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III

Prohibited Purpose for Accumulation of Earnings

Joseph D. Sullivan

AN ACCUMULATED EARNINGS tax case often involves two principal questions of fact: (1) whether there are reasonable business needs for all of the earnings retained by the taxpayer corporation;¹ and (2) whether the earnings are retained for the purpose of avoiding the income tax imposed

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upon shareholders.² The reasonableness of the accumulation is usually the paramount question involved in such a case, since current earnings required for the reasonable needs of the business are not subject to the accumulated earnings tax.³ Also, this question more easily lends itself to a solution by reference to objective facts. However, in many situations it may be necessary to prove that there was no tax avoidance motive in order to prevent the imposition of this tax. This article will review the subjective aspect of the accumulated earnings tax provisions — the necessity of a tax avoidance purpose.

I. PURPOSE OF AVOIDING INCOME TAX TO SHAREHOLDERS

The Internal Revenue Code states that the accumulated earnings tax applies to corporations 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."⁴

A. Tax Avoidance Purpose

Although the precise meaning of the phrase "the purpose" is

¹ INT. REV. CODE OF 1954, § 535(c) [hereinafter cited as CODE §].

² CODE § 532.

³ CODE § 535(c).

⁴ CODE § 532(a).

still the subject of some controversy, it appears that the tax avoidance purpose does not have to be the sole purpose or even the dominant or primary reason for the retention of earnings. In all likelihood, shareholder avoidance of income tax must only be one of the determining purposes for a corporation's retention of its earnings.⁵

B. Shareholders of the Corporation

The accumulated earnings tax may still be imposed even though the persons deciding corporate dividend policy would not themselves avoid a substantial amount of income tax as shareholders, as long as the decision to accumulate was motivated by the purpose of avoiding tax to the shareholders of the corporation. Therefore, in theory, the tax could be imposed upon all corporations whether publicly owned or closely held. In practice, however, the tax does not seem to have been imposed where the public owned more than fifty per cent of the outstanding stock of a corporation, no matter how obvious the unreasonable accumulation. The reason for this probably lies in the difficulty of establishing a shareholder-tax-avoidance motive. However, the tax was imposed in a case where the members of the board of directors of a corporation controlled approximately seventy-five per cent of the outstanding stock and the public shareholders owned the remaining twenty-five per cent.⁶

C. Shareholders of Any Other Corporation

The accumulated earnings tax can be imposed if the purpose of the accumulation was the avoidance of income tax on the shareholders of any other corporation.⁷ The regulations indicate that this imprecise language was intended to extend to situations where the purpose of the accumulation of earnings in a subsidiary corporation is to avoid income tax on shareholders of the parent corporation.⁸

⁵ *Fenco, Inc. v. United States*, 234 F. Supp. 317, 326 (D. Md. 1964), *aff'd per curiam*, 348 F.2d 456 (4th Cir. 1965).

⁶ *Trico Prod. Corp.*, 46 B.T.A. 346 (1942), *aff'd*, 137 F.2d 424 (2d Cir.), *cert. denied*, 320 U.S. 799 (1943). See also *Trico Prod. Corp. v. McGowan*, 67 F. Supp. 311 (W.D.N.Y. 1946), *aff'd*, 169 F.2d 343 (2d Cir.), *cert. denied*, 335 U.S. 899 (1948).

⁷ CODE § 532(a).

⁸ Treas. Reg. § 1532-1(a) (2) (1959) [hereinafter cited as Reg. §].

II. BURDEN OF PROOF ON THE REASONABLENESS OF RETAINED EARNINGS

If the taxpayer-corporation cannot establish that its earnings were retained for the reasonable needs of its business, it will have to establish another reason or an excuse for the accumulation. That is, in order to establish the absence of the prohibited purpose of avoiding income tax on shareholders, it will be necessary for the corporation to prove that the earnings were retained for some other reason such as a good faith, although erroneous, judgment that the earnings were needed in its business. Another possible excuse is that the conservative nature of those formulating the dividend policy of the corporation was the cause of the retention.

