automatically dispose of the case for the taxpayer but, rather, it must still carry the ultimate burden of demonstrating that it was not availed of for the prohibited purpose. Nevertheless, with regard to the 1939 Code year, the reasonableness of the accumulation of funds was thought strongly to suggest, as a practical matter, the absence of the forbidden purpose. Then, illustrating the understanding of the distinction between the Code sections, the court stated:

> The problem has been simplified as to the last two years here involved by the advent of § 535(a) and (c)(1). Since we have found that all the earnings were retained for the reasonable needs of the business, the § 531(c)(1) credit for fiscal 1955 and 1956 would be the total taxable income for each of these years and, accordingly, the § 535(a) accumulated taxable income on which the § 531 tax is imposed would be zero as to each year.[57]

Thus, it is clear that at this point the Tax Court is fully aware of the significance

53. 33 T.C. 162 (1959).
54. Wellman Operating Corporation, 33 T.C. 162, 182-83 (1959).
55. Id. at 183. Other opinions involving this category which were decided in favor of the government are American Metal Products Corporation v. Commissioner, 287 F.2d 860 (8th Cir. 1961); Smoot Sand & Gravel Corporation v. Commissioner, 274 F.2d 495 (4th Cir. 1960); Jerome E. Casey, 16 T.C.M. 1024 (1957); R. Gsell & Co., Inc., 34 T.C. 41 (1960); Kerr-Cochran, Inc., 30 T.C. 69 (1958); and Oyster Shell Products Corporation, Inc., 20 T.C.M. 1668 (1961). See also Barrow Manufacturing Company, Inc., 19 T.C.M. 195 (1960). The latter case was affirmed in Barrow Manufacturing Company, Inc. v. Commissioner, 294 F.2d 79 (5th Cir. 1961), where it was stated that "under the circumstances, the Tax Court's failure explicitly to impose the burden of proof on the Commissioner does not constitute reversible error." 294 F.2d at 82.
56. 19 T.C.M. 1401 (1960); opinion by Judge Forrester.
57. Fotocrafters Inc., 19 T.C.M. 1401, 1409 (1960).

of the accumulated earnings credit and the relationship of the finding that earnings and profits may or may not be accumulated for the reasonable needs of the business to this credit and the eventual tax.[58] However, with regard to the burden of proof, it still failed to come to a conclusion or decision.[59]

Category 3: IN SPITE OF ANYTHING CONNECTED WITH REASONABLE BUSINESS NEEDS, THE ULTIMATE BURDEN OF SHOWING THE PROHIBITED PURPOSE DOES NOT EXIST IS ON THE TAXPAYER.

This approach has been manifested in many cases, including *Pelton Steel*, and while it might be proper for a 1939 Code case, it would definitely seem to be improper for any case involving only the 1954 Code provisions. However, in the Tax Court, aside from the implication in Judge Forrester's opinion in *Fotocrafters Inc.* that he might be aware of this, nothing to this effect has been stated.

Because of the limited number of cases to which the 1954 Code provisions alone are applicable, there have really not been many opportunities for discussions on this point. However, it would have been possible in *Raymond I. Smith, Inc.*,[60] a case involving the calendar year 1954 as well as earlier years. Even though the 1954 Code was applicable to the year 1954, the ultimate burden of proof with regard to all of the years, including 1954, was said to be on the taxpayer.[61] *Pelton Steel* was cited in support of this proposition. This, of course, indicates a failure to distinguish between the years involved. The issue should have been before the court because the taxpayer claimed the accumulated earnings credit under Section 535(c)(1) by saying it was entitled to the full

58. In other words, if the accumulations are for the reasonable needs of the business, there can be no accumulated earnings tax.

59. Other cases in this category are Breitfeller Sales, Inc., 28 T.C. 1164 (1957); F. E. Watkins Motor Co., 31 T.C. 288 (1958); and Penn Needle Art Company, 17 T.C.M. 504 (1958).

60. 33 T.C. 141 (1959).

61. Raymond I. Smith, Inc., 33 T.C. 141, 154 (1959). Although the Ninth Circuit affirmed this decision in Raymond I. Smith, Inc. v. Commissioner, 292 F.2d 470 (9th Cir. 1961), that court illustrated a keen understanding of the 1954 Code burden of proof provisions when it stated as follows:

> The Tax Court's opinion states, 'The petitioner, of course, has the ultimate burden of proof.' As indicated above, this is not true in any case covered by section 534 if by 'ultimate burden of proof' the Tax Court was referring to the burden of proving that the accumulations were beyond the reasonable needs of the business. Moreover, it is not true in this case if the Tax Court was referring to the burden of proving the proscribed purpose, to avoid the income tax upon shareholders. The Commissioner sought to prove that purpose only by showing that accumulations were excessive, and as to this showing the Commissioner had the burden of proof.
>
> The Tax Court's statement is correct if it was referring to the burden of proof placed upon a taxpayer where the Commissioner has established the basic fact that the accumulations were excessive. As stated in section 533(a), that fact is determinative of the proscribed purpose 'unless the corporation by the preponderance of the evidence shall prove to the contrary.'

292 F.2d at 474.

Nevertheless, the affirmance was based on the fact that no prejudice resulted to the taxpayer even assuming the Tax Court incorrectly found it to have the burden of proof since no substantial finding of fact adverse to the taxpayer was predicated solely on its failure to sustain the burden of proof.

amount of its accumulation at the end of 1954 as a credit under this provision. The Commissioner's brief entirely ignored this point, and the taxpayer did not elaborate. With this as a basis, Judge Murdock stated "thus the court is without any help from the parties on this issue, which apparently requires decision."[62] Then, in order to settle the matter of the accumulated earnings credit, the court found certain accumulations to be unreasonable and the balance of them to be within the reasonable needs of the business. However, as a practical matter, those which were designated unreasonable constituted the whole amount of the accumulations. So, in effect, there was no credit. This, of course, was done without any reference to the burden of proof.

The *Young Motor Company, Inc.*[63] case is an example of how the Tax Court can completely overlook a possible significance of the reasonable needs of the business and the burden of proof. In that case the notice of deficiency provided in part that

> 'it has been determined that . . . your earnings and profits have been permitted to accumulate (instead of being divided and distributed as dividends among your shareholders) beyond the reasonable needs of your business for the purpose of preventing the imposition of surtax on your shareholders.'[64]

Thus, although this involved 1939 Code years, the notice of deficiency did not merely set forth the prohibited purpose; rather, it specifically stated that the taxpayer allowed the earnings and profits to accumulate beyond the reasonable needs of the business. In this respect it is different from the notice of deficiency in the *Pelton Steel* case and could conceivably place this squarely within the language of Section 534, i.e., a proceeding before the Tax Court involving a notice of deficiency based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business. The preciseness with which this was set forth in the notice of deficiency could even be construed as manifesting an election on the part of the Commissioner to base his case on the reasonable needs of the business as distinguished from the prohibited purpose without reference to these needs.[65] However, that these distinctions are to be set aside is made obvious by the opinion which opens with a reference to the *Pelton Steel* case and says the "burden of proving absence of the ultimate corporate activity prohibited by § 102 is concededly imposed upon petitioner."[66] It continues by

62. Raymond I. Smith, Inc., supra note 61 at 154.
63. 32 T.C. 1336 (1959).
64. Id. at 1343.
65. In Raymond I. Smith, Inc. v. Commissioner, 292 F.2d 470 (9th Cir. 1961), the court concluded that the Commissioner based his case on the proposition that the accumulations were beyond the reasonable business needs when this was suggested in his answer, although the notice of deficiency made no reference to such ground. Therefore, he was said to have the entire burden of proof, the proscribed purpose aspect not being severed because this itself was based upon the reasonableness of the accumulation. See the quotation at note 61, supra.
66. Young Motor Company, Inc., supra note 63 at 1343.

saying that even assuming in favor of the taxpayer that the evidentiary element of the business need has not been rebutted by the Commissioner because of the taxpayer's statement, "that factor then merely becomes neutral."[67]

In addition, the opinion mentions a confusion existing between proof of unreasonable accumulations which, if present, is prima facie evidence of the prohibited purpose under Section 102, and proof of absence of the condemned purpose, which does not follow automatically from affirmative proof of business needs. While this is entirely correct with regard to a 1939 Code year, it would have been an excellent opportunity to say that while the Section 102 penalty tax can apply in spite of the fact that an accumulation might be made for reasonable business needs, in the instant case the Commissioner's deficiency notice was predicated upon earnings and profits having been permitted to accumulate beyond the reasonable needs of the business and, therefore, the Commissioner has elected to follow this approach and not the approach based upon the prohibited purpose alone. Then, of course, the reasoning from Section 534 and the burden of proof could have been utilized to place this burden on the Commissioner with regard to his stated fact of accumulations exceeding reasonable business needs. However, rather than taking this opportunity to connect the burden of proof and the reasonable business needs, the opinion stated that "if there is no proof by respondent of the unreasonableness of the accumulation as regards business needs and there is no other evidence, petitioner must still fail because the burden of proof of facts sufficient to show the error of respondent's determination is basically upon it as in all comparable proceedings."[68]

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67. Ibid.

