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IMPROPER ACCUMULATION OF SURPLUS

W. E. NORVELL, JR.*

Section 102 of the Internal Revenue Code, as amended, levies an additional or surtax on corporations. Said Section 102 is entitled "Surtax on Corporations Improperly Accumulating Surplus." However, this title is slightly misleading, in that the *purpose* is the criterion. Section 102 (a) levies the said additional tax upon the net income of every corporation (other than a personal holding company or a foreign personal holding company)

"if such corporation, however created or organized, is *formed or availed of* for the *purpose* of preventing the imposition of the 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, a surtax . . ." [Italics added]

Subsection (b) provides that the fact that any corporation is a mere holding or investment company shall be prima facie evidence of the existence of such purpose.

Subsection (c) creates a presumption and reads as follows:

"(c) *Evidence Determinative of Purpose.*—The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the *clear preponderance* of the evidence shall prove to the contrary." [Italics added]

The remaining subsections of this section apply to definitions and the computation of "net income," as used in this section.

Income Tax Regulations 111, Sections 29.102-1-4, deal with this section.

Section 29.102-2 relates to the purpose to avoid surtax, evidence, burden of proof and definition of holding or investment company. It states that the Commissioner's determination that the corporation was formed or availed of for the purpose of avoiding the individual surtax is subject to *disproof* by competent evidence. It states that the existence or non-existence of the *purpose* may be indicated by circumstances other than the evidence specified in the Internal Revenue Code and whether or not such purpose was present "depends upon the particular circumstances of each case." The regulation then states:

"In other words, a corporation is subject to taxation under section 102 if it is formed or availed of for the *purpose* of preventing the imposition of surtax upon shareholders through the medium of permitting earnings or profits to accumulate,

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even though the corporation is not a mere holding or investment company and does not have an unreasonable accumulation of earnings or profits; and on the other hand, the fact that a corporation is such a company or has an accumulation is not absolutely conclusive against it if, by clear and convincing evidence, the taxpayer satisfies the Commissioner that the corporation was neither formed nor availed of for the purpose of avoiding the individual surtax. All the other circumstances which might be construed as evidence of the purpose to avoid surtax cannot be outlined, but among other things the following will be considered: (1) Dealings between the corporation and its shareholders, such as withdrawals by the shareholders as *personal loans* or the expenditure of funds by the corporation for the personal benefit of the shareholders, and (2) the investment by the corporation of undistributed earnings in *assets having no reasonable connection* with the business. The mere fact that the corporation distributed a large portion of its earnings for the year in question does not necessarily prove that earnings were not permitted to accumulate beyond reasonable needs or that the corporation was not formed or availed of to avoid surtax upon shareholders." [Italics added]

Section 29.102-3 touches directly on the question of the unreasonable accumulation of surplus. The latter part of this section relates to instances where one corporation is a mere instrumentality of another corporation, and all of its stock, or substantially all of its stock, is owned by the parent corporation. The first part of this section is as follows:

"29.102-3. *Unreasonable accumulation of profits.*—An accumulation of earnings or profits (including the undistributed earnings or profits of prior years) is unreasonable if it is not required for the purposes of the business, considering all of the circumstances of the case. It is not intended, however, to prevent accumulations of surplus for the reasonable needs of the business if the *purpose* is not to prevent the imposition of the surtax. No attempt is here made to enumerate all the ways in which earnings or profits of a corporation may be accumulated for the reasonable needs of the business. Undistributed income is properly accumulated if retained for *working capital* needed by the business; or if invested in *additions* to plant reasonably required by the business; or if in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation. The nature of the investment of earnings or profits is immaterial if they are not in fact needed in the business. Among other things, the nature of the business, the financial condition of the corporation at the close of the taxable year, and the use of the undistributed earnings or profits will be considered in determining the reasonableness of the accumulations.

"The business of a corporation is not merely that which it has previously carried on, but includes in general any line of business which it may undertake. However, a *radical change of business* when a considerable surplus has been accumulated may afford evidence of a purpose to avoid the surtax." [Italics added]

In other words, it should always be borne in mind that it is the *purpose* to prevent the imposition of a surtax on shareholders through the medium of permitting earnings or profits to accumulate, and *not* the fact of unreasonable or unneeded accumulation of earnings or profits. In the case of companies other than investment companies, it will be noticed from Sections 29.102-2 and 3 of Regulation 111 that while the *fact* of whether or not there is an un-

reasonable accumulation is *not* determinative, yet if the accumulation is needed in the business; that fact is strongly evidentiary in behalf of the taxpayer, subject to the exception of radical change in the business when a considerable surplus has been accumulated.

