

THE ACCUMULATED EARNINGS TAX: DISPLACEMENT OF THE AVOIDANCE TEST AND A SUGGESTED BUSINESS PURPOSE TEST

The accumulated earnings tax, imposed upon corporate earnings accumulated in excess of the reasonable needs of the business for the purpose of avoiding income tax on dividends distributed to shareholders, has been undergoing evolutionary change through statutory modification and judicial interpretation since it was first enacted in 1921.¹ To determine the tax liability of accumulating corporations, Congress and the courts have consistently emphasized the aspect of the reasonableness of the accumulation; simultaneously they have deemphasized the aspect of a tax avoidance purpose for the accumulation. The Supreme Court's recent decision in *United States v. Donruss Co.*² represents the latest development in this ongoing process. This comment will analyze the impact of *Donruss* upon the changing administration of the accumulated earnings tax, and will discuss the theoretical and practical deficiencies in the original structure of the tax giving rise to the change. It is concluded that the "purpose to avoid" test has all but vanished as a significant factor for determining tax liability, and that an alternative test based upon the "legitimate business purpose" concept could be utilized effectively to replace that residue of the former test left by the *Donruss* decision.

I. PRESENT FORM OF THE ACCUMULATED EARNINGS TAX

The accumulated earnings tax is imposed by Section 531 of the Internal Revenue Code of 1954.³ The operative section, however, is 532, which defines corporations which shall be subject to the tax as

every corporation . . . (with certain exceptions)⁴ 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.⁵

¹ The accumulated earnings tax is contained in the Internal Revenue Code of 1954, §§ 531-37. The original version of the tax, which imposed a direct tax on shareholders rather than on the corporate taxpayer, first appeared in the Tariff Act of 1913, § II(a)(2), 38 Stat. 166 (1913). The tax was first enacted in its present form (taxing the corporate taxpayer) in the Revenue Act of 1921, § 220, 42 Stat. 247 (1921).

² 393 U.S. 297 (1969).

³ Section 531 imposes an accumulated earnings tax equal to the sum of

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

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

Int. Rev. Code of 1954, § 531.

⁴ Personal holding companies (as defined in § 542), foreign personal holding companies (as defined in § 552), and corporations exempt from tax under sub-chapter F (§§ 501-26) are exempt from the accumulated earnings tax. Int. Rev. Code of 1954, § 532(b).

⁵ Int. Rev. Code of 1954, § 532(a).

The tax imposed by section 535 is in addition to other taxes imposed by Chapter 1 of the Code.⁶

Section 535 allows a credit of "an amount equal to such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business."⁷ Therefore, no accumulated earnings tax is imposed upon that portion of the total accumulation which is found to be for the reasonable needs, including reasonable anticipated needs,⁸ of the corporation. Thus, if the corporation's accumulation does not exceed its reasonable needs, even though the accumulation was gathered for the purpose of tax avoidance to shareholders, there would be no tax imposed upon any of the accumulation.

If it is determined that an accumulation is in excess of the reasonable needs of the corporation, section 533 attaches a presumption that the accumulation was for the purpose of avoiding income tax on the shareholders. The section provides that

the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.⁹

As to the initial issue of the extent of the reasonable needs of the corporation the government has the burden of proof.¹⁰ This burden may be shifted to the taxpayer if the Secretary gives timely notice to the taxpayer that a proposed notice of deficiency includes an amount alleged to be an unreasonable accumulation subject to section 531 taxes.¹¹ Upon receipt of such a notice the taxpayer may then shift the burden back onto the government if it gives timely notice of the grounds upon which it relies to establish the reasonableness of the accumulation, along with sufficient facts to support its allegation.¹² However, even if an accumulation is found to be unreasonable, the ultimate test for liability under section 532 remains whether the taxpayer's purpose for the accumulation was to avoid income tax. If such a purpose is found not to have been present no liability attaches.

II. *United States v. Donruss Co.*

In *United States v. Donruss Co.* the taxpayer corporation was a solely owned enterprise engaged primarily in the business of manufacturing candy and bubblegum. From 1955 to 1961 the corporation increased its undistributed earnings from \$1,021,288.58 to \$1,679,315.37.¹³ The sole shareholder received a salary from the corporation, but no dividends were declared

⁶ Int. Rev. Code of 1954, § 531.