68. Id. at 1344. Note, however, that the Tax Court's opinion was reversed and remanded by the First Circuit Court of Appeals, Young Motor Company, Inc. v. Commissioner, 281 F.2d 488 (1st Cir. 1960). The basis for the action of the First Circuit was that the Tax Court relegated the reasonable business needs issue too much to the background. The Circuit Court thought it entirely illogical to say that since that issue was only a subsidiary factor and not determinative of the case, "it is proper to disregard it and look simply at the rest of the record." 281 F.2d at 490. Further, even though the ultimate question (in this 1939 Code case) is the proscribed purpose and not the reasonable needs of the business, the answer to the latter question

> may well be the single most important consideration in concluding whether taxpayer acted with a proper purpose in mind, or the proscribed one . . . . To by-pass that subsidiary question and then in deciding the case to say the taxpayer has failed on the ultimate issue is like saying that we will overlook any question of self defense and then conclude that on the rest of the record a finding of deliberate homicide is justified.

281 F.2d at 491.

Other opinions which may be included in this category are found in Wellman Operating Corporation, supra note 54; Smoot Sand & Gravel Corporation, 17 T.C.M. 1086 (1958); and Knoxville Iron Company, 18 T.C.M. 251 (1959). In Automotive Rebuilding Co., Inc., 17 T.C.M. 968 (1958), the taxpayer expressly disclaimed any reliance on the burden of proof and proceeded to trial on the theory that it bore the burden. Similarly, in Mountain State Steel Foundaries, Inc., 18 T.C.M. 306 (1959), affirmed, Mountain State Steel Foundaries, Inc. v. Commissioner, 284 F.2d 737 (4th Cir. 1960), the taxpayer conceded it had the burden of showing the Commissioner's determination erroneous.

Category 4: THE TAXPAYER'S STATEMENT IS INSUFFICIENT WITHIN THE MEANING OF SECTION 534, AND, THEREFORE, THERE CAN BE NO SHIFT IN THE BURDEN OF PROOF.

In the *I. A. Dress Co., Inc.*, case,[69] the taxpayer submitted a statement in two parts. The first part, entitled "Grounds Upon Which The Taxpayer Relies," stated:

> (A) The welfare of the corporation would have been jeopardized by the distribution of any part of its earnings.
>
> (B) The continued corporate existence can be insured only by the full retention of all earnings.[70]

The second part, entitled "Facts Which Show The Basis Of The Grounds," consisted of 13 paragraphs, the majority of which dealt with the intention of the taxpayer to purchase the fee interest in the real property it was then leasing.[71]

The taxpayer contended that as a result of this statement at least a partial shift in the burden of proof had been effected. However, upon examination of the grounds in the statement, the court noted that the first one was "so broad in scope and so nebulous in its nature as to fail to constitute a statement of a ground which would justify an accumulation of surplus under § 102 of the 1939 Code."[72] The second ground was said to justify the accumulation of at least part of the funds determined to be excessive, if it were true. However, the statement failed to present facts sufficient to support the indicated grounds, "whether or not the grounds are sufficient to comply with the requirements of § 534."[73]

In summary, "no facts were stated disclosing whether or not an actual need existed for such an acquisition of property, and, if so, whether the need was immediate or remote."[74] Thus, the facts in the statement were "not sufficiently clear or definite to support the asserted grounds of accumulation so as to comply with the requirements of § 534(c), and petitioner accordingly must assume the entire burden of proof."[75]

A similar situation arose in *Wellman Operating Corporation*.[76] The grounds set forth therein are as follows:

> *Ground No. 1.* The corporation was not created or organized for the purpose of preventing the imposition of a surtax upon its shareholders.
>
> *Ground No. 2.* The corporation was not availed of for such pur-

69. 32 T.C. 93 (1959).
70. I. A. Dress Co., Inc., 32 T.C. 93, 96 (1959).
71. See Id. at 96-97.
72. Id. at 100.
73. Id. at 101.
74. Ibid.
75. Ibid.
76. 33 T.C. 162 (1959).

> pose in any of said three years, no part of the earnings accumulated in any of those years being beyond the reasonable needs of its business.[77]

The court thought these were not grounds as that term was intended to be understood in Section 534. Rather, they were "mere reformulations of § 102 itself."[78] The court quoted from the Senate Finance Committee report which said " 'in order for the burden of proof to be shifted, the taxpayer * * * must submit a statement indicating *why* the needs of the business required a retention of earnings and profits, together with facts sufficient to show the basis thereof.' [S. Rept. No. 1622, 83d Cong., 2d Sess., p. 315. Emphasis supplied.]"[79]

The grounds stated by the taxpayer were thought not to be "reasons for accumulating earnings and profits, but rather conclusions masquerading as reasons. As such, the statement is deficient for failing to allege appropriate grounds."[80]

The facts presented in the statement were also discussed and similarly declared to be insufficient to show the basis of the alleged grounds. Although the facts themselves are not set out in the opinion, judging from the discussion therein they lacked detail. The court stated this in the following manner:

> In sum, the 'specific' allegations in petitioner's statement of 'facts' consist of sketchy references to certain transactions, some of which were considered and others of which were consummated; they in no sense substantiate petitioner's general allegations of fact that it was handicapped in its operations by insufficient resources. Such general allegations fail to satisfy the requirements of section 534.[81]

Other Tax Court discussions following the line set forth in this category are found in *The Dixie, Inc.*,[82] and *American Metal Products Corporation*.[83]

A great deal has been written concerning the cases which have had pronouncements in this burden of proof area. As a result of these varying approaches of the courts, many writers have been quite skeptical about there being any effectiveness to Section 534. In fact, some feel that the intended purpose of Section 534 has been vitiated and that it is almost valueless as an aid to taxpayers.[84] However, the pronouncements of the Second Circuit do give some indication to the contrary.

77. Wellman Operating Corporation, supra note 54 at 183.
78. Ibid.
79. Ibid.
80. Id. at 183-4.
81. Id. at 184-5.
82. 31 T.C. 415 (1958).
83. 34 T.C. 89 (1960). See also Kerr-Cochran, Inc., 30 T.C. 69 (1958).
84. See Barker, Penalty Tax on Corporations Improperly Accumulating Surplus, 35 Taxes 949 (1957); Wagman, Taxation of Accumulated Earnings and Profits: A Procedural Wrangle, 37 Taxes 573 (1959); Holzman, R. S., Why Taxmen are Sore at "534," 39 Taxes 777 (1961); Forman, The Burden of Proof, 39 Taxes 737 (1961); Altman, Corporate Accu-

Burden of Proof in the Second Circuit

One of the first opportunities the Second Circuit had to deal with Section 534 came in 1959 in *Casey v. Commissioner*.[85] The petitioner, Casey, was transferee of Bankers Development Corporation and, being thus liable for any of the corporation's unpaid taxes, was refuting the Section 102 tax alleged against the corporation for a fiscal year ending in 1950. The *Casey* case represents a good statement of how Section 534 relates to a Section 102 case and the evidence determinative of the prohibited purpose.

