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ACCUMULATED EARNINGS TAX AND STOCK REDEMPTIONS—FURTHER THOUGHTS ON THE REASONABLE BUSINESS NEEDS TEST

MICHAEL S. WEINER* AND BRUCE M. GRAHAM, JR.**

I. INTRODUCTION

FEW PENALTY TAXES HAVE BEEN IMPOSED with the frequency of the tax on unreasonable accumulations of corporate earnings and profits.¹ Any corporation "formed or availed of for the purpose of avoiding income tax with respect to its shareholders by permitting earnings and profits to accumulate instead of being divided or distributed"²

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¹ I.R.C. §§ 531-537.

Other articles in the area include Altman, *Improper Accumulation of Earned Surplus: Circumstances Which Invoke the Section 531 Penalty Tax: Business Needs; Purpose to Avoid Surtax; Multiple Corporations & Section 531*, PROC. N.Y.U. 24TH ANN. INST. FED. TAX. 805 (1966); Bradley, *Stock Transfer Restrictions & Buy-Sell Agreements*, 1969 U. ILL. L.F. 139; Canty, *The Accumulated Earnings Tax 1954 Reforms: An Appraisal*, 2 U. S.F. L. REV. 242 (1968); Cunningham, *More Than You Ever Wanted to Know About the Accumulated Earnings Tax*, 6 J. CORP. TAX. 187 (1979); Frost, *Accumulated Earnings Tax Looms as Threat to Buy-Out Agreements*, 9 J. TAX. 324 (1958); Herwitz, *Stock Redemptions & the Accumulated Earnings Tax*, 74 HARV. L. REV. 866 (1961); Kahn, *Mandatory Buy-Out Agreements for Stock of Closely Held Corporations*, 68 MICH. L. REV. 1 (1969); Maxfield, *Recent Cases Forecast More Liberal Trend in Allowing Accumulations to Redeem Stock*, 25 J. TAX. 43 (1966); O'Neill, *The Accumulated Earnings Tax—Effects of Stock Redemptions*, 46 TAXES 172 (1968); Polasky, *Planning for the Disposition of a Substantial Interest in a Closely Held Business*, 46 IOWA L. REV. 516 (1961); Rudolph, *Stock Redemptions & the Accumulated Earnings Tax—An Update*, 4 J. CORP. TAX. 101 (1977); Weithorn, *What Constitutes a "Reasonable" Corporate Accumulation?*, PROC. N.Y.U. 17TH ANN. INST. FED. TAX. 299 (1959); Weyher & Noall, *Providing for Succession Through Buy-Sell Agreements & Recapitalizations*, PROC. N.Y.U. 21ST ANN. INST. FED. TAX. 445 (1963).

In the mid-sixties it was noted that the accumulated earnings penalty tax was "the sword of most general applicability and of rapidly increasing significance" available to the Treasury Department for the purpose of slaying those who dared manipulate corporations for their personal tax benefit. Canty, *supra* this note, at 243. At that time the number of cases litigated in the area was rising. Although exact numbers are difficult to derive, an informal survey by the authors seems to indicate that this may no longer be true. Nonetheless, it is fair to state that, due to its severity, this weapon is brandished upon audit in occasionally marginal circumstances. A corporate taxpayer must be able to deal with it effectively so as to remove it from the settlement picture.

² I.R.C. § 532(a).

is subject to the tax. However, the tax is not properly imposed where the accumulations are for the reasonable business needs of the corporation. Accordingly, the question of what constitutes reasonable business needs is critical. This article considers one aspect of the reasonable business needs question: Under what circumstances should a redemption of corporate stock or the funding of a proposed redemption be considered a reasonable business need?

The reasonable business needs issue is raised most often in the situation where a closely held corporation considers redeeming the stock of its founder or the heirs of its founder.³ Such a redemption undeniably redounds to the benefit of the redeemed shareholder. However, the transaction also has considerable significance for the corporation in that control is shifted.⁴ The crucial issue for purposes of the tax on accumulated earnings is whether the accumulation should be characterized as undertaken for the corporation's reasonable business needs or for the redeemed shareholder's tax benefit.