The majority of the cases sustaining the Commissioner have involved corporations which were both *formed and availed* of to avoid the surtax on stockholders.¹ No case has been found where the tax has been applied to a corporation solely because it was *formed* for the prohibited purpose, when its subsequent conduct was legitimate, but the Board of Tax Appeals in the case of *Nipoch Corporation v. Commissioner*² said:

"The Commissioner has been sustained in applying section 104 and its predecessors in a number of cases. But in each of those cases there has been a finding that the corporation was 'availed of' within the taxable year for the purpose described in the statute. No case has come to our attention where the Commissioner has been sustained solely on the ground of the purpose for which a corporation was 'formed.' However, in at least two cases there are statements to indicate that that purpose alone would be sufficient. *Saenger, Inc. v. Commissioner*, 84 Fed. 2d 23 (1936), affirming 33 B.T.A. 135 (1935). *Rands, Inc.*, 34 B.T.A. 1094 (1936)."

However, as the tax is levied in the alternative, corporations, though formed legitimately and with no such purpose, are subject to the tax if *later* there is present the said purpose.

Congress, from the very beginning of the income tax laws, has recognized that the corporate form of doing business and holding property, especially in closed corporations, might be used to evade or avoid individual surtax. It, therefore, commencing with the Tariff Act of 1913, has inserted provisions designed to deter corporations from accumulating surplus beyond the reasonable requirements of the business. A rather complete history of the various statutes on that question enacted prior to the decision of the Board of Tax Appeals in the case of *Mead Corp. v. Commissioner*³ appear in footnotes to the opinion thereof. Initially, in the Acts of 1913, 1916 and 1918, the tax was levied on the shareholders rather than upon the corporation, and, indeed, the 1918 Act, Section 220, provided that in such instances there should be no corporate tax but that the shareholders should be taxed as in the case of partners in partnerships and in the case of personal service corporations. In 1921, The Congress, fearful that the entire penal section might be held invalid, abandoned the idea of taxing the shareholders, and introduced the presently operative notion of a penalty tax against corpora-

1. See *William C. deMille Productions, Inc.*, 30 B. T. A. 826 (1934). *Olin Corporation v. Commissioner*, 42 B. T. A. 1203 (1940), *aff'd*, 128 F. 2d 185 (C. C. A. 7th 1942). See also *Suffolk Securities Corp.*, 41 B. T. A. 1161 (1940), *aff'd*, 128 F. 2d 743 (C. C. A. 2d 1942).

2. 36 B. T. A. 662, 668 (1937).

3. 38 B. T. A. 687 (1938).

tions, and that has been the course since the Revenue Act of 1921. Indeed, in the Acts of 1913 and 1916, the language appeared "formed or *fraudulently* availed of for the purpose. . . ." Commencing with the Act of 1918 the word "fraudulently" has been omitted.

The reasons for accumulations will be carefully investigated, especially in cases of one man corporations and so-called "incorporated talents" companies. In such instances, the tax has usually been applied, although in a leading case⁴ the taxpayer was successful. Further, the fact that the stock of the corporation is closely held is an apparently important element.

The great majority of the decided cases involve corporations whose stock, or the stock of whose parent corporation, is owned by a single shareholder, or by members of a family. There are few decided cases dealing with large publicly owned corporations. The *Trico* case⁵ involved a corporation with over two thousand stockholders, but the controlling interest was held by a small director-group. Professor Cary denies in an excellent article in a recent issue of the *Harvard Law Review*⁶ that *Trico* is a public corporation, pointing out that more than 74% of *Trico's* stock was held by six of the original shareholders.⁷ While earlier income tax regulations provided that a statutory presumption could be overcome by showing that the stock was owned "by a large number of persons and in comparatively small blocks," these regulations were subsequently amended⁸ and the later regulations now contain no such provision.

The applicability of the statute, aimed as it is at the "purpose," depends upon the participant's *state of mind*.⁹ However, it is difficult to prove the forbidden purpose unless the accumulations are *too large* for the fair needs of the business, except in the case of a sudden change of policy coincident with large increases in surtax rates, i.e., somewhat along the line of Section 29.102-3 of Income Tax Regulations 111. In the case of *United Business Corporation of America v. Commissioner*¹⁰ Judge Learned Hand said:

4. Cecil B. De Mille v. Commissioner, 31 B. T. A. 1161 (1935), *aff'd*, 90 F. 2d 12 (C. C. A. 9th 1937), *cert. denied*, 302 U. S. 713 (1937).