The *Casey* facts are quite interesting. Bankers Development Corporation was organized in 1920 with its principal business being that of soliciting new depositors for banks, doing so at a fixed fee per depositor. Casey was first employed by Bankers as a solicitor and then became supervisor of solicitation operations. Casey remained with Bankers when its business fell off in the 1930's, and, in 1939, when Bankers was in a precarious financial condition, Casey and a person named Owen each purchased 50% of the corporation's stock.

It was in the 1930's that banks began to impose service charges on their checking account customers who did not maintain balances sufficient to compensate the banks for carrying the accounts. This service charge being an irritation to the customers, the banks sought a less displeasing method of being paid for their services and devised a method whereby the depositor was charged a fixed sum per check. In order for the bank to keep separate accounts for the two kinds of deposits (substantial accounts vs. modest accounts) the checks which had been paid for in advance had to have some identifying marks such as "special checking account." One bank conceived the idea of printing the customer's name on the checks instead of using a special legend. The opinion of the court suggested that perhaps this was because the special legend was an indication that the drawer was "relatively impecunious." Having his names on the check would give those who saw his checks the impression that he was a depositor of distinction, rather than that he was a depositor with a small balance.[86]

Bankers Development Corporation took this opportunity to supply the equipment which banks would need in order to print the names of special account customers on their checks. It discovered a small inexpensive machine and, in 1939, made a contract with a large bank to furnish it one of these machines, the bank to pay Bankers $1.50 for the first book of 20 checks sold the depositor, and 1¢ per check for additional books of 20 checks sold to the same depositor. Other contracts followed, and the system, designated "ThriftiCheck," gradually

mulation of Earnings, 36 Taxes 933 (1958); Hall, The Accumulated Earnings Tax, 38 Taxes 849 (1960); and Kopperud & Donaldson, The Burden of Proof in Accumulated Surtax Cases, 35 Taxes 827 (1957).

85. 267 F.2d 26 (2d Cir. 1959).

86. Casey v. Commissioner, 267 F.2d 26, 28 (2d Cir. 1959).

developed to a point where Bankers derived, in 1943, at least 90% of its income from this operation.

However, the hand printing machine utilized by Bankers left room for improvement. A more automatic machine was desirable, and serious competition developed. Between 1948, when a competitor displayed an automatic printing machine, and 1950, Bankers lost several customers to this competitor. In 1949 Bankers attempted to have a manufacturer develop an automatic printing machine for it, but the machines had defects which could not be satisfactorily eliminated. As a result, another company offered to produce the desired machines if Bankers would finance the production.

Owen, the individual owning the other 50% interest in Bankers, was unwilling to invest more than $50,000 of Bankers money in the development of the new machines. He was not certain that enough of them would be satisfactory to be worth a larger risk. However, Bankers did advance $50,000 to finance the production, and, in addition, Casey himself personally loaned $50,000 or more. Again, they were not satisfactory machines. Casey acquired Owen's stock in 1951 and in that year discovered another manufacturer, which, in 1952 and thereafter, did produce a satisfactory printing machine.

After starting with an accumulated deficit of over $41,000 in 1939, in 1950 Bankers had accumulated earnings of $173,970.71, of which $53,504.97 was in controversy.[87]

Without Section 534, the Commissioner's determination that the earnings and profits were accumulated beyond the reasonable needs of the business would give rise to the presumption of the prohibited purpose and then the taxpayer would have the burden of establishing the contrary by a clear preponderance of the evidence.[88] However, the effect of Section 534, according to the Second Circuit, was to "indicate that Congress did not want the taxing authorities to be second guessing the responsible managers of corporations as to whether and to what extent profits should be distributed or retained, unless the taxing authorities were in a position to prove that their position was correct."[89] The court stated specifically that the notices and statements having been sent, "the Commissioner of Internal Revenue then, had the burden of

87. The Tax Court determined that Bankers could charge itself with $43,825.14 because of potential liabilities which could arise as the result of a suit brought against the corporation by the estate of a former commission employee. In addition, Bankers carried on its books an asset entitled "goodwill (including unoperated portion of signed contracts)" in an amount of $26,640.60, which had become practically worthless but never been written off. The Tax Court held that money retained in the treasury to compensate for the inevitable write-off of this item should not be treated as an unreasonable accumulation. That court also found another need of the business was replacing printing machines and that $50,000 was adequate for that purpose. Thus, with the $43,825.14, the $26,640.60, and the $50,000 all deducted from the $173,970.71 accumulated surplus, the Tax Court was dealing with the remaining $53,504.97 as an excess of accumulation subject to the § 102 surtax.

88. See Casey v. Commissioner, supra note 86 at 30. Note, also, that the 1954 Code revision eliminated the word "clear," requiring the proof to be "by the preponderance of the evidence." Int. Rev. Code of 1954, § 533(a).

89. Casey v. Commissioner, supra note 86 at 30.

proof that Bankers had unreasonably accumulated profits."[90] The Commissioner, however, produced nothing to tend to show that it would have been unreasonable for the corporation to have spent the money for the machines, in other words, to show that the accumulation of the $53,504.97 was unreasonable. Therefore, the presumption of motive did not fit, this being a much different situation from the ordinary one where the Commissioner's task is made easy "by imposing on the taxpayer the burden of proving by a clear preponderance of the evidence that the purpose of an accumulation of profits beyond the reasonable needs of the business is other than a purpose of keeping the shareholders free of surtaxes."[91] Also, with regard to the question of the prohibited purpose itself, the court said little except to hold for the taxpayer. Perhaps the language of the court which appears early in the case signifies its thoughts in the area and explains why not much was said at this time: "In the instant case, as perhaps in most § 102 cases, the real controversy is as to the presence or absence of a business reason for accumulating rather than distributing the corporate earnings."[92]

The next case to be considered by the Second Circuit was *I. A. Dress Co., Inc.*[93] There, however, the court considered it unnecessary to pass upon the question of burden of proof because on the record before it the Tax Court's findings in favor of the government were supportable regardless of which party had the burden of proof. The statement submitted by the taxpayer was previously described in the section dealing with Category 4 of the opinions and explanations.[94] This was subsequently described by the Second Circuit (in the *Gsell* case)[95] as being a statement amounting to no more than notification that the taxpayer intended to attempt to prove that the accumulations were reasonable in light of the needs of the business. The reason given by the taxpayer for the accumulation was basically that the taxpayer planned to buy the fee of the building it was leasing. However, there was no evidence to substantiate this other than in a general sense and without detail.[96] The court summarized its views by saying:

> If such a vague plan were sufficient to avoid the corporate surtax, any individual could organize a one-man corporation, lease a building and discuss with the lessor the purchase of the building at some future time, and then assert that in the meantime business needs required

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90. Ibid.
91. Id. at 32.
92. Id. at 27.
93. I. A. Dress Co., Inc. v. Commissioner, 273 F.2d 543 (2d Cir. 1960).
94. See p. 343 supra.
95. R. Gsell & Co., Inc. v. Commissioner, 294 F.2d 321 (2d Cir. 1961). See p. 348 infra.
96. The taxpayer had no option to acquire the fee; in the year in question it had no reason to know whether or when it could come to terms with the owner (who was willing to sell at a price some $300,000 in excess of what the taxpayer was willing to pay); and it expected to finance part of the purchase through a mortgage, but there was no evidence as to the amount of the mortgage or as to expected earnings before the purchase might eventually be made at a future indefinite date.

accumulation of corporate earnings. Congress could never have intended § 102 to be so easily evaded.[97]

In *Dixie, Inc.*,[98] the Second Circuit again found such ample support in the record on behalf of the Tax Court's findings that it deemed it unnecessary "to determine the limitations of the statutory presumption set out in Section 102(c) or involve the determination of the case with the niceties of burden of proof indicated in Section 534."[99] Again similar to *I. A. Dress Co.* with regard to an alleged prospective acquisition of a building, this time a hotel, the court quoted from its decision in that case as set forth above.