II. THE MECHANISM IMPOSING THE ACCUMULATED EARNINGS TAX

A. *In General*

Section 532(a) of the Code describes the type of corporation upon which the tax will fall. It is to be imposed upon every corporation "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed."⁵ Thus, two elements must exist if the corporation is to be assessed: 1) it must have permitted its earnings and profits to accumulate; and 2) it must have done so with the intent of avoiding income tax with respect to its shareholders. These elements are often referred

³ Few publicly owned companies have ever been confronted with an assessment of the tax, and then only where control can be ascribed to a handful of insiders. See *Golconda Mining Corp. v. Commissioner*, 58 T.C. 139 (1972), *rev'd*, 507 F.2d 594 (9th Cir. 1974); *Trico Prods. Corp. v. Commissioner*, 46 B.T.A. 346 (1942), *aff'd*, 137 F.2d 424 (2d Cir.), *cert. denied*, 320 U.S. 799 (1943). See also *Trico Prods. 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).

⁴ These types of corporate stock repurchases are favored under the Internal Revenue Code by yielding capital gains treatment under certain circumstances for the redeemed shareholders. See, e.g., I.R.C. § 302. In the case of a deceased shareholder, however, such capital gains treatment is limited to the extent it does not exceed the sum of the estate, inheritance, legacy and succession taxes, and the funeral and administration expenses. *Id.* § 303. See notes 100-08 *infra* and accompanying text.

⁵ I.R.C. § 532(a). *But see* I.R.C. § 532(b), which sets forth certain exceptions to the general rule described, e.g., personal holding companies. Such exceptions are not pertinent to this article.

to as the "proscribed conduct" and the "proscribed purpose," respectively.⁶

B. *The Intent Factor and Objectifying the State of Mind*

To measure the existence of the proscribed purpose, the state of mind of the corporate taxpayer must be gauged. It has been observed that a motive cannot accurately be attributed to a corporation; the state of mind must be measured with respect to those individuals in control.⁷ Because subjective intent is difficult to establish, certain presumptions from which the proscribed purpose can be inferred have always been included in the statutory scheme.⁸

The most important presumption for purposes of the present discussion is that if earnings and profits are permitted to accumulate beyond the reasonable needs of the business, the existence of that fact will "be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by preponderance of the evidence shall prove to the contrary."⁹

⁶ For similar analyses, see *American Trading & Prod. Corp. v. United States*, 362 F. Supp. 801 (D. Md. 1972), *aff'd mem.*, 474 F.2d 1341 (4th Cir. 1973); *GPD, Inc. v. Commissioner*, 60 T.C. 480 (1973), *rev'd*, 508 F.2d 1076 (6th Cir. 1974).

⁷ *Casey v. Commissioner*, 267 F.2d 26, 32 (2d Cir. 1959) (Hand, J., concurring); *KOMA, Inc. v. Commissioner*, 8 T.C.M. (CCH) 1064, 1070-71 (1949), *aff'd*, 189 F.2d 390 (10th Cir. 1951). See Herwitz, *supra* note 1, at 869.

⁸ See 7 MERTENS, *Presumptions with Respect to Avoidance*, L. FED. INCOME TAX. § 39.28 (1976). See also *Stanton v. Commissioner*, 44 B.T.A. 56 (1941), *aff'd*, 138 F.2d 512 (1943) (per curiam); *DeMille v. Commissioner*, 31 B.T.A. 1161 (1935), *aff'd*, 90 F.2d 12 (9th Cir.), *cert. denied*, 302 U.S. 713 (1937).

The United States Supreme Court had this observation on the presumptions of the accumulated earnings tax: "As Judge Learned Hand said of the much weaker presumption contained in the Revenue Act of 1921, § 220, 42 Stat. 247, '[a] statute which stands on the footing of the participants' state of mind may need the support of presumption, indeed be practically unenforceable without it . . .'" *United States v. Donruss Co.*, 393 U.S. 297, 308 (1969) (quoting *United Business Corp. v. Commissioner*, 62 F.2d 754, 755 (2d Cir. 1933)). The Court continued, "[t]he utility of . . . [that] presumption . . . is well nigh destroyed if . . . [it] is saddled with requirement of proof of "the primary or dominant purpose" of the accumulation.'" *Id.* (quoting *Barrow Mfg. Co. v. Commissioner*, 294 F.2d 79, 82 (5th Cir. 1961), *cert. denied*, 369 U.S. 817 (1962)).