5. *Trico Products Corp. v. Commissioner*, 137 F. 2d 424 (C. C. A. 2d 1943), *cert. denied*, 320 U. S. 799 (1943).

6. Cary, *Accumulations Beyond the Reasonable Needs of the Business: The Dilemma of Section 102 (C)*, 60 HARV. L. REV. 1282 (1947).

7. After the decision in the *Trico* case a minority shareholder, asserting that the penalty surtax had been incurred as the result of the directors' fault, brought an action against those directors and a company that held part of their stock. This action was settled, the holding company paying nearly two million dollars and one of the directors paying more than two hundred thousand dollars. This settlement was approved by the court. *Mahler v. Oishei*, N. Y. Sup. Ct., N. Y. Cty., File No. 28485—1947.

8. T. D. 4470, C. B. XIII-2 at 151.

9. See *United Business Corporation of America v. Commissioner*, 62 F. 2d 754, 755 (C. C. A. 2d 1933).

10. *Ibid.*

"Ordinarily it will indeed be difficult to prove the forbidden purpose, *unless the accumulations are too large for the fair needs of the business*. But it may not be impossible to do so, even though the profits arise out of normal business, as they did not here. The management may for example be shown to have always been sanguine, and to have withheld only small reserves, though prudence justified more. A sudden change of policy, coincident with large increases in the surtax rates, might in that situation betray a purpose to accumulate against a season more propitious for distribution. Or the officers might unguardedly disclose a scheme to avoid surtaxes, though the other evidence was not enough." [Italics added]

That case was decided against the taxpayer; it appeared that the stock was owned by one man, who was subject to heavy surtaxes, and the corporation made large loans to him, a fact which usually causes a decision adverse to the taxpayer.

It was stated in the case of *United States v. R. C. Tway Coal Sales Company*:¹¹

"This purpose may be proved unaided by presumption, but the fact that the surplus is not unreasonably large in respect to the needs of the corporation's business is repugnant to the existence of such purpose, and, while not conclusive, must be accepted as *substantial evidence* in denial of proofs or inferences that it exists." [Italics added]

The corporation was one engaged in the business of selling coal. The stock was owned by Mr. Tway and his wife, with two others owning a small number of shares each. The lower court¹² was impressed by the fact that the capital and surplus did *not* equal the current accounts receivable of the corporation, because the coal was sold by it on 30, 60 and 90 days' time, and while the evidence showed that the coal producing companies which had sold coal to the corporation had *not* been in the habit of exacting immediate payment, yet there was nothing to show they did not have the right to do so "had the exigencies of their business demanded such payment," and the court found that it certainly would not have been an unreasonable act on the part of the officers and directors of the corporation to permit the accumulation of a surplus sufficiently large to meet the possible requirements to pay for the coal it purchased before its customers had paid their accounts.

One of the best known cases is the *Cecil B. De Mille* case.¹³ The decision of the Board of Tax Appeals¹⁴ was in favor of the taxpaying corporation, it appearing that a large part of the earnings, both of the corporation and the preceding partnership, had been withheld from distribution to partners

11. 75 F. 2d 336, 337 (C. C. A. 6th 1935).

12. 3 F. Supp. 668 (W. D. Ky. 1933).

13. *Cecil B. De Mille v. Commissioner*, 31 B. T. A. 1161 (1936), *aff'd*, 90 F. 2d 12 (C. C. A. 9th 1937), *cert. denied*, 302 U. S. 713 (1937).

14. 31 B. T. A. 1161 (1936).

and to stockholders, and was invested in various properties and enterprises and otherwise accumulated in accordance with a *consistent* plan of the individuals (who were members of the partnership and later stockholders and officers of the corporation) to build up an organization sufficiently financed for the independent production of business. The stock of the corporation was closely held. The court there said:¹⁵

"Under oath, each flatly denied that the company was formed for the purpose of preventing the imposition of surtax upon its shareholders; or that it was availed of, or accumulated its profits for that purpose. They denied that the matter of surtax avoidance by the shareholders was ever discussed, or that the *possibility of such avoidance* was ever a consideration in determining the disposition of the company's earnings. These denials remain unshaken by cross-examination. Of course, such denials are not entirely controlling. Perhaps they are to be expected, for without them there would be no controversy." [Italics added]

The Circuit Court of Appeals for the Ninth Circuit affirmed the decision of the Board of Tax Appeals.¹⁶ The opinion is quite brief, and the Board of Tax Appeals was affirmed on the ground that the finding that the company (not being a mere holding or investment company) was neither formed nor availed of for the purpose of preventing the imposition of surtaxes upon its share holders through the medium of permitting profits to accumulate was a finding of fact which will not be disturbed on appeal, where it was supported by substantial evidence. In other words, so far as the circuit court of appeals was concerned, it might have decided the case either way had it been a court of original jurisdiction. Since certiorari was denied,¹⁷ there was no opinion indicating whether the Supreme Court would or would not have agreed with the result reached by the circuit court of appeals *simply* upon the ground on which the circuit court of appeals based its decision.