⁷ Int. Rev. Code of 1954, § 535(c)(1).

⁸ Int. Rev. Code of 1954, § 537.

⁹ Int. Rev. Code of 1954, § 533(a).

¹⁰ Int. Rev. Code of 1954, § 534(a).

¹¹ Int. Rev. Code of 1954, § 534(b).

¹² Int. Rev. Code of 1954, § 534(c).

¹³ 393 U.S. at 298.

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during this period. The corporation made no loans to the sole shareholder, nor did it make any investments unrelated to its business.¹⁴

Among the reasons given by the sole shareholder for the policy of accumulation were capital and inventory requirements, increasing costs, and inherent risks in the business and general economy.¹⁵ It was also claimed that as a general expansion move the corporation wished to acquire an interest in its major distributor, Tom Huston Peanut Company. In 1964 Donruss purchased 10,000 shares of Tom Huston stock, but no definite plans for acquisition existed.¹⁶

The Commissioner assessed taxes on the accumulated earnings for the years 1960 and 1961 under section 531. Donruss paid the taxes and brought suit for refund in the United States Court for the Western District of Tennessee.¹⁷ The jury found that the corporation had accumulated earnings beyond its reasonable needs, but, upon an instruction from the court that for liability to exist tax avoidance to shareholders must be "the purpose" of the accumulation, they found further that no such purpose motivated Donruss' accumulation.¹⁸ Therefore, no accumulated earnings tax was imposed and the refund was ordered.

On appeal to the United States Court of Appeals for the Sixth Circuit,¹⁹ the government argued that the trial judge had erroneously refused to instruct the jury as requested; that "it is not necessary that avoidance of shareholder's tax be the sole purpose for the unreasonable accumulation or earnings; [that] it is sufficient if it is *one* of the purposes for the company's accumulation policy."²⁰ (Emphasis added.) The court of appeals rejected this contention and held that the tax applied only if tax avoidance to shareholders was "the dominant, controlling, or impelling motive" behind the accumulation.²¹ The court remanded for a new trial, however, because it felt that the jury may have been led to believe, incorrectly, that tax avoidance must be the sole purpose for the accumulation in order to create liability.²²

The Supreme Court granted certiorari for the purpose of resolving a

¹⁴ Id.

¹⁵ Id.

¹⁶ Id.

¹⁷ 15 Am. Fed. Tax R.2d 896 (1965).

¹⁸ The following interrogatories were submitted to the jury:

1. Did plaintiff corporation permit its earnings or profits for . . . [1960 and 1961] to accumulate beyond the reasonable or reasonably anticipated needs of its business? [Answer: Yes].

. . . .
. . . .

2. Were such accumulations retained by plaintiff corporation for the purpose of avoiding the income tax on its stockholder, Don Weiner [sic]? [Answer: No].

. . . .
. . . .

Id. at 904.

¹⁹ Donruss Co. v. United States, 384 F.2d 292 (6th Cir. 1967). A more detailed description of the proceedings below appears in 43 Notre Dame Law. 566 (1968).

²⁰ 384 F.2d at 296.

²¹ Id. at 298.

²² Id.

conflict among the circuits as to whether, in order for tax liability to exist, the avoidance purpose must be the *dominant* reason, or just *one* of the reasons for the accumulation.²³ The Court held that the government's interpretation of the proper burden of proof was correct, and modified the court of appeals remand order so as to institute a new trial on the issue whether tax avoidance was *one* of the purposes of Donruss' accumulation.²⁴ The Court stated that, while the relevant language of section 532, "formed or availed of for the purpose of avoiding the income tax," was inconclusive on its face as to which test was correct, the legislative history of the accumulated earnings tax indicated that Congress intended the existence of *any* purpose to avoid income tax to shareholders, regardless of its comparative weight, to be sufficient to establish liability.²⁵