The latter two cases have been subjected to some criticism and they have been utilized in part along with other cases to support the proposition that the Section 534 burden of proof element has been inserted in the Internal Revenue Code to no avail. However, it would appear that any confusion resulting from these cases has been cleared up in the most recent pronouncement by the Second Circuit in the *Gsell*[100] case so that if any doubt were cast upon the thoughts of the Second Circuit as to the burden of proof, that has now been vacated in favor of an indication that the Second Circuit has adopted not only a reasonable but a logical approach to the question and one which seems to be in accord with Congressional intent.

R. Gsell & Co., Inc. v. Commissioner

R. Gsell & Co., Inc., the taxpayer, is a New York corporation engaged in the business of purchasing, assembling, and selling Swiss watches and movements. The case involved the fiscal years 1947 through 1950 and 1952, during which period the taxpayer's business functioned in two departments—one, a merchandising department, the other, a commission department.[101]

The merchandising department placed orders with Swiss factories, but the latter would not contract for a fixed delivery date. Rather, in line with the practices of the Swiss watch cartel, the taxpayer would be cabled that its watch movements were being shipped. It was then incumbent upon the taxpayer to pay for the watches within eight days of the shipment date in order to gain the five percent discount necessary to the successful operation of its competitive business. Also under the practices of the cartel, an order once placed with a factory was not cancellable since the watch plates were stamped with the

97. I. A. Dress Co., Inc., supra note 93 at 544.
98. Dixie, Inc. v. Commissioner, 277 F.2d 526 (2d Cir. 1960).
99. Id. at 527.
100. R. Gsell & Co., Inc. v. Commissioner, supra note 95.
101. Through the merchandising inventory the taxpayer was able to supply commission customers with watches in the event they underestimated their needs. Also, the experience gained in this phase of the business made it possible to give commission customers style advice by keeping abreast of the market trends. In addition, a profitable merchandising business would enable the taxpayer to survive should it lose some of its commission customers to another broker or through a decision to import directly from the Swiss watch manufacturers.

taxpayer's United States customs and brand marks early in the manufacturing process.

During the years in question, the time span from placement of order to delivery took from 8 to 24 months. No exact prediction was possible and, as a result of these time gaps, commitments for movements were always high in relation to present sales.[102] All outstanding orders might have been shipped at one time at the discretion of the Swiss factories, although they never were. In addition to paying the Swiss factories, when the movements arrived in the United States, the taxpayer was required to pay a customs duty in cash which amounted to anywhere from 60–80% of the value of the movements.

The taxpayer lost money during eight of the ten years from 1930 through 1939, having been moderately successful prior to 1930. Not until World War II created a seller's market, however, did it erase its capital deficit, and, at the end of its 1944 fiscal year, the taxpayer completed more than twenty years of operation with a capital surplus of only $7,676. 1947, the first tax year at issue in the case, was the most successful in taxpayer's history. In that year both the commission and the merchandising departments were profitable. However, during all the other pertinent years, the merchandising department lost money and was carried by the commission department. Even so, by the end of 1947 the taxpayer attained a capital surplus of approximately $116,000 and, by the end of 1952, this increased to $168,157.

During the depression years the taxpayer experienced very little success in its repeated efforts to obtain loans to finance its buying. When loans were obtained they were for a very limited time and were often called upon short notice. Because of this, the taxpayer decided to forego the use of bank credit in its business and undertook to use its own resources to finance operations. However, during 1945, 1946, and 1947, the taxpayer did borrow funds from another company controlled by the individual who owned substantially all of its stock.

In the late 1940's and early 1950's a sharp recession was experienced in the watch business. The taxpayer reduced its inventory and, as a result, its cash position increased accordingly as it weathered the recession. During this period, the taxpayer was looking for a new line of watches to strengthen its merchandising business and, in 1952, did add a new line of less expensive watches. As sales increased and the taxpayer increased its inventory, cash on hand and outside investments correspondingly decreased. A $5,000 dividend was paid in 1951, and, in 1952, a $7,000 dividend was paid.

It was on these facts that the Tax Court found the accumulations to be beyond the reasonable business needs and for the proscribed purpose.[103] In doing so the Tax Court stated that throughout its discussion it assumed the

102. For example, the taxpayer had open commitments as of June 30, 1947, in the amount of $397,643, and as of December 31 of the following years they amounted to: 1948, $457,537; 1949, $239,085; 1950, $248,548; 1951, $115,815; 1952, $244,717.

103. R. Gsell & Co., Inc., 34 T.C. 41 (1960).

taxpayer had shifted the burden of proof to the Commissioner insofar as its reasonable business needs were concerned but that it reached its conclusion as to its reasonable business needs on the basis of affirmative facts of record. Thus, the sufficiency of the taxpayer's statement did not have to be considered.

The Second Circuit noted that where in a Section 102 case the Commissioner alleges an accumulation of earnings and profits by the taxpayer beyond its reasonable business needs, "the taxpayer must prove otherwise or be faced with a particularly heavy burden of proving that the accumulations were not motivated by a purpose to avoid a surtax on the shareholders."[104] It stated further, however, that this burden of the taxpayer was ended by the implementation of Section 534, which section provided "a method through which the taxpayer could switch to the Commissioner the burden of proving that the accumulations were unreasonable."[105] The details of this are explained in the opinion. The foundation was thereby established for the Second Circuit's reversal of the Tax Court's opinion.

Gsell: Adequacy of Statement

In the Second Circuit, one of the Commissioner's contentions was that "the taxpayer's statement was inadequate in that it did not state legally sufficient grounds to show that taxpayer did not permit earnings and profits to accumulate beyond the reasonable needs of the business."[106] In this regard, said the Second Circuit:

> The Commissioner seemingly has placed the proverbial cart before the horse. In order to switch the burden of proof on this issue to the Commissioner, § 534 demands only that a taxpayer submit a statement of the grounds, and facts sufficient to show the basis thereof, on which it relies to prove that there was no unreasonable accumulation.[107]

Then, as we noted previously, it stated that this was not a case where the statement was no more than a notification of the taxpayer's intention to attempt to prove that the accumulations were reasonable in light of the needs of the business. Rather, the

> taxpayer paid the full price of switching the burden of proof on the unreasonable accumulations issue to the Commissioner. In a 24 page statement, taxpayer showed its hand by stating substantially all the grounds on which it would rely to prove that the accumulations were not unreasonable in relation to its need for ready cash in its business. The statement was more than adequate to invoke the operation of § 534 and to switch the burden of proof to the Commissioner on the issue of the reasonableness of the challenged accumulations in the light of taxpayer's business needs.[108]

104. R. Gsell & Co., Inc. v. Commissioner, 294 F.2d 321, 325 (2d Cir. 1961).
105. Ibid.
106. Ibid.
107. Ibid.
108. Ibid.

Gsell: Importance of Burden of Proof

After noting how the Tax Court refused to determine the adequacy of the statement to shift the burden to the Commissioner and found that on the record as a whole the accumulations were unreasonable, the Second Circuit recognized that in some cases where the proof is convincing that there is no justification in a taxpayer's business for the alleged accumulations it may not be necessary to determine who has the burden of proof on the question.[109] However, the court further states that:

> In close cases the determination of who has the burden of proof on the unreasonable accumulations issue must be resolved. The party having the burden of proof does not merely have the burden of coming forward with evidence; it has the burden of persuasion and once fixed that burden does not shift. . . . Congress purposefully inserted § 534 into the Internal Revenue Code of 1954 and the courts have a duty to give the section its intended effect. Taxpayer having here submitted a statement sufficient to shift the burden of proof on the issue of whether the accumulations were beyond the reasonable needs of the business to the Commissioner, the government must assume the burden of persuasion that the accumulation was unreasonable.[110]

To conclude this aspect of the case the court then found the evidence adduced by the Commissioner insufficient to support any findings that he had met his burden of proof.