As far as has been found, the Supreme Court has considered similar provisions in a Revenue Act in only two cases. One of these cases is *Helvering v. National Grocery Company*.¹⁸ The Court in this case reversed the decision of the Circuit Court of Appeals for the Third Circuit,¹⁹ the circuit court of appeals having, in turn, reversed the decision of the Board of Tax Appeals²⁰ against the taxpayer. The other case was that of *Helvering v. Chicago Stock Yards Co.*,²¹ where the commissioner was sustained, and the Circuit Court of Appeals for the First Circuit holding in favor of the

15. *Id.* at 1175.

16. 90 F. 2d 12 (C. C. A. 9th 1937).

17. 302 U. S. 713 (1937).

18. 304 U. S. 282 (1938).

19. 92 F. 2d 931 (C. C. A. 3d 1937).

20. 35 B. T. A. 163 (1936).

21. 318 U. S. 693 (1943).

taxpaying corporation,²² was reversed, which decision, in turn, reversed the decision of the Board of Tax Appeals against the taxpayer.²³

Both of these Supreme Court cases, decided against the taxpayer, involved one man corporations, the National Grocery Company having at all times been a one man corporation, the stock being owned by a Mr. Kohl, and the Stockyards Company having been a one man corporation for some years, the stock being owned by a Mr. Prince. While both of these cases were *one man* corporation cases, some of the statements in the opinion of the Supreme Court are of interest generally. Briefly, the facts in the *National Grocery Company* case were that the corporation was formed in 1908, prior to the first Income Tax Act of 1913. The case partially went off in the Supreme Court on the ground that the circuit court of appeals had made an independent determination as upon a trial *de novo* of the issues before the Board. The Supreme Court held that there was evidence to support the findings and decisions of the Board of Tax Appeals and reversed the circuit court of appeals, as stated. Since the decision of the Supreme Court in the case of *Dobson v. Commissioner*,²⁴ as to the finality of findings of fact by the Board of Tax Appeals (now the Tax Court of the United States), where the determinative issue is one of a *state of mind*, i.e., *purpose*, which can ordinarily be ascertained as an *inference* to be drawn from positive facts, it seems that it will be quite difficult in the future to have a finding by the Tax Court on this question set aside, unless Section 10 of the recently enacted Federal Administrative Procedure Act²⁵ be applicable to the review of decisions of the Tax Court. The letter of the Attorney General to the Senate Judiciary Committee to the contrary notwithstanding,²⁶ the Circuit Court of Appeals for the Sixth Circuit in the recent case of *Lincoln Electric Co. v. Commissioner*,²⁷ concluded that a review of Tax Court decisions was governed by the Administrative Procedure Act, but did not deem it necessary to decide to what extent its power of review had been broadened, awaiting a case when clear cut questions of fact or mixed questions of law and fact should be brought to the court for review.²⁸

Of course, since the corporation was formed prior to the levying of any such tax as that in question, there was no issue as to the corporation's

22. 129 F. 2d 937 (C. C. A. 1st 1942).

23. 41 B. T. A. 590 (1940).

24. 320 U. S. 489 (1943), *rehearing denied*, 321 U. S. 231 (1944).

25. 60 STAT. 237, 243 (1946).

26. This letter was written during the pendency of the bill. See 162 F. 2d 379, 382 (C. C. A. 6th 1947).

27. 162 F. 2d 379 (C. C. A. 6th 1947).