⁹ I.R.C. § 533(a). The strength of this presumption should not be underestimated. For example, another presumption used in the accumulated earnings tax is that if a corporation is a mere holding or investment company, that fact shall be "prima facie evidence of the purpose to avoid the income tax with respect to shareholders." *Id.* § 533(b). Comparing the former presumption with the latter, the former is "determinative" of the proscribed purpose while the latter is merely "prima facie evidence." Hence, the presumption contained in section 533(a) is accorded even greater weight than that which usually attaches to a determination made by the Commissioner. See Herwitz, *supra* note 1, at 870-72; 7 MERTENS, *supra* note 8, *Unreasonable Accumulation of Earnings and Profits Determinative of Purpose* at § 39.29.

The Treasury Regulations indicate that the existence or nonexistence of the purpose to avoid income tax with respect to shareholders, *i.e.*, the proscribed purpose, may be proven by circumstances other than those specified in section 533.¹⁰ However, as a practical matter, litigation has centered upon the "reasonable business needs" issue. Once assessed, avoidance of the tax almost always depends upon justification by the taxpayer of the accumulations in terms of the reasonable needs of the corporation's business.¹¹

C. *The Burden of Proof*

The corporate taxpayer has an opportunity to redress the imbalance created by the statutory presumption by taking advantage of the procedures set forth in section 534 of the Code. Before mailing a notice of deficiency, the Commissioner of the Internal Revenue Service is required to send to the taxpayer a separate notice to the effect that the forthcoming deficiency notice will include an amount attributable to excessive accumulations of earnings and profits.¹² Within sixty days of the date the section 534 notice is mailed, the taxpayer may respond by submitting a statement of the grounds upon which it relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business.¹³ The effect of the statement is to shift to the Commissioner the burden of proof as to his/her allegations that the corporation has accumulated excessive earnings and profits.¹⁴

The burden will be shifted only to the extent that the statement includes facts sufficient to demonstrate the factual basis of the taxpayer's allegations.¹⁵ Where the statement is too broad or vague, the burden

¹⁰ Treas. Reg. § 1.533-1(a)(2) (1959).

¹¹ See, e.g., *Smoot Sand & Gravel Corp. v. Commissioner*, 241 F.2d 197 (4th Cir.), *cert. denied*, 354 U.S. 922 (1957); *Gazette Publishing Co. v. Self*, 103 F. Supp. 779 (E.D. Ark. 1952); *World Publishing Co. v. United States*, 104 F. Supp. 784 (N.D. Okla. 1952); *Trico Prods. 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); *Breitfeller Sales, Inc. v. Commissioner*, 28 T.C. 1164 (1957); *Whitney Chain & Mfg. Co. v. Commissioner*, 3 T.C. 1109 (1944), *aff'd*, 149 F.2d 936 (2d Cir. 1945) (*per curiam*).

¹² I.R.C. § 534(b). In the event the Commissioner fails to provide such notice, the burden of proof on the issue of reasonable business needs will remain on him. *Id.* § 534(a)(1); Treas. Reg. § 1.534-2(a)(1) (1959).

¹³ Treas. Reg. § 1.534-2(d)(2) (1959).

¹⁴ I.R.C. § 534(a)(2).