In two recent cases, the taxpayers successfully proved that the proscribed tax avoidance purpose was not present even though it was concluded that their earnings had been unreasonably accumulated.⁹ In *Bremerton Sun Publishing Co.*,¹⁰ the Tax Court concluded that the taxpayer's earnings had been unreasonably accumulated because of conservative business judgment rather than a tax avoidance purpose. The court stated:

Although we feel that the total accumulation was somewhat beyond the reasonable foreseeable business needs of the petitioner, we are convinced that the only reason for the excessive retention of earnings was the conservative policies of the directors and not their concern for the surtax liability of [the sole shareholder and chairman of the board].¹¹

In *Duke Labs., Inc. v. United States*,¹² a jury concluded that no tax avoidance purpose was present after having made specific findings that there had been an unreasonable accumulation of earnings in all of the four years in question. This was another typical case involving a closely held corporation with a substantial amount of cash and a poorly documented record. The taxpayer's success was due to excellent preparation for trial including effective expert testimony and direct examination of the controlling shareholder.

Apparently, taxpayers have not realized all of the possibilities

⁹ *Duke Labs., Inc. v. United States*, 222 F. Supp. 400 (D. Conn. 1963), *aff'd*, 337 F.2d 280 (2d Cir. 1964); *Bremerton Sun Publishing Co.*, 44 T.C. 566 (1965).

¹⁰ 44 T.C. 566 (1965).

¹¹ *Id.* at 590.

¹² 222 F. Supp. 400 (D. Conn. 1963), *aff'd*, 337 F.2d 280 (2d Cir. 1964).

with respect to the use of juries to hear accumulated earnings tax cases. It would seem that in the absence of an obvious tax avoidance pattern, most juries would be sympathetic to a taxpayer in an accumulated earnings tax case because of the penalty nature of the tax. The use of a jury should be given thorough consideration.

In *Corporate Inv. Co.*,¹³ the president and sole shareholder of the taxpayer-corporation, while aware of the penalty tax on an unreasonable accumulation, erroneously believed that the corporation had paid out all of its earnings in the year in question. The tax was not assessed by the court on the grounds that the intent to distribute all of the company's earnings was inconsistent with a tax avoidance purpose.¹⁴

The above cases demonstrate that even if it is impossible to convince the management of a corporation that an accumulated earnings tax problem exists, the tax lawyer should at least try to prevent the creation of a record indicating tax avoidance as the motive for the unnecessary accumulation. Some possible alternatives might be the payment of large salaries or substantial dividends. Loans to shareholders, expenditures of corporate funds for the personal benefit of shareholders, investments having no reasonable connection with the corporation's business,¹⁵ and other activities which would be indicative of shareholder tax avoidance should all be avoided.

III. POSSIBLE IMPOSITION OF TAX EVEN IF EARNINGS ARE NOT UNREASONABLY ACCUMULATED

A question may arise as to whether a corporation is subject to the accumulated earnings tax where its earnings have not been accumulated beyond the reasonable needs of its business but where the corporation has been availed of for the purpose of avoiding the income tax on its shareholders. It is possible that the corporation could be subject to the tax under these circumstances. For example, a corporation with 300,000 dollars of retained earnings in cash, including current earnings, which is reasonably in need of a new 500,000 dollar plant may make a term loan to a corporation in

¹³ 40 B.T.A. 1156 (1939), *nonacq.*, 1940-1 CUM. BULL. 10.

¹⁴ *Id.* at 1176.

¹⁵ Reg. § 1.533-1(a) (2) (1959).

which its sole shareholder has a financial interest. The lending corporation has a business need for the earnings retained but it has made a record indicating that the earnings were not retained for that purpose. Under circumstances such as these, a court might conclude that the accumulated earnings credit is not applicable to an amount equal to the loan, since these earnings were retained for the benefit of the shareholder rather than the corporation. Recently the Tax Court held that it was unnecessary to consider whether the proscribed purpose was present once it was established that the taxpayer was entitled to the credit for the reasonable needs of the business.¹⁶ However, the court seems to have avoided the question since it concluded: "However, even if petitioner were availed of for the proscribed purpose, it would still be entitled to a credit equal to the amount of earnings and profits for the taxable years which have been retained for the reasonable needs of the business."¹⁷ In view of the doubt surrounding this question and the express language of section 535, a corporation might be well advised to build a record tying the retention of its earnings to its business need if other circumstances might indicate a nonbusiness purpose for the retention.¹⁸

¹⁶ John P. Scripps Newspapers, 44 T.C. 453 (1965).

¹⁷ *Id.* at 474.

¹⁸ See *Accumulated Earnings Tax*, 35 THIRD TAX MANAGEMENT PORTFOLIO A-38.