28. See Dickinson, *Administrative Procedure Act: Scope and Grounds of Broadened Judicial Review*, 33 A. B. A. J. 434 (1947). See also Alexander Tax News Letter, June 14, 1947, ¶ 5218.

having been *formed* for the prohibited *purpose*. The Supreme Court commented on subsection (b) of Section 104 of the Revenue Act of 1928²⁹ to the effect that the fact that the gains or profits were permitted to accumulate beyond reason shall be prima facie evidence of a purpose to escape the surtax. The Court, speaking through Mr. Justice Brandeis (Justices McReynolds and Butler dissenting) commented upon the fact that Kohl, the sole stockholder, drew a large yearly salary and, in addition, borrowed heavily from the corporation, his borrowings for the seven year period prior to January 31, 1931, aggregating \$610,000. The Court quoted from the opinion of the circuit court of appeals in the case of *United Business Corporation v. Commissioner*³⁰ to the effect that such loans are incompatible with a purpose to strengthen the financial position of petitioner, and entirely accord with the *desire* to get the equivalent of his dividends under another guise. The Court also held against the contention that the surplus was accumulated for the reasonable needs of the business. It was true that the corporation had been organized in 1908 as a small business of eleven grocery stores, and had expanded to the ownership of 815 stores in 1936. Its capital was \$200,000, and in the ten year period preceding January 31, 1931, it had accumulated surplus profits in the amount of \$5,742,455.35; and the distribution of its surplus profits for the fiscal years 1930 and 1931 as dividends would have caused Kohl to have paid substantial additional surtaxes. Of these large accumulated profits, on January 31, 1931, approximately four-fifths were in the form of bonds, stocks and excess cash. Kohl testified that he estimated the cost of opening each new store to be about \$5,000. The Court found that the increase in the number of stores for the ten year period in question when the stores in the chain increased from 358 to 815 could only account for about one-half of the profits accumulated, noting that ". . . no conceivable expansion could have utilized so large a surplus."³¹

The Court further remarked that high taxes were first imposed in 1919, and that subsequently no dividend was paid until after the close of the taxable year involved in the case.

It appeared that during the year 1931 there was depreciation in the market value of securities held in an amount greater than the net income, and the corporation contended that hence there were no gains or profits realized in that year. The Court said that this was simply a matter of evidence to be considered by the Commissioner and the Board in determining the issue of fact whether the accumulated profits were in excess of the

29. 45 STAT. 814 (1928), 26 U. S. C. 2104 (1928).

30. 62 F. 2d 754, 755 (C. C. A. 2d 1933).

31. *Helvering v. National Grocery Company*, 304 U. S. 282, 294 (1938).

reasonable needs of the business; and remarked that depreciation in the market value of securities which the corporation continued to hold did not, *as a matter of law*, preclude a finding that the accumulation of the year's profits was in excess of the reasonable needs of the business.

In the *Chicago Stock Yards Company* case³² it appeared that a Mr. Prince became a stockholder in the Union Stockyards and Transit Company in Chicago, which had been incorporated in 1865 to operate stockyards in that city. In 1890 certain packers threatened to remove their plants from Chicago unless they were given a share of the profits. Mr. Prince and other stockholders met this situation by organizing a holding company under the laws of New Jersey, the Chicago Junction Railways & Union Stockyards Company. The new company issued bonds in the amount of \$14,000,000 secured by its Transit Company stock. The new company later acquired all of the stock of the Transit Company. By payments in cash and its own bonds, it procured from the packers an agreement to maintain the stockyards at their then location for fifteen years. When this agreement was about to expire, the packers presented fresh demands, and Mr. Prince organized in 1911 the Chicago Stockyards Company as a Maine corporation, which purchased all of the stock of the New Jersey company by giving it \$200 par of its five per cent bonds for each share of stock, stamped with the company's agreement to pay a nine per cent dividend. Armour & Company was given twenty per cent of the respondent's stock, Mr. Prince retaining eighty per cent. Pursuant to an anti-trust case degree, Armour had to part with its interest in the stockyards, and Mr. Prince acquired this stock.

Since the charter of the New Jersey company was to expire in 1940, Mr. Prince formulated the plan of accumulating *cash* in the respondent's treasury sufficient to pay the debts of the New Jersey corporation, and to liquidate it by that time. This would require the redemption of the outstanding preferred stock at par and the payment of the \$14,000,000 mortgage and over \$6,000,000 of fixed obligations of subsidiaries, which had been guaranteed by the New Jersey company, and it would also be necessary to purchase some 6,258 shares of the New Jersey company's common stock, not then owned, or, in other words, there would have been an expenditure of about \$28,000,000 by 1940. If this were done, then the Maine company would own the entire enterprise, clear of debts other than its own bonds outstanding in the amount of \$3,227,000, due in 1961. In the year in question the enterprise as a whole had cash and liquid assets amounting to some \$21,000,000, and fixed and other assets of a book value of \$40,000,000. The bulk of the liquid assets had been drawn into the treasury of the Maine corporation. The Maine corporation's assets on December 31, 1939, ex-

32. 318 U. S. 693 (1943).

ceeded its liabilities, including its capital stock, by some \$19,000,000, and from that date to the close of 1933 its earnings were some \$10,000,000, of which only \$1,600,000 was paid out in dividends.