Justice Harlan, who dissented in part and was joined by Justices Douglas and Stewart, stated that the one-purpose test applied by the majority essentially denied the taxpayer that "last clear chance" to avoid tax liability which Congress intended to create by establishing the taxpayer's right to rebut the presumption contained in section 533.²⁶ While the dissenting Justices agreed that the legislative history of the accumulated earnings tax revealed a "progressive congressional intention to rely more and more heavily upon a comparatively objective criterion: whether the accumulated earnings were in excess of the corporation's reasonable business needs,"²⁷ they believed that the one-purpose test went too far toward destroying what opportunity remained for the taxpayer to escape liability by showing absence of the proscribed purpose. The dissenters argued that a jury is likely to believe that it must find a purpose to avoid, and, therefore must find liability, whenever the government shows that the taxpayer had knowledge that tax savings to shareholders would result from a corporate accumulation. Since such knowledge is likely to be present in most cases of unreasonable accumulation, it was felt that the one-purpose test was far too "loaded against the taxpayer."²⁸

As an alternative, the dissenting Justices suggested that the proper test should be whether the accumulation would have occurred "but for" the taxpayer's knowledge that a tax savings would result. Under this test the taxpayer

²³ The dominant purpose test adopted by the court of appeals had also been adopted in the First Circuit. See, e.g., *Young Motor Co. v. Commissioner*, 281 F.2d 488, 491 (1960); *Apollo Indus., Inc. v. Commissioner*, 385 F.2d 867, 875-76 (1966). The Second Circuit appeared to have adopted the one-purpose test. See, e.g., *Trico Prods. Corp. v. Commissioner*, 137 F.2d 424, 426 (2d Cir.), cert. denied, 320 U.S. 799 (1943); *United States v. Duke Laboratories, Inc.*, 337 F.2d 280 (2d Cir. 1964). The Fifth Circuit was in agreement with the Second Circuit. See, e.g., *Barrow Mfg. Co. v. Commissioner*, 294 F.2d 79, 82 (5th Cir. 1961). An intermediate test had been applied by the Eighth and Tenth Circuits to the effect that the accumulated earnings tax is imposed if tax avoidance is one of the "determinating purposes" of the accumulation. See, e.g., *Kerr-Cochran, Inc. v. Commissioner*, 253 F.2d 121, 123 (8th Cir. 1958); *World Pub. Co. v. United States*, 169 F.2d 186, 189 (10th Cir. 1948), cert. denied, 355 U.S. 911 (1949).

²⁴ 393 U.S. at 301.

²⁵ *Id.* at 307-08.

²⁶ *Id.* at 310.

²⁷ *Id.*

²⁸ *Id.* at 312.

could overcome the presumption of tax avoidance purpose raised by the finding of unreasonableness of the accumulation if it could prove that the accumulation resulted from purposes other than tax avoidance, or, conversely, that the accumulation would have resulted even if no tax savings were possible.²⁹ This "but for" test, according to the dissenters, would be more easily understood by a jury because it avoided the risk of confusion between knowledge and purpose inherent in the one-purpose test. It was claimed to be superior to the one-purpose test because it gave the taxpayer a realistic opportunity to overcome the presumption of tax avoidance purpose and thereby more fully implemented congressional intent underlying section 533.³⁰

III. THE IMPACT OF *Donruss* UPON THE SUBJECTIVE "PURPOSE TO AVOID" TEST

The majority's requirement of the absence of any tax avoidance purpose places a heavier burden of proof upon the taxpayer than he would bear under the requirement to establish only the absence of a dominant or controlling tax avoidance purpose. However, whether *Donruss* effectively eliminates the taxpayer's "last clear chance" to avoid tax liability by proving lack of the proscribed purpose, as claimed in the dissent, is questionable. In support of their position the dissenters point out that showing knowledge of the tax savings consequences of an accumulation on the part of the taxpayer may induce the jury to find the presence of a purpose to avoid. Such knowledge reasonably should be taken as some evidence of a purpose to avoid; however, it is by no means conclusive in establishing the proscribed purpose. Moreover, the jury may be charged, in those cases where the court believes that confusion between knowledge and purpose is likely to be present, that evidence of knowledge alone is not legally sufficient to establish a purpose to avoid. In those cases proof of knowledge, while some evidence of a purpose to avoid, would have to be supported by other independent evidence of a tax avoidance purpose in order for the taxpayer to be held liable.