Gsell: Proscribed Purpose

The court then proceeded to the question of whether, in spite of its determination with regard to the reasonable business needs, the taxpayer was otherwise availed of for the prohibited purpose. Acknowledging that the accumulated earnings tax should be "rigorously applied" to prevent abuse of the corporate form by individuals desiring to lower their individual tax rates, the court was, nevertheless, of the opinion that

> the Commissioner may not use § 102 as a device to enable him to look over the shoulder of the corporate manager and assess a penalty any time the Commissioner believes that a corporation has not been generous in its dividend policy or has temporarily invested its surplus in a manner not entirely acceptable to the Commissioner.[111]

The Second Circuit felt that the Tax Court had minimized the importance of the issue concerning reasonable needs of the business when it (the Tax Court) stated, placing reliance upon its *Young Motor Company* decision, that "in the final analysis, however, reasonableness of the accumulation is merely a subsidiary consideration, the ultimate question being whether the taxpayer is availed of for the purpose proscribed by the statute."[112] The Tax Court's re-

109. An example of this is given as Dixie, Inc. v. Commissioner, supra note 98.
110. R. Gsell & Co., Inc. v. Commissioner, supra note 104 at 326.
111. Ibid.
112. Ibid. See also R. Gsell & Co., Inc., supra note 103 at 51-52.

liance upon this language was said to be misplaced in that it caused the court to "lose sight of the importance of the question of whether the accumulations were beyond the reasonable needs of the taxpayer's business, although it did find on inadequate evidence that the accumulations were unreasonable."[113]

Noting that the Tax Court and the Commissioner appear to find proof that the proscribed purpose existed by virtue of the fact that the individual shareholders would have paid a higher individual income tax if the earnings and profits had been distributed to them, the Second Circuit thought such a showing failed to prove that the forbidden purpose was a motivating force in the decision not to distribute. In fact, it pointed out, "an identical situation could be found in every § 102 case except where the shareholders of the taxpayer-corporation had net losses in excess of the amount earned by their corporation."[114]

As suggested previously, the taxpayer was apparently in a position where it could have arranged financing from another corporation controlled by its main stockholder. However, "that taxpayer chose not to put itself in a position where it would have to rely on outside financing to continue its operations falls far short of proving that it was availed of for the purpose of preventing the imposition of a surtax."[115]

Even though in this 1939 Code case the presumption of Section 102(c) did not arise because the Commissioner failed to show the accumulations to be unreasonable, still to be met was the presumption of correctness of the Commissioner's determination. This was overcome by a combination of the Commissioner's failure to prove the unreasonable accumulation issue as well as by the findings of the Tax Court whch were said to warrant the conclusion that the taxpayer was not availed of for the prohibited purpose.[116]

In final analysis, the Second Circuit found the determination of the Tax Court was clearly erroneous.

> The Commissioner having failed to submit adequate evidence to carry the burden of persuasion that taxpayer permitted the earnings and profits to accumulate beyond its reasonable needs, and, there being convincing evidence that taxpayer was not availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting earnings and profits to be accumulated instead of being divided and distributed, we are left with the firm conviction that a mistake has been committed.[117]

113. R. Gsell & Co., Inc. v. Commissioner, supra note 104 at 326.
114. Id. at 327.
115. Ibid.
116. Taxpayer proved that (1) earnings were retained to meet the needs of its business; (2) reasonable salaries were paid its stockholder-employee; (3) corporate funds were not used by shareholders as their own; (4) taxpayer's chief stockholder engaged in various activities relating to other corporations in which he was a major stockholder which led to the declaration of dividends.
294 F.2d at 327.
117. R. Gsell & Co., Inc. v. Commissioner, supra note 104 at 328.

THE SIGNIFICANCE OF GSELL

Gsell is a 1939 Code case to which Section 534 was found applicable. In other words, this means the notice of deficiency must have been based in whole or in part on a determination that the taxpayer had accumulated earnings and profits beyond the reasonable needs of the business. Being a 1939 Code case, it did not involve any accumulated earnings credit. Therefore, the significance of establishing the question of the reasonable business needs had to do with determining whether a presumption of the prohibited purpose arose requiring the taxpayer to show by a clear preponderance of the evidence that the accumulation was not for the proscribed purpose. However, as strong as might be the findings that the accumulations were reasonable with regard to the business needs, it is still recognized that in a 1939 Code case it is possible for the proscribed purpose to exist even though the accumulations are not unreasonable. Thus, it would appear that the taxpayer must make some showing to overcome whatever presumption might attach to the correctness of the Commissioner's determination. This presumption, however, is significantly different from the statutory presumption which cannot arise unless there be a satisfactory determination that the accumulations are beyond the reasonable needs of the business.

The statements of the Second Circuit in the *Gsell* case provide substantial guidelines not only for evaluating an accumulated earnings tax case but also for assisting in its preparation and trial. The opinion actually sets forth a great many items of significance.

(1) The Second Circuit is correctly analyzing the accumulated earnings tax provisions with regard to its approach to the 1939 Code years. Clearly, a statutory presumption in favor of the proscribed purpose can arise if it is established that the earnings and profits have been accumulated beyond the reasonable needs of the business. If this presumption does arise, the taxpayer still has an opportunity to prevail by showing by a clear preponderance of the evidence that such is not the case. Also, even if the statutory presumption does not arise, the proscribed purpose may exist and the accumulated earnings tax may attach. All of this was very succinctly stated in the *Gsell* opinion.

(2) No firm indication has been given as to how the Second Circuit will analyze the modifications in the 1954 Code when an all-1954 Code case is involved. In other words, there has been no clear statement indicating the Second Circuit accepts the premise that for a 1954 Code year no penalty tax can attach if the earnings and profits have not been accumulated beyond the the reasonable needs of the business. However, because of the logic and good judgment applied to the 1939 Code years when the same have involved the new Section 534 and because of the Second Circuit's general tendency to equate lack of the proscribed purpose with the existence of reasonable business needs,

it may be expected that when it acts on a 1954 Code case it will conclude accordingly.[118]

(3) The Second Circuit attaches a strong significance to the existence of accumulations for reasonable business needs. It does not say that this absolutely determines the question for a 1939 Code year, but it is most probable that the proscribed purpose will not be ascribed to the taxpayer if it is determined that the earnings and profits have been accumulated for reasonable business needs. This tendency with regard to the proscribed purpose and the business needs in the 1939 Code years is substantial and is one of the reasons for anticipating that in a 1954 Code case, with the statute as clear as it is with regard to the accumulated earnings credit, this will be the determining factor.[119]

(4) The Commissioner's argument, based on the theories advanced in Category 4, *supra* (the taxpayer's statement is insufficient within the meaning of Section 534 and, therefore, there can be no shift in the burden of proof), is not likely to be very effective in the Second Circuit if the taxpayer has done a thorough job on its statement. In the *Gsell* case the taxpayer's statement was 24 pages in length. It was described by the court as showing substantially all the grounds on which the taxpayer would rely to prove its position that its accumulations were reasonable, in this case not unreasonable in relation to its need for ready cash in its business. The Commissioner's argument, contending the statement to be inadequate in that it did not state legally sufficient grounds to show the taxpayer did not permit earnings and profits to accumulate beyond the reasonable needs of the business, was well met by the court when it made reference to the Commissioner's having "placed the proverbial cart before the horse."[120] Of course, the court did recognize a difference between the *Gsell* statement and that presented in the *I. A. Dress Co.* case. However, a well prepared statement should eliminate this argument which may be expected to be advanced in all cases by the Commissioner.

(5) Concerning the statement itself, it is clear that it must be more than

118. Also, based solely on the technical aspects of the statute, no other result would seem possible.

119. Note that the First Circuit, in spite of its pronouncements in Young Motor Company concerning the significance of the reasonable needs of the business (see note 68 supra) stated that the re-enactment of the provisions dealing with preponderance of the evidence (§ 533(a))

> tends to minimize the emphasis on reasonable business needs which is reflected in the legislative history leading to the enactment of section 534(a) . . . . Some of the discussion, standing alone, might indicate that Congress felt that the incidence of tax should be determined solely by the objective reasonableness or lack of reasonableness of the accumulation . . . . However, we think section 102(a), now section 532, must still be regarded as directed at the taxpayer's actual intent.

Young Motor Company v. Commissioner, 281 F.2d 488, 491, n.3 (1st Cir. 1960).
This indicates possible confusion in the First Circuit as to the meaning of the 1954 Code provisions. However, it had little, if any, meaning in the decision itself and, since it is susceptible to double interpretation, should not be construed as being necessarily contrary to the proposition that no penalty tax can attach in an all-1954 Code case if the accumulations are for reasonable business needs.