¹⁵ Treas. Reg. § 1.534-2(a)(2) (1959). For the procedure of preparation and mailing of the letter of notification, see Rev. Proc. 56-11, 1956-1 C.B. 1028. For an example of a partially unsuccessful section 534 statement, see *Shaw-Walker Co. v. Commissioner*, 390 F.2d 205, 217-33 (6th Cir. 1968), *vacated*, 393 U.S. 478 (1969) (*per curiam*).

will remain with the taxpayer.¹⁶ Accordingly, section 534 statements should contain estimates of the dollar amounts involved for the particular business needs set forth.¹⁷ Finally, choice of forum becomes important in litigating reasonable business needs issues because the section 534 procedure is applicable only to complaints filed with the Tax Court and not to refund claims in the district courts and the Court of Claims.¹⁸

Even if the corporation successfully shifts the burden of proof with respect to the reasonable business needs issue, it still bears the final burden of persuasion that the amounts at issue were not accumulated to facilitate shareholder tax avoidance, *i.e.*, the presence or absence of the "proscribed purpose".¹⁹ The elaborate statutory structure clearly indicates the considerable importance Congress attached to allocation of the burden of proof on the reasonable business needs issue.²⁰

D. *Determining the Tax Base: Accumulated Taxable Income and the Accumulated Earnings Credit*

Section 535 of the Code defines "accumulated taxable income," the income base against which the tax rates are applied. "Accumulated tax-

¹⁶ Herzog Miniature Lamp Works, Inc. v. Commissioner, 481 F.2d 857 (2d Cir. 1973); R. Gsell & Co. v. Commissioner, 294 F.2d 321 (2d Cir. 1961); Hamabe Realty Corp. v. Commissioner, 33 T.C.M. (CCH) 1029 (1974); 31 W. 53rd St. Corp. v. Commissioner, 33 T.C.M. (CCH) 142 (1974); Powder Mill Realty Trust v. Commissioner, 32 T.C.M. (CCH) 707 (1973); Federal Ornamental Iron & Bronze Co. v. Commissioner, 28 T.C.M. (CCH) 391 (1969); I. A. Dress Co. v. Commissioner, 32 T.C. 93 (1959), *aff'd on other grounds*, 273 F.2d 543 (2d Cir. 1960).

¹⁷ Bohac Agency, Inc. v. Commissioner, 30 T.C.M. (CCH) 979 (1971). For instances of the taxpayer successfully shifting the burden of proof, see Delaware Trucking Co. v. Commissioner, 32 T.C.M. (CCH) 105 (1973); Chatham Corp. v. Commissioner, 48 T.C. 145 (1967); Oman Constr. Co. v. Commissioner, 24 T.C.M. (CCH) 1799 (1965); Ted Bates & Co. v. Commissioner, 24 T.C.M. (CCH) 1346 (1965); Vuono-Lione, Inc. v. Commissioner, 24 T.C.M. (CCH) 506 (1965).

¹⁸ I.R.C. § 534(a). If a taxpayer questions in a federal district court the imposition of the accumulated earnings tax, there is no procedure for shifting the burden of proof to the Commissioner regarding the reasonableness of the accumulation.

¹⁹ R. Gsell & Co. v. Commissioner, 294 F.2d 321 (2d Cir. 1961); Pelton Steel Casting Co. v. Commissioner, 251 F.2d 278 (7th Cir.), *cert. denied*, 356 U.S. 958 (1958); Powder Mill Realty Trust v. Commissioner, 32 T.C.M. (CCH) 707 (1973); Cheyenne Newspapers, Inc. v. Commissioner, 32 T.C.M. (CCH) 234 (1973); I. A. Dress Co. v. Commissioner, 32 T.C. 93 (1959), *aff'd on other grounds*, 273 F.2d 543 (2d Cir. 1960). For a historical approach to the litigation of the section 534 issue, see Canty, *supra* note 1, at 253-58.

²⁰ On occasion, however, courts have failed to make a specific finding as to where in the intricate legal tangle the burden of proof is to be placed. Several decisions have been handed down merely upon a consideration of the record as a whole. See, *e.g.*, Smoot Sand & Gravel Corp. v. Commissioner, 274 F.2d 495 (4th Cir.), *cert. denied*, 362 U.S. 976 (1960); McMinn v. Commissioner, 21 T.C.M. (CCH) 913 (1962); Barrow Mfg. Co. v. Commissioner, 19 T.C.M. (CCH) 195 (1960), *aff'd on other grounds*, 294 F.2d 79 (5th Cir. 1961), *cert. denied*, 369 U.S. 817 (1962); Pacific Ore. v. Commissioner, 17 T.C.M. (CCH) 504 (1958).