The "but for" test suggested by the dissenters does not solve the problem of possible confusion between knowledge and purpose, but it does reduce the prejudicial impact on the taxpayer. In essence, the "but for" alternative is very similar to the primary purpose test adopted by the Sixth Circuit in *Donruss*. To the extent that the primary purpose or "but for" tests lessen the burden of proof on the taxpayer by requiring him only to establish absence of a dominant purpose to avoid income tax to shareholders, they have the corollary effect of reducing the harmful impact of evidence tending to show knowledge of tax savings consequences. For even if such knowledge is shown to be present and is interpreted by the jury as indicating a purpose to avoid, the jury still must determine whether that purpose was the primary purpose causing the accumulation.

If *Donruss* has reduced the availability to the taxpayer of the subjective test for ultimate escape of liability, it is nevertheless clear that the decision has not eliminated the "purpose to avoid" standard altogether. *Donruss* leaves

²⁹ Id. at 313.

³⁰ Id.

a diminished but distinct residue of subjectivity which the taxpayer may still call to his aid in those cases (admittedly few) in which the corporation can present convincing evidence that, although its accumulation was found to be unreasonable, tax avoidance was not a purpose behind the accumulation. Also, in those few cases where a corporation may be able to prove that even though it had knowledge of the tax savings consequences of an unreasonable accumulation, such knowledge was not a purpose behind the accumulation, the "purpose to avoid" standard still aids the taxpayer.

The fact that *Donruss* has so sharply reduced the importance of the subjective test raises the question whether that test serves any remaining useful function. The resolution of this question necessitates an analysis of the factors causing the shift in emphasis from the subjective to the objective standard.

IV. THE DIMINISHING VITALITY OF THE "PURPOSE TO AVOID" TEST

It has been observed that most accumulated earnings tax cases are now fought on the issue of reasonableness.³¹ The focus on this issue has resulted from recodification and from subsequent judicial interpretations. The earliest version of the accumulated earnings tax demanded a fraudulent intent to avoid income tax to shareholders as requisite for liability.³² However, because it was found that in most cases the government was unsuccessful in its effort to prove the existence of fraud, Congress later deleted this requirement, and thus made liability depend upon an unconditional purpose to avoid income tax.³³ With the requirement of proving the elements of fraud removed it was less difficult for the government to establish the proscribed purpose. Consequently, the taxpayer's burden to prove absence of the proscribed purpose was necessarily increased, and taxpayers were forced to rely more heavily upon their ability to prove that the accumulation was not unreasonable.

Several changes in the accumulated earnings tax were made between 1921 and 1954 which deemphasized the subjective test.³⁴ However, the most significant revisions of this type appeared in the Revenue Act of 1954 and in subsequent amendments.³⁵ One such change was the creation of the accumu-

³¹ B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* § 6.02, at 219 (1st ed. 1959).

³² See 393 U.S. at 303-04.

³³ *Id.* at 304.

³⁴ In 1934 personal holding companies were exempted from the provisions of the accumulated earnings tax and were subjected to a specific tax on undistributed income, regardless of the purpose of the accumulation. Revenue Act of 1934, §§ 102, 351, 48 Stat. 702, 751. It was Congress' intention to prevent the hitherto widespread practice whereby personal holding companies made only partial distributions of profits, claimed a need for retaining the remainder, and thereby defeated government attempts to prove a purpose to avoid taxes. H.R. Rep. No. 704, 73d Cong., 2d Sess. 11 (1934).

In 1936 Congress attempted to overcome the difficulty of proof of a purpose to avoid taxes by imposing an undistributed profits surtax on certain types of corporations. Liability for this tax did not require a purpose to avoid, and the tax was imposed in addition to the accumulated earnings tax. Revenue Act of 1936, § 14, 49 Stat. 1648, 1655.

³⁵ For a detailed discussion of the decline of the subjective test resulting from the 1954 revisions to the accumulated earnings tax see, Ziegler, *The "New" Accumulated Earnings Tax: A Survey of Recent Developments*, 22 Tax L. Rev. 77 (1966); Comment,

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lated earnings credit in the amount of the reasonable needs of the business.³⁶ Prior to 1954 all of an accumulation found to have been amassed for the purpose of tax avoidance was subject to the accumulated earnings tax, even that portion which may have been required for the reasonable needs of the corporation.³⁷ With the inclusion of the tax credit, even if the taxpayer could not prove absence of a purpose to avoid taxes, he could minimize his liability by establishing that a large part of the surplus was required by the reasonable needs of the business. Furthermore, in 1958 Congress amended the accumulated tax credit to include a \$100,000 minimum in all cases.³⁸ Thus, in no case would the first \$100,000 of an accumulation for tax avoidance purposes be subject to the accumulated earnings tax, regardless whether it was for the reasonable needs of the business.