120. R. Gsell & Co., Inc. v. Commissioner, supra note 104 at 325. See also p. 350 supra.

a notification that the taxpayer intends to prove the accumulations were reasonable. This was the manner in which the *I. A. Dress Co.* case was distinguished in the *Gsell* opinion by the Second Circuit.

(6) If a taxpayer has a poor case, it may expect the decision to be non-technical in nature and that nothing of any significance will be accomplished by way of easing its circumstances through a shift in the burden of proof.[121] This does not mean that anything is lacking in the significance of Section 534 and the location of the burden of proof. Rather, it signifies that this is a practical manner in which to dispose of such a case. However, in close cases, the taxpayer can expect a decision with regard to the burden of proof on the reasonable needs of the business; and, of course, the same will be true if the taxpayer has a good case. On the other hand, perhaps in this latter instance, because of such a good case, the decision will again be on a non-technical basis and arrived at on the basis of the record as a whole. Of course, this should make litle difference to the successful litigant.

(7) Once the burden of proof is determined to be upon the Commissioner, he will have not merely the burden of coming forward with the evidence, but he will have the burden of persuasion as well. In other words, in a 1954 Code case, this should mean that if the burden is on the Commissioner with regard to the reasonableness of the accumulations and if he produces no evidence and the taxpayer also produces no evidence, the taxpayer will prevail. On the other hand, if the Commissioner does produce evidence, all the taxpayer should have to do is to meet this. The taxpayer, then, could prevail with only a 50% case as described previously. The Commissioner, however, must have the more than 50% case before he can prevail under these circumstances.

Of course, in a 1939 Code case, if the burden is on the Commissioner with regard to the reasonableness of the accumulations and he produces no evidence, this will mean merely that the statutory presumption will not arise in his favor. He may still rely upon the presumption of the correctness of his determination. If this happens, the taxpayer can produce evidence to negate the presumption of the correctness of the Commissioner's determination and then the matter will have to be decided on the basis of the evidence before the court. Howver, under these circumstances, the eventual burden of proof that the proscribed purpose did not exist will be on the taxpayer. This, then, is no different from the normal type of tax case.

(8) The Second Circuit is well aware of the Congressional intent as expressed in the committee reports with regard to the penalty tax and improper accumulation of corporate surplus and may be depended upon to manifest its recognition of this Congressional intent in its decisions. In fact, it has accepted this as its duty. It noted this by saying "Congress purposefully inserted § 534 into the Internal Revenue Code of 1954 and the courts have a duty to give

121. See Dixie, Inc. v. Commissioner, 277 F.2d 526 (2d Cir. 1960).

the section its intended effect."[122] It also noted that although it was in agreement with the theory that Section 102 should be rigorously applied to make it impossible for the corporate form of business to be abused by individuals, this may not be used as a device to enable the Commissioner to

> look over the shoulder of the corporate manager and assess a penalty any time the Commissioner believes the corporation has not been generous in its dividend policy or has temporarily invested its surplus in a manner not entirely acceptable to the Commissioner.[123]

(9) If the Commissioner has the burden of proof, and if the taxpayer has grounds for needing "ready cash," the court will not be particularly receptive to a claim by the Commissioner that he is meeting his burden of proof through the introduction of evidence showing that the taxpayer has made outside investments, if they can be easily liquidated. In the *Gsell* case the taxpayer had large investments in stocks and bonds of the American Telephone and Telegraph Company and in government securities. The Commissioner contended this indicated these funds were not needed in the operation of the taxpayer's business and that this was evidence that the accumulations were beyond the reasonable needs of taxpayer's business. The court noted, however, that these securities were readily saleable and taxpayer could have quickly converted them into cash.

(10) Furthermore, the Commissioner will not be able to sustain his burden of proof or otherwise show the existence of the prohibited purpose by saying that the individual shareholders would have paid a greater amount of income tax if there had been a distribution.[124] Clearly, the Second Circuit noted that both the Tax Court and the Commissioner were in error in appearing to find proof that the proscribed purpose existed by virtue of this fact, particularly since "an identical situation could be found in every § 102 case except where the shareholders of the taxpayer-corporation had net losses in excess of the amount earned by their corporation."[125]

(11) Nor will the Commissioner be able to contend that the taxpayer must rely upon financing which might be available from other corporations it or its shareholders control. Much to the contrary, if the taxpayer chooses not to put itself in a position where it must rely on its outside financing to continue its

122. R. Gsell & Co., Inc. v. Commissioner, supra note 104 at 326. See also p. 351 supra.

123. Ibid. Note that this is described in Casey v. Commissioner as not second-guessing corporate management unless the taxing authorities can prove their position correct. See p. 346 supra.

124. In a 1954 Code case the significance of this factor is likely to be diminished because it relates more closely to the proscribed purpose than to the reasonableness of accumulations for business needs.

125. R. Gsell & Co., Inc. v. Commissioner, supra note 104 at 327. See also p. 352 supra. Note that in Young Motor Company v. Commissioner, supra note 119 at 491, the First Circuit also pointed out that if knowledge of the fact that declaring dividends would increase a stockholder's surtaxes were the test of the purpose, "then the only corporations that could safely accumulate income would be those having stockholders with substantial net losses."

operation, this "falls far short of proving that it was availed of for the purpose of preventing the imposition of the surtax."[126] Thus, the accumulations will not be deemed unreasonable just because funds may be available elsewhere, and neither the unreasonableness of an accumulation nor the proscribed purpose can be claimed to flow from this issue.[127]

(12) The Second Circuit will reverse the Tax Court on a "clearly erroneous" basis even though the Tax Court may consider it has evidence to support its finding. All that is required is that the Second Circuit, on the entire evidence, be left with a "definite and firm conviction that a mistake has been committed."[128]

The Second Circuit Taxpayer

There is no reason to expect the Second Circuit will not continue along the lines already suggested by its opinions. In other words, it should continue to back up the Congressional intent as it has explained its view thereof and continue to give some meaning to the burden of proof. Its strong pronouncements have been with regard to 1939 Code cases, and it is reasonable to expect that its views will continue to be strong when focused on 1954 Code years, particularly when one realizes that its opinions can be buttressed by the stronger statute. With this in mind we can give some attention to how a taxpayer might conduct itself when faced with an accumulated earnings tax case.

Note that this is the period when we are beginning to be faced with more 1954 Code years and less with those governed by the 1939 Code. Therefore, we are moving to the time when the reasonable needs of the business should be absolutely determinative of the issue in favor of the taxpayer.[129] In other words, not only do we have the Second Circuit tending to equate accumulations for reasonable business needs with a lack of the proscribed purpose set for by Section 102, we now have the statute saying this also with regard to Section 531. Therefore, the taxpayer should be aware of all these aspects and act accordingly.

There is no reason why a Second Circuit taxpayer should fail to consider the burden of proof as his extra vehicle of leverage in an accumulated earnings tax case. Of course, the degree to which this is possible will vary with the circumstances of each particular case. Certainly, however, a taxpayer with a legitimate position who feels himself "put upon" by the examining agent should take every possible advantage of the burden of proof element. This means,

126. R. Gsell & Co., Inc. v. Commissioner, supra note 104 at 327.

127. This, of course, has significance with respect to such broad aspects of corporate financing as "self insurance" and various other types of internal funding.

128. R. Gsell & Co., Inc. v. Commissioner, supra note 104 at 328. See also p. 352 supra.

129. However, if the accumulations are found to be unreasonable, the taxpayer can still show a purpose therefor other than the proscribed one. In other words, a taxpayer might accumulate earnings and profits without relation to the reasonable needs of the business, but it may also do this without any intent to prevent the imposition of the surtax on its shareholders.

clearly, that if a case is being set up against a taxpayer which seems to fall within the area of abuses set forth by Congress as something intended to be disposed of, the taxpayer should not react with fear or be bluffed by the agent. Rather, if the proposal seems to fall into this category, the taxpayer will find authority and comfort in the Second Circuit decisions to enable him to stand his ground. This will also be true even if the case is a close one.