The Court declined to consider the question of whether or not the Maine corporation was a mere holding or investment company, to-wit, nothing but a pocketbook for Mr. Prince.

It further said, however, that while the company was not formed for the purpose of avoiding the surtax on its stockholders, yet the corporate practice adopted ". . . for mere convenience or other reasons, and without tax significance when adopted, may have been continued with the additional motive of avoiding surtax on the stockholders. The Board's conclusion may justifiably have been reached in the view that, whatever the motive when the practice of accumulation was adopted, the purpose of avoiding surtax induced, or aided in inducing, the continuance of the practice."

The Court said the situation was similar in legal effect to that presented in the *National Grocery Company* case and said that although Mr. Prince denied any purpose to avoid surtaxes, the Board, as in the *National Grocery Company* case, was free to conclude from all of the evidence that such was the purpose. The Court then answered the position or contention of the respondent as follows:

"The respondent's position is that, as the New Jersey Company's charter was to expire in 1940, and as respondent was under what it deemed a moral and, indeed, a legal obligation to pay off the mortgage debts of the New Jersey Company and its subsidiaries and to redeem its outstanding stock, the accumulation of earnings was necessary to the preservation of its business. There are two sufficient answers. Mr. Prince, the sole stockholder, if in receipt of the respondent's earnings, could equally well have done what the respondent proposed to do, that is, turn accumulated earnings into invested capital. And the evidence shows that the New Jersey Company's charter could have been renewed in 1940. Continuance or refinancing of such an enterprise on the face of things would have been practicable."

An analysis of the cases indicates that there is little to fear if an industrial corporation, as distinguished from an investment or holding company, retains assets to invest in additional plant and equipment.³³ It appears from the opinion in the *Dill* case³⁴ that the taxpaying corporation had a capital of \$100,000 and a surplus of \$746,458.46; and had at the end of the year some cash and something over \$300,000 invested in Government bonds. However, most of the surplus resulted from several years' accumulations. This surplus represented physical plant and improved manufacturing facilities. The corporation had thus been able to sustain an increase in its income on which income tax had previously been paid. The court said:

"Justice Holmes once said 'A page of history is worth a volume of logic,' *New York Trust Co. v. Eisner*, 256 U. S. 345. Thus, the economic history of the country

and this company is both pertinent and illuminating. So, particularly where, as here, the petitioner is not a holding company but is engaged in a manufacturing business, *which is so obviously hazardous from a business viewpoint*, we will hesitate before substituting our judgment upon the reasonableness of the corporate accumulations, for that of the directors. See *Klug & Smith Co.*, 18 B. T. A. 966.

"The attitude of petitioner toward its earlier gains and profits may have a bearing upon the reasonableness of the accumulation existing in the tax year. See *United Business Corporation of America v. Commissioner*, *supra*; and *C. H. Spitzner & Sons, Inc.*, *supra*. But respondent points to the large corporate surplus account of petitioner in the tax year as constituting 'accumulated gains and profits' under the act. However, the greater part of this surplus is the result of accumulations over many years and represents physical plant and improved manufacturing facilities by which the petitioner has been enabled to sustain and increase its income upon which it has already paid income tax." [Emphasis added]

However, where a company has a large portion of its assets in liquid form, it is highly desirable to be able to show that within a reasonable time expansion will occur through the purchase of plant or equipment or the making of improvements, or at least that active efforts are being made to locate another plant or to prepare for the making of such expenditures. *Indefinite* contemplated plans of expansion, without any action in that direction, are not sufficient.³⁵

In both the *Perry*³⁶ case and the *Wilkerson*³⁷ case, the Circuit Court of Appeals for the Ninth Circuit decided adversely to the taxpayer, largely upon the proposition that the adverse findings by the Board of Tax Appeals were *questions of fact*. In the *Perry* case the court went into the facts, and from the opinion it appears that the taxpayer contended that the undistributed income of the corporation was reasonably required by it for *contemplated repairs and working capital*. J. M. Perry & Company was engaged in the business of cold storage and warehousing in the State of Washington. It did not make the repairs contemplated. In finding against the corporation on its contention that this undistributed income was reasonably required by it for contemplated repairs and working capital, the circuit court said:

"It appears that the taxpayer corporation was engaged in the business of cold storage and warehousing in Yakima, Washington. It maintained a cold storage plant, divided into four units, having a total capacity of 490,000 boxes of fruit. It presented evidence to the effect that various alterations and repairs to its plant were contemplated in the tax years. Other witnesses for the taxpayer testified that \$250,-

33. See *Dill Mfg. Co. v. Commissioner*, 39 B. T. A. 1023 (1939); *J. E. Baker Co. v. Commissioner*, B. T. A. Memo Opinion Docket No. 87758 (June 9, 1939).