Section 537 of the 1954 Code defines reasonable needs of the business as including "reasonably anticipated needs of the business." This provision further shifts the emphasis to the issue of reasonableness for determining liability, because it eliminates the immediacy requirement by which courts had defined "reasonable needs" to include only short term projects.³⁹

The 1954 revisions also provided, for the first time, that the burden of proof as to reasonableness may be shifted from the taxpayer to the Commissioner.⁴⁰ This transfer of burdens occurs when the taxpayer submits to the Service a statement of the grounds, "together with facts sufficient to show the basis thereof,"⁴¹ upon which the corporation relies to establish that the accumulation, or any portion of it, is for the reasonable needs of the business. The ability to shift this burden to the government undoubtedly is an inducement to the taxpayer to seek to escape liability by the route of establishing the reasonableness of the accumulation rather than that of attempting to prove lack of a "purpose to avoid." It has been observed, however, that this revision provides only limited aid to the taxpayer because in some cases the Commissioner has claimed that the statement submitted was too vague to meet the statutory requirements for shifting the burden of proof to the government.⁴² As a result of such a challenge, the corporation must be prepared to go forward with evidence at the trial, if the Commissioner's allegation of insufficiency is sustained, just as if it had the initial burden of proof.⁴³

The courts also have promoted the reasonableness test over the avoidance purpose test. It has been held that the basic objective test is the "single most important consideration" in the determination whether a "purpose to avoid"

Accumulated Earnings Tax: Burdens of Proof of Reasonableness and Purpose, 54 Calif. L. Rev. 1050, 1051-53 (1966).

³⁶ Int. Rev. Code of 1964, § 535(c)(1).

³⁷ See Int. Rev. Code of 1939, § 102.

³⁸ Int. Rev. Code of 1954, § 535(c)(2), amended by § 205(a) of P.L. 85-866, 72 Stat. 1680 (1958).

³⁹ See H.R. 1337, 83d Cong., 2d Sess. 53 (1954). See also Comment, *supra* note 35, at 1053.

⁴⁰ Int. Rev. Code of 1954, § 534(a); S. Rep. No. 1622, 83d Cong., 2d Sess. 70-71 (1954).

⁴¹ Int. Rev. Code of 1954, § 534(c).

⁴² Ziegler, *supra* note 35, at 82.

⁴³ *Id.*

motivated the accumulation.⁴⁴ Thus, the presumption of the existence of the proscribed purpose raised by a finding of unreasonableness was viewed as extremely strong and difficult to overcome. Moreover, some courts have manifested an increasing reluctance to entertain or credit evidence as to subjective intent, even when the evidence favors the government.⁴⁵ This tendency would indicate that those courts view the determinative issue to be whether the accumulation was in fact reasonable in light of the business needs of the corporation. It has been stated that the cumulative effect of these statutory changes and court interpretations has been to "reduce the importance of the subjective test to a 'last hope' argument for the corporation."⁴⁶

The decline of the subjective test can be attributed to at least three basic causes. First, it is clear from the legislative history of the Revenue Act of 1954 that Congress was dissatisfied with the administration of the accumulated earnings tax.⁴⁷ It was believed that the Commissioner had used threats of imposing the tax on alleged unreasonable accumulations to force settlements with taxpayers on other disputed, but unrelated, tax matters. It was claimed that as a result taxpayers were forced to incur heavy expenses in efforts to prove the reasonableness of the accumulation, and that many small corporations necessarily paid deficiencies rather than bring legitimate defenses.⁴⁸ The Commissioner was said also to have imposed taxes in cases which were inadequately analyzed and which resulted in a "poor record" for the government in accumulated earnings tax cases.⁴⁹

These problems gave rise to the provisions in the 1954 Code which tended to equalize the relative burdens of proof borne by the taxpayer and the Commissioner. These provisions also reduced the possibility that corporations accumulating for a legitimate business purpose would be coerced into settlements by threats of tax liability.