Initial Negotiations

The first opportunity for discussing an accumulated earnings tax case will be when it is initially proposed at the revenue agent level. An agent will often start off with, "Show me why your accumulations are not beyond the reasonable needs of your business." In reply, a practical approach for a taxpayer may be to attempt to turn the situation around and take advantage of it. This might be accomplished by noting the burden of proof and the respect with which this is handled in the Second Circuit and requesting that the agent explain why he feels the accumulations are beyond the reasonable needs of the business, and, in addition, and perhaps even more important, what evidence he has to prove such an allegation. Thus, the burden of proof, a phrase which so glibly rolls over the lips of revenue agents because, in most instances, this is an aspect of the case where the taxpayer is put to the test, might become a weapon for the taxpayer. The fact that revenue agents use this so often as a talking point suggests they do consider it as a weapon and as one having significance. Therefore, a strenuous application of the policy of pointing out to the Commissioner's representative that this is one case where he is likely to have to prove his position may have some favorable effects in early negotiations.

Of course, when Section 534 first came into being it was thought that it might be so utilized to have such effects. However, it is not clear whether this has been so in many cases. Certainly, judging from some of the litigated cases, the section has often appeared to have had no effect at all, not only with regard to negotiations at this level but, in addition, with regard to subsequent negotiations up to and including the trial. Nevertheless, it is very often the "poor" examples which become most notorious, and their existence should not be construed to mean that under other circumstances the burden of proof provisions may not be responsible for generating "good" effects. This can and does happen—the only thing lacking is the publicity.[130]

With regard to some of the details which may be the subject of discussion between taxpayer's counsel and the Internal Revenue Service, it might be well to emphasize that in Second Circuit cases one of the most frequent arguments of the Service can be discounted to a very great extent. This is the claim in very common usage that the government's case is enhanced and the taxpayer's case is, therefore, weakened by the showing that if the earnings and profits had

130. A review of the docket disposition shows many accumulated earnings tax cases closed on stipulation without any trial.

been distributed instead of accumulated, the shareholders would have paid a greater amount of income tax. This has been handled by the Second Circuit in such a manner as to suggest that that court will not attach to this any significance in favor of the government's case. Note, however, that this argument itself may even fade as it becomes accepted that a taxable proscribed purpose can not exist if the accumulations are for reasonable business needs. This is because such an argument is directed more toward the existence of the proscribed purpose than toward anything associated with the reasonable needs for the accumulation.

It would also seem well for the taxpayer to emphasize the strength of his own case in negotiations of this sort by not allowing himself to be burdened by the vague generalities that are so commonly heard. Rather, emphasis should be placed on the particulars of the agent's assertions. These particulars, of course, should be something more than his own views since this was something specifically described by Congress as an aspect to be avoided. Nevertheless, the extent of success in this regard will hinge upon the qualifications and ability of the examining agent.[131]

Thus, in the early stages of a Section 531 case, the taxpayer should be able to judge the validity of the proposed case from the caliber of all of the agent's suggestions. Of course, in a matter such as this, it is always well for the tax practitioner who will eventually be handling the case to be doing so from the initial stages. This is so particularly when it comes to imparting information to the agent or having the ability to manifest the significance of such a thing as the burden of proof.

Other Pre-Trial Negotiations

If negotiations with the examining agent prove unsuccessful, two alternatives arise concerning the manner in which next to proceed. Thus, depending upon the personal preferences of the tax practitioner and depending upon the case itself, who is handling it for the government, and other local conditions, the manner in which the burden of proof will be "worked" will vary. The alternatives are either taking advantage of each available preliminary step to negotiate or foregoing some or all. In other words, the case may be discussed at the informal conference level and in the Appellate Division prior to petitioning the Tax Court, or, in the alternative, the Section 531 negotiations may be eliminated at lower levels and the case taken directly to the Tax Court.

131. Note that in Announcement 61-106, 1961 Int. Rev. Bull. No. 51 at 13, it was stated that the evaluation of an agent's overall performance is to be based on specific quality elements to the elimination of quantitative measurements. Therefore, to refine this approach the accumulation and distribution of statistics of case and dollar production by individual agents and by groups is now prohibited at all levels of the Service. Thus, it is hoped the agents will be evaluated on their overall performance, ability, treatment of taxpayers, efficiency in performing audits, and effectiveness in inspiring confidence in the self-assessment system. If this announcement actually has any substance, perhaps it will also manifest itself in the manner in which § 531 cases are handled.

Many tax practitioners prefer the former alternative on the basis of a general policy of desiring to make efforts to settle cases at the earliest possible stage. Also, there is the possibility that if the case can be settled prior to becoming involved with the Tax Court, time will be saved, if for no other reason than that no statement will have had to be prepared. Again, some consider these preliminary negotiations as a good opportunity to "warm up" for preparing a statement if it is eventually needed. Thus, the period would function in part as a time to allow for a more leisurely and, sometimes, more detailed, ferreting out of the entire case. In addition, many people feel the modification in the burden of proof provisions of the Code was specifically intended to provide additional leverage for handling the case at the early stages and that, therefore, this procedure should be adopted. Others will prefer to take advantage of all opportunities merely because they feel this will be doing the client the best service; the thought would be that to eliminate a step is to eliminate a point of possible favorable action to the client.

If a taxpayer prefers to enter into an informal conference and, if unsuccessful there, carry the case via a protest to the Appellate Division, it will be able to use the burden of proof advantageously in both instances. However, to do so practically, it would appear the taxpayer must press the burden of proof issue and present its own case in such a manner as to avoid any detailed analysis of the reasonableness of its accumulations. By such a procedure, it will be possible to utilize the conference opportunities and the burden of proof argument without undue expenditure of time. However, as soon as the taxpayer reaches the point where he is involved in substantial detail of his own case, he will be partially defeating the use of the burden of proof as his weapon. Once detail of this nature becomes involved, the taxpayer will no longer be talking about the Commissioner's burden of proof but, rather, he will be acting as though he had the burden of proof and was adducing evidentiary matter in order to meet his own burden. This does not mean, however, that the taxpayer should be reluctant to emphasize his position by providing general information which will, in effect, outline the substance of what would later appear in the statement, if needed. Nor does this mean that the burden of proof should not be used in conjunction with a showing of the taxpayer's strength aside from the burden issue instead of being relied upon all by itself. This, indeed, may be the most practical approach in a majority of circumstances. In general, however, it would not appear practical to make a variety of detailed statements in written form at either the informal conference or Appellate Division level. Rather, detail of this nature might best be reserved for the statement itself, if it is necessary.

Those who favor a "direct to the Tax Court" approach may base their reasoning on a variety of factors.[132] However, one which may be most promi-

132. Note, too, that some taxpayers may have decided that if litigation is going to be necessary it will be on a suit for refund in the District Court and not in the Tax Court.

nent is the theory that by going to the Tax Court the primary negotiations prior to trial will involve the government attorney, the one who will be trying the government's case and who is most likely to appreciate the significance of the burden of proof.

Of course, this approach is not confined solely to the burden of proof. It may also be considered appropriate to have other issues handled by the government attorney as distinguished from other conferees along the line. Note, however, that in the normal procedure for a docketed Tax Court case, the case is assigned to a technical adviser in the Appellate Division who works on it with the government attorney and with whom there are usually other opportunities for discussion if desired. Thus, access to the Appellate Division is not entirely eliminated. The necessity of a protest, however, vanishes.

This approach may also be thought of by some as a time-saver. However, it is questionable whether this can be stated as a general rule. If the case is settled without the necessity of a trial, the time-saving factors will have been that there was no informal conference, no protest, and no extra Appellate Division conference.[133] However, in order to get to this point and be able to use the burden of proof means that the taxpayer will have had to prepare his statement pursuant to Section 534.

On the other hand, if the negotiations at this level are unsuccessful and actual litigation is necessary, it may be considered most likely that a trial would have taken place in any event and that nothing would have been gained by taking the time to negotiate at lower levels. This would quite definitely involve a time-saving factor.