34. *Dill Mfg. Co. v. Commissioner*, *supra* note 33.

35. See *J. M. Perry & Co. v. Commissioner*, B. T. A. Memorandum Opinion Dockets 92,275 and 94,523, *aff'd*, 120 F. 2d 123 (C. C. A. 9th 1941). See also *Wilkerson Daily Corporation v. Commissioner*, 125 F. 2d 998 (C. C. A. 9th 1942).

36. *J. M. Perry & Co. v. Commissioner*, *supra* note 35.

37. *Wilkerson Daily Corp. v. Commissioner*, *supra* note 35.

000 was a reasonable amount for a business of the size and character of that of taxpayer to retain on hand for working capital, including financing of growers.

"Taxpayer's balance sheets for 1935 and 1936 disclose the following: On December 31, 1935, taxpayer had on hand over \$150,000 cash, and almost \$49,000 in United States and other bonds. On this same day it owed in accounts payable only the sum of \$312.16. On December 31, 1936 the cash on hand had increased to over \$268,000, and the investment in bonds had increased to over \$71,000. The accounts payable amounted to only \$843.87.

"As against the taxpayer's evidence as to contemplated repairs and necessary working capital, *it was developed that the contemplated alterations and repairs have never been made, and that the peak of the taxpayer's financing loans in 1935 and 1936 amounted to approximately \$35,000.*" [Italics added]

The court then remarked that in spite of the fact that the taxpayer contended that it needed to maintain this large cash reserve on hand, it proceeded to make various investments, which had no relation to its storage business, citing an instance in 1934 when it purchased some mining stock which it sold in 1935 at a profit of nearly \$48,000; another instance cited was when the corporation purchased in 1935 forty-five residential lots in Yakima, Washington, and commenced construction of some houses; still another instance was when it purchased a banking building in Yakima which was sold to its principal stockholder, Perry, in 1936, at its cost price, and the price was charged to Perry's account; and, finally, it had loaned in 1935 various amounts to individuals not in any manner connected with its fruit business, these loans aggregating about \$100,000 (and in the year 1936 Perry borrowed from the corporation over \$30,000). Of course, these latter matters made the case somewhat harder for the taxpayer, but they do not detract from the general statement.

In *Wilkerson Daily Corporation v. Commissioner*³⁸ all of the stock was finally owned by two stockholders, Mr. Wilkerson and his mother, Mr. Wilkerson owning the larger share. In the fiscal year ending November 31, 1931, there was a loss, but thereafter, in the fiscal years through the one ending July 31, 1936, there were small profits until the said last fiscal year, when there was a profit of some \$58,000. In none of the years were any dividends declared. If dividends had been paid, Wilkerson would have had to pay surtax on the additional income therefrom. There was present the important element that Mr. Wilkerson borrowed from the corporation from year to year, so that in the fiscal year ending July 31, 1936, he owed the corporation nearly \$70,000. However, on the point here in question the Court said:

"Wilkerson testified that the purpose of permitting petitioner's gains and profits to accumulate instead of being divided or distributed was to enable petitioner to expand its corporate business and to provide a reserve for certain contingencies. The

38. 125 F. 2d 998 (C. C. A. 9th 1942).

Board did not credit this testimony. Instead, the Board noted that the expansion plans testified to by Wilkerson *were never carried out*, and that the failure to carry them out was not satisfactorily explained. To the Board, moreover, the purpose mentioned by Wilkerson seemed inconsistent with petitioner's action in making loans to Wilkerson." [Italics added]

In the recent case of *Lion Clothing Co. v. Commissioner*,³⁹ the decision was in favor of the taxpayer. In the years 1940 and 1941, after federal taxes, approximately twenty-five per cent of the net profits was distributed in dividends, and the balance was added to earned surplus, and in the year 1942 about one-third was distributed as dividends, and the balance was added to earned surplus. The concern was an old merchandising one in San Diego, which city grew rapidly. In the depression years of 1930, 1931 and 1932 the company had suffered losses, banks to which it was indebted had forced it to reduce its inventory in order to pay them off, and the president loaned it an amount, which indebtedness he forgave. These experiences with the bank and the depreciation losses made a deep impression on the mind of John H. Fox, who became President in 1939 after the death of his father, the former President, Samuel I. Fox.