A second major problem inherent in the subjective test is the relative difficulty with which the taxpayer's lack of a "purpose to avoid" must be established. While reasonableness of an accumulation can usually be determined by examination of "hard" evidence—balance sheets, yearly reports, inventories, market projections, planned expansions, acquisitions, stock re-

⁴⁴ *Young Motor Co. v. Commissioner*, 281 F.2d 488, 490-91 (1st Cir. 1960); *United States v. Duke Laboratories, Inc.*, 337 F.2d 280 (2d Cir. 1964).

⁴⁵ See, e.g., *Sandy Estate Co. v. Commissioner*, 43 T.C. 361 (1964), where the court decided for the taxpayer even though the government introduced a memorandum from the corporation's accountant indicating to the management that tax savings might result if the taxpayer accumulated earnings rather than distributed them as dividends. The court held that the objective needs of the corporation exceeded in significance any purpose to avoid taxes which the corporation may have had.

⁴⁶ Ziegler, *supra* note 35, at 81.

⁴⁷ See S. Rep. No. 1622, 83d Cong., 2d Sess. 70 (1954).

⁴⁸ *Id.* It has also been claimed that the Commissioner's alleged abuse of the accumulated earnings tax has had a potentially harmful effect on federal antitrust efforts. The reasoning is that closely held corporations, which are the usual target of accumulated earnings tax levies, are often induced by the Commissioner's threat of imposition of taxes upon accumulated earnings to sell out to public corporations, which are rarely charged with accumulating unreasonably. See Ziegler, *supra* note 35; at 120-21.

⁴⁹ S. Rep. No. 1622, 83d Cong., 2d Sess. 70 (1954).

demptions and so forth—the presence of a subjective purpose is a much more elusive determination to make. Indeed, the soundness of basing tax liability upon such state-of-mind tests as purpose, motive or intent, has been seriously questioned.⁵⁰

These subjective criteria defy precise definition or quantification. Moreover, the best evidence as to the existence of a particular state of mind rests within the peculiar knowledge and conscience of the taxpayer. Because very often no other tangible evidence can be brought to bear on the question by either the taxpayer or the government, in the absence of presumptions liability inevitably turns on the jury's appraisal of the taxpayer's credibility. But frequently the taxpayer is unsure of his motive, purpose or intent in execution of a particular transaction.⁵¹ Indeed, he may have acted through custom, habit, ignorance, mistake or sheer obstinacy. His purpose may have been highly irrational, yet unrelated to tax avoidance. Even if the taxpayer is aware of one or some of the reasons for entering into the transaction, it is not unlikely that he will be unable to assign to any one of them the dominant role in the formation of his decision. He may have been aware that several consequences would result from his action and, from the totality of these consequences, decided to take the contemplated action. He may be unable to say, however, that without one or more of these perceived consequences he would have refrained from so acting.

In all these situations where the taxpayer is himself unsure of the character or relative weight of the factors motivating his decision to accumulate, it is unrealistic to speak of the taxpayers "purpose" as the basis for liability. If the crucial "purpose to avoid" is in fact unknown or ambiguous to the actor, a jury is not deciding liability upon the taxpayer's possible purpose, but rather upon something very different. The jury actually applies what one expert has called the "comparative relatedness theory" to the facts of the case.⁵² Under this theory, a jury confronted with the task of determining the taxpayer's state of mind actually compares the taxpayer's activities to those of a hypothetical person with a bona fide purpose to avoid income tax. Thus, if Y, intent upon avoiding income tax through accumulation, would reasonably engage in acts A, B and C, a jury would determine whether the taxpayer X had a purpose to avoid by gauging how closely his acts compared with A, B and C. Thus, in the context of accumulated earnings tax litigation, most taxpayers would go about establishing lack of the proscribed purpose by showing that their acts were reasonable in light of their alleged business purpose, and not by attempting to prove an "acceptable set of thoughts attributable to the corporation."⁵³ Since, therefore, the subjective test relies heavily upon the use of objective evidence as to the reasonableness of an accumulation for its efficacy, it is doubtful that it serves any purpose where it is applied in con-

⁵⁰ Blum, *Motive, Intent and Purpose in Federal Income Taxation*, 34 U. Chi. L. Rev. 485 (1967).