Tax Court Motion Practice

If a case reaches the point of trial in the Tax Court, it is foolish to suppose that because of the burden of proof provisions of Section 534 a taxpayer can afford inactivity. The burden of proof being so confusing and no one being certain just what aspect thereof must be manifested or met, a taxpayer can hardly take a do-nothing attitude—no more so than any other litigant in any other case. For this reason, it would appear that the most useful part of Section 534 and its burden of proof comes at some time prior to the trial.

If all negotiations prove unsuccessful, regardless of which have been

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Even if this is the case, it is possible first to utilize the conference procedures in an effort to prevail at an early stage—and in doing so to involve the burden of proof factor. Incidentally, consideration of the District Court as the forum may be very worthwhile. It was pointed out in October of 1961 that "every accumulated earnings tax case that has gone to a jury (seven cases in all) has been won by the taxpayer." See Holzman, R. S., Why Taxmen are Sore at "534," 39 Taxes 777, 782 (1961). With regard to a Tax Court proceeding it was also suggested there at page 783 that "certainly a statement should be filed despite the lessons of history. There always is the possibility that some one other than the corporation's advisors may have read what Congress has written about the intended function of Section 534."

133. Incidentally, even if an Appellate Division conference is held prior to the time of the petition to the Tax Court, the Appellate Division will again be in the picture with the government attorney.

adopted, and the case is to be tried, we arrive at a time when an active motion practice may be helpful to the taxpayer's case.[134] When the Commissioner has the burden of proof on an issue, he must set forth in his answer a statement of the facts on which he relies to sustain such issue.[135] Thus, the failure of the Commissioner to present his case with regard to the reasonable needs of the business (assuming, of course, that the burden will be upon the Commissioner) makes him subject to a motion under Rule 17 (c) for an order to file a further and better statement of the nature of his claim.[136]

At this stage in the development of the accumulated earnings tax burden of proof in the Tax Court, it is not likely that the taxpayer can expect too much from the Tax Court along the lines of having the court make a decision as to the sufficiency of the statement or the location of the burden of proof, which factors would necessarily have to be determined prior to an order by the Tax Court directing the Commissioner to improve upon his answer. Motions by the taxpayer-petitioner requesting the court to rule on the burden of proof issue have been regularly unsuccessful. The reasoning adopted by the Tax Court has been described as developing along three lines.[137] (1) Since the judge hearing the motion may not preside at the trial, he should not make a decision that would bind the trial judge on such an important aspect of the case. (2) No ruling should be made with regard to the Section 534(c) statement because the statement itself may be a sham. (3) To rule upon the burden of proof it would be necessary for the court first to determine whether the grounds and facts of the statement are sufficient to justify the accumulation. This should not be done since it would be prejudging the issue to be resolved at the trial.

All of these reasons are poor. Even though the location of the burden of proof is very important in a case of this kind, the Tax Court rules themselves,

134. Of course, depending on the circumstances, this point may very well arrive prior to any negotiations at all.

135. See Rule 14(b), Rules of Practice of the Tax Court of the United States.

136. Rule 17, Rules of Practice of the Tax Court of the United States, is entitled Amended and Supplemental Pleadings. Paragraph (c) thereof states as follows:

(c) *Amendment ordered.*—

(1) *Occasion for.*—The Court upon its own motion, or upon motion of either party showing good cause filed prior to the setting of the case for trial, may order a party to file a further and better statement of the nature of his claim, of his defense, or of any matter stated in any pleading. Such a motion filed by a party shall point out the defects complained of and the details desired.

(2) *Consideration of such motion.*—The Court, in its discretion may set such a motion for hearing (see Rule 27(a)) or may act upon it *ex parte.*

(3) *Penalty for failure to amend.*—The Court may strike the pleadings to which the motion was directed or make such other order as it deems just, if an order of the Court to file amended pleadings hereunder is not obeyed within 15 days of the date of the service of said order or within such other time as the Court may fix.

137. See Barker, Penalty Tax on Corporations Improperly Accumulating Surplus, 35 Taxes 949, 951-53 (1957), and Kopperud & Donaldson, The Burden of Proof in Accumulated Surplus Cases, 35 Taxes 827, 876-77 (1957). See also Wagman, Taxation of Accumulated Earnings and Profits: A Procedural Wrangle, 37 Taxes 573, 579-81 (1959).

which have established a motion procedure and outlined things which are to be accomplished thereby, would appear to be losing significance when it is said to be unwise for the judge presiding at the motion calendar to make a determination with regard to an issue merely because this would bind the judge presiding at the trial. Also, the suggestion of the possibility of the statement being a sham is hardly a reason. Any statement which presents the grounds and detailed facts as it should can be examined for defects based on a claim of sham. This, of course, is an argument which may be developed and advanced by the Commissioner. However, lacking evidence of this, there is no good reason for the Tax Court to refuse to rule concerning the statement simply on the theory that it might be a sham. In addition, a significant distinction is being overlooked with regard to what is being ruled on in such a motion. A ruling concerning the sufficiency of a statement or the location of the burden of proof is in no way prejudging the merits of the case or establishing the reasonableness of the accumulations. The statute merely provides that the taxpayer's statement shall set forth the grounds and facts on which it relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business. The fact that these grounds are set forth does not necessarily mean they do justify the accumulation as being reasonable, and an order directed toward the sufficiency of the statement would have nothing to do with the issue of whether they were.[138]

Nevertheless, experience in the Tax Court so far has shown that not too much can be expected.[139] However, as decisions like the *Gsell* case continue to come forth, these might invoke a change in the views of the Tax Court. Also, even if a taxpayer is unsuccessful in this regard in his Tax Court motion practice, he may feel assured that his efforts will not be overlooked by the Second Circuit when he is acting with regard to a legitimate case.

This type of motion practice could play a very important and significant part in the handling of accumulated earnings tax cases and is in accord with the tax practice now being developed with regard to fraud cases, another area where the Commissioner has the burden of proof.[140] Actually, it is this type of development that was envisioned when the new Section 534 and its burden of proof became a part of the Internal Revenue Code. Also, it is because of the failure of such things to happen that so much pessimism has been directed toward the significance of this modification. Nevertheless, as long as the Second Circuit Court of Appeals continues to attach meaning to Section 534 and its provision for shifting the burden of proof to the Commissioner, taxpayers who will eventually be in that Circuit may feel a little more at ease in handling their cases. Perhaps, too, as the Code cases progress and we are dealing with circumstances where the burden of proof becomes extremely important because

138. Ibid.
139. See also Altman, Corporate Accumulation of Earnings, 36 Taxes 933, 936-37 (1958).
140. See Commissioner v. Licavoli, 252 F.2d 268 (6th Cir. 1958).

of the ability of the reasonable needs of the business issue completely to determine the case, the burden of proof element will gather a revised meaning in the Tax Court.

In spite of any aid which may come to the taxpayer through the burden of proof element, there still exists one element which must be weighed and which may tend to limit the manner in which a taxpayer is able to proceed. This is with regard to the costs he must necessarily incur in order to defend even a preposterous case which is set up against him. Until some system evolves which will give costs to the taxpayer under circumstances such as these, there will continue to be a lack of flexibility in the way the taxpayer is able to proceed. In other words, until the element of nuisance value can satisfactorily be eliminated from a case, a taxpayer's bargaining power will continue to be somewhat limited.

CONCLUSION

Some, no doubt, have the feeling that the existence of the opportunity to shift to the Commissioner the burden of proof in accumulated earnings tax cases is something which should be applied in their favor all the time. However, taxpayers must recognize that when the change in the 1954 Code was adopted, the Congressional intention was not to void the accumulated earnings tax but to curb certain abuses concerning its use, particularly where it was utilized as a threat to induce settlement on other issues or to second-guess management. Nevertheless, even when this factor is recognized, it is still clear that the burden of proof element of Section 534 has received disappointing response in the Tax Court and in some circuit courts. In spite of this, taxpayers in the Second Circuit have been given the opportunity to utilize the burden of proof as a factor which may very well prove decisive in a close case. For this reason, the filing of a Section 534 statement and the significance of the *Gsell* case should not be overlooked.