In 1938 the directors adopted a motion in regard to future earnings of the company so that a definite policy should be followed: to pay \$20,000 a year to the Metropolitan Life Insurance Company to which there was owing approximately \$205,000 on a mortgage on the building, which was assumed at the time of acquisition; second, to pay bonuses; and, third, of any earnings, at least fifty per cent should go into surplus "so that the company should have funds for expansion *or any unseen business depression that might occur.*"

The court remarked that the petitioner needed new fixtures for its store, new lighting equipment and new fronts, and needed a freight elevator very badly, but decided not to put it in until it paid off its debts and built up a reserve; that it estimated that its inventory would have to be expanded after the war some \$100,000, or to an amount three times as great as the inventory at the end of 1942 and fifty per cent more than the inventory at the end of 1939. At the end of 1942, the net asset position, exclusive of inventories, was approximately three to two.

The court had no reasonable doubt of the petitioner's estimate that \$100,000 would be needed to enlarge inventories or that \$50,000 would be needed to increase the size of its accounts receivable, and that in addition it would need some \$100,000 to purchase the stock interest of a closely related business which operated a women's ready-to-wear department in petitioner's place of business.

The court referred to the resolution adopted in 1938, stating:

39. 8 T. C. Docket No. 5370 (June 17, 1947).

"The reason we think that earnings and profits of petitioner were not accumulated beyond the reasonable needs of its business is because petitioner has proved by evidence which seems convincing to us that in the year 1938 it adopted by appropriate corporate action a policy of accumulating a part of its net profits each year to be added to surplus 'so that the company have funds for expansion or any unseen depression that might occur,' and that this policy under all the circumstances of the case was a reasonable one and has been carried out, including the taxable years which we have before us. We do not think it can be said that a taxpayer's earnings were accumulated beyond the reasonable needs of the business where it is shown that the purpose of their accumulation is to retire mortgage indebtedness, to make improvements which will add to the convenience and efficiency of operation of the business, to expand operations by purchasing the interests of concessionaires, to accumulate some cash reserves as a bulwark against future depressions, and to meet unknown risks of the war and post-war period."

The court further stated that the case was more akin to that of *General Smelting Co. v. Commissioner*⁴⁰ than to the case relied upon by the Commissioner.⁴¹ In the latter case there were larger loans to stockholders and in addition there was a large investment in an *unrelated* corporation. It was mainly because of these facts that the court held that in the taxable year in question the taxpayer corporation, by permitting its earnings and profits to accumulate instead of being distributed, had been used for the purpose of preventing the imposition of the surtax upon the stockholders.

As do many others, the writer feels that as far as possible from the standpoint of a sound taxing system, a statute which predicates liability for a tax on intent, motive or purpose, as distinguished from actions and objective matters, should not be enacted. The consequent uncertainty as to what a court may hold years later as to the motive or purpose does not conduce to sound business administration.

While the revenue may have to be protected by some law to prevent wide-spread avoidance of individual surtaxes by stockholders in closed corporations, we must not overlook the fact that directors of such corporations are influenced in many instances to try to avoid the attempted application of Section 102 to their corporations, or perhaps a claim of personal liability by minority stockholders in the light of developments in the *Trico* matter, and, in so doing, to distribute as dividends more earnings than would be justified by an eye solely to what is best for the corporations concerned. This is especially true now when the replacement of inventory and capital assets is on an increasing cost scale and we see corporations with good earnings borrowing for the said purposes, as well as for expansion. Small businesses must be allowed to grow, as in the past, if the capitalistic system is to function successfully and, perhaps, survive.

40. 4 T. C. 313 (1944).

41. *Whitney Chain and Mfg. Co. v. Commissioner*, 3 T. C. 1109 (1944), *aff'd*, 149 F. 2d 936 (C. C. A. 2d 1945).

In the case of individuals and firms, engaged in business, their troubles, in this regard, would be largely relieved by a substantial decrease in personal income tax rates. In the case of corporations, any further decrease in rates is improbable in the near future, and I thoroughly agree with the eleventh recommendation of the Special Tax Study Committee, of which Mr. Roswell Magill was Chairman, that Section 102 should be modified so as to (1) place upon the Commissioner the burden of proving that earnings or profits have been unreasonably accumulated; (2) limit the tax to the portion of Section 102 income that is unreasonably accumulated and (3) permit dividends paid within 75 days after the end of the tax year to be deducted in computing Section 102 income for such year. Such modification would be helpful.