⁵¹ *Id.* at 504-13.

⁵² *Id.* at 496-506.

⁵³ *Id.* at 514.

junction with a pre-existing reasonable needs test. The result of this dual test is that "despite a statutory test framed in terms of purpose, state of mind turns out to have surprisingly little significance."⁵⁴

A distinction also remains to be made between tax avoidance as a purpose motivating a particular transaction and tax minimization.⁵⁵ Every taxpayer wants to minimize his taxes. The rational man does so by taking every advantage within the law. Yet tax avoidance, in the context of the accumulated earnings tax, denotes certain steps beyond the law taken to prevent the imposition of taxes. One authority has pointed out that the state of mind of the actor in both situations is identical, in that, as a "mental phenomenon, a desire to minimize taxes does not differ from a desire to avoid taxes."⁵⁶ Therefore, if the state of mind of the taxpayer at most differs only in degree in the two situations, it is fallacious to hinge liability on a purpose to avoid taxes because the standard provides no distinction between innocent and willful evasion. When "purpose" tests are employed, often what is actually determinative of liability is not the purpose itself but the relative weight of the taxpayer's non-tax objectives, as opposed to the weight of his tax reduction objectives.⁵⁷ The taxpayer does not generally bring evidence directly bearing upon the nonexistence of a tax avoidance purpose, since such evidence of a negative allegation is extremely difficult to obtain. Rather, the taxpayer will more likely attempt to show that the transaction served, or reasonably could have served, an important non-tax goal.⁵⁸ If the jury believes that a significant non-tax objective was present, it will usually conclude that no tax avoidance purpose motivated the accumulation.

A third difficulty with the subjective "purpose to avoid" test is that it does not result in taxation of accumulated earnings which are unreasonable but which are not gathered for the purpose of tax avoidance. A corporation may accumulate earnings far beyond its reasonable needs and avoid tax liability by showing that it had no knowledge of the tax savings consequences of the accumulation.⁵⁹ In such a situation the taxpayer's shareholders are benefitted by the corporation's alleged ignorance of the accumulated earnings tax provisions, as compared to the shareholders of a similarly situated corporation which is found to have an unreasonable accumulation but which had knowledge of the tax savings consequences of accumulation. The results of requiring the taxpayer to prove absence of a "purpose to avoid" is to penalize taxpayers knowledgeable of the tax laws, or those who seek tax

⁵⁴ Id. at 515.

⁵⁵ Id.

⁵⁶ Id.

⁵⁷ Id. at 516.

⁵⁸ Id. at 516-17.

⁵⁹ For example, some of the jurors in *Donruss* thought that they were deciding the case in favor of the government by finding that the accumulation was unreasonable but not motivated by any tax avoidance purpose. It appears that the jury believed that the second interrogatory, dealing with the question whether *Donruss* had a purpose to avoid, was surplusage, and that a finding of unreasonableness was alone sufficient for liability. See 43 Notre Dame Law. 566, 568 n.17 (1968).

counsel, to the comparative advantage of taxpayers ignorant of the law.⁶⁰ This loophole appears to be inexcusable, for it allows corporations to accumulate for purposes unrelated to the business and yet avoid taxation if ignorance of the law is established. To overcome the problems raised by the subjective "purpose to avoid" test, the following discussion suggests that the present standard be replaced by a positive test utilizing the "legitimate business purpose" concept.

V. A "BUSINESS PURPOSE" STANDARD

The corporate franchise is universally granted for limited purposes only. A corporation generally possesses only those powers necessary, incidental or related to the conduct of the particular business of the corporation.⁶¹ Accordingly, corporations are subject to strict regulation designed to insure that they do not exceed the limited powers conferred by a grant of corporate status. In light of the *limited* purposes of corporate existence, it appears that a more appropriate ultimate test of liability under the accumulated earnings tax would be, not whether the excess accumulation beyond the reasonable needs of the corporation was for the purpose of tax avoidance, but whether the accumulation was amassed for a legitimate business purpose reasonably related to the business of the corporation. As a determinant of liability, the essentially negative "purpose to avoid" test would be replaced by the affirmative requirement of a reasonably related business purpose.

The central issue would continue to be the reasonableness of the accumulation. Thus the initial determination would be whether the accumulation or some portion of it was for the reasonable needs of the business. If all of the accumulation was found to be required for the reasonable needs of the corporation there would, of course, be no tax imposed because the section 535 tax credit would still apply. However, if an accumulation in excess of the reasonable needs of the business were found to exist, the taxpayer could still avoid liability by proving that the dominant motive behind the excess accumulation was a legitimate business purpose. Thus, the necessity of proving a negative allegation—absence of an avoidance purpose—is eliminated. This test reduces the tax savings "windfall" experienced by the shareholders of a corporation accumulating unreasonably but with no purpose to avoid. In addition, the taxpayer is still afforded a "last clear chance" to avoid liability after losing on the reasonableness issue if he can convincingly demonstrate that the excess accumulation was primarily motivated by legitimate business purposes. Reasons which are irrational in light of existing business conditions, ignorance of tax savings consequences, or mistake would not be sufficient to avoid liability. Nor would tax avoidance be considered a legitimate business purpose.

⁶⁰ See Blum, *supra* note 50, at 516.

⁶¹ See, e.g., General Corporation Law of Delaware, tit. 8, § 121(a) (1967), which grants to corporations the powers, including those incidental thereto, which "are necessary or convenient or convenient to the conduct, promotion or attainment of the business or purposes set forth in its certificate of incorporation."

It should be emphasized that the burden of proof on the corporation requires that it show that the primary purposes of the accumulated excess were legitimate and related to the business. This requirement would prevent corporations from successfully avoiding liability by setting up any ostensibly legitimate business purpose with an abundance of contrived "paper" evidence. It must establish that the alleged purpose was the dominant motivation for the accumulation. Moreover, the size of the excess accumulation would be taken into account by the jury in the determination whether the alleged purpose was entertained in good faith by the taxpayer. If the excess is greatly disproportionate to what would be the reasonably anticipated requirement of the alleged business purpose, the jury would undoubtedly be less inclined to believe that the corporation was primarily motivated by that purpose.

It is recognized that this test results in taxation of those accumulations which occur innocently, without any tax avoidance purpose. In view of the supposedly finite business purposes for which corporations exist, it does not appear inequitable to prevent the use of the corporate form for purposes or consequences unrelated to the business for which it was chartered. While it is not suggested that the Internal Revenue Code should be used as a method of enforcing state corporation laws, the fact that corporations may engage in activities very remote from their main business, and that earnings may be accumulated pursuant to those activities, should not confer a tax advantage upon the shareholders. Furthermore, the greatest possibility of a genuinely innocent accumulation would probably arise among small corporations lacking tax counseling and having more informal management. In these cases the taxpayer is protected by the \$100,000 minimum tax credit allowed in section 535. In the case of larger corporations the conclusion would seem to be justified that in the great majority of instances management was aware of the tax consequences of accumulations. Furthermore, actual knowledge would not have to be proved; it is not unreasonable to hold management to be aware of the elementary consequences of corporate decisions. Certainly this is a minimal duty to impose upon the officers of a modern business corporation.

CONCLUSION

The determination of liability for federal income taxation of accumulated corporate earnings has gradually shifted from the subjective standard of "tax avoidance purpose" to the more objective criterion of the reasonableness of the accumulation. *Donruss Co. v. United States* has furthered this trend by increasing the burden of proof on the taxpayer so as to require him to prove complete absence of any tax avoidance purpose to escape liability. The diminishing importance of the subjective test has resulted from congressional dissatisfaction with administration of the accumulated earnings tax, and from difficulties inherent in the determination whether an accumulation was motivated by a purpose to avoid taxes. Another shortcoming of the present subjective test is that it allows the taxpayer's shareholders to realize tax advantage "windfalls" through unreasonable though "innocent" accumulations, even

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when the accumulation was not motivated by a legitimate business purpose. To overcome these problems it is suggested that the essentially negative tax avoidance test be eliminated, and that the taxpayer be allowed to escape tax liability on unreasonable accumulations only if he can prove that the excess accumulation was motivated primarily by a legitimate business purpose.

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