able income" consists of taxable income minus the dividends paid deduction (as set forth in section 561 and subsequent sections) and the accumulated earnings credit (as set forth in section 535(c)), with further adjustments.²¹ The dividends paid deduction includes the sum of dividends paid during the taxable year, the consent dividends for the taxable year, and certain carryover dividends in the case of personal holding companies.²² The rates applied to the "accumulated taxable income" base are twenty-seven and one-half percent on the first \$100,000 of such income and thirty-eight and one-half percent on the excess.

"Accumulated taxable income" should not be confused with the corporation's earnings and profits, the phrase used in the "proscribed purpose" portion of the statute. While there may be a number of items which are part of both in an accounting sense, the two terms are not synonymous. Earnings and profits increase from year to year as a part of corporate growth; accumulated taxable income is the taxable base upon which the tax is imposed if the accumulation of earnings and profits is for the proscribed purpose. In a given year it would be possible for a corporation to have accumulated taxable income and incur liability for the penalty tax despite a decrease in the earnings and profits account.²³

The accumulated earnings credit was a response on the part of Congress to complaints that the accumulated earnings tax was imposed on an "all or nothing" basis which could result in extensive tax liability as a result of a few dollars in excessive accumulations.²⁴ For a corporation that is not a mere holding or investment company the accumulated earnings credit is an amount equal to such part of its earnings and profits for the taxable year in question which are retained "for the reasonable needs of the business" minus the deduction allowed by section 535(b)(6), relating to the excess of net long-term capital gain over net short-term capital loss.²⁵ If the general credit as computed above is less than \$150,000, an alternative minimum credit contained in the statute may result in a larger credit amount for the taxpayer. This alternative minimum credit is ascertained by subtracting from \$150,000 the ac-

²¹ I.R.C. § 535(a).

²² Treas. Reg. § 1.561-1, T.D. 6598, 1962-1 C.B. 92, 127.

²³ An increase in earnings and profits during the taxable year in which the accumulated earnings tax is levied is not necessary. Despite what may appear to be clear statutory language requiring an "accumulation," it has been held that Congress never intended this to be a pre-condition to imposition of the tax. *GPD, Inc. v. Commissioner*, 508 F.2d 1076 (6th Cir. 1974); *Ostendorf-Morris Co. v. United States*, 70-2 U.S.T.C. ¶ 9550, 26 A.F.T.R. 2d 70-5369 (N.D. Ohio 1968). See Rudolph, *supra* note 1, at 112-20.

²⁴ Canty, *supra* note 1, at 258-61; 7 MERTENS, *supra* note 8, *General* at § 39.25.

²⁵ I.R.C. § 535(c)(1).

accumulated earnings and profits of the corporation as of the close of the preceeding taxable year.²⁶ For the purposes of this minimum credit, the accumulated earnings and profits are reduced by the dividends which are considered as having been paid during the taxable year.²⁷ The net effect of this two-tiered credit system is to allow a corporation to accumulate its first \$150,000 of earnings and profits without fear of running afoul of the unreasonable accumulations tax.

It can be seen that the reasonable business needs test is incorporated into the statutory scheme at two distinct points. First, it is a concept employed in arriving at a determination, by means of the statutory presumption, as to the existence of the proscribed purpose. Second, upon a finding of a proscribed purpose, accumulations for reasonable business needs act as a means by which the accumulated earnings credit may be increased so as to decrease the amount of tax assessed.²⁸

E. *Business Needs Deemed Reasonable by Statute*

Section 537 of the Code lists three items which are deemed to fall within the "reasonable needs of the business" rubric: 1) the reasonably anticipated needs of the business; 2) redemptions in connection with section 303 relating to payment of a deceased shareholder's estate taxes and other qualifying expenses; and 3) redemptions of stock from a private foundation which, if it remained in the hands of the foundation, would constitute excess business holdings.²⁹

The concept of "anticipated needs" was promulgated to counter an earlier judicial rule that only the immediate needs of the business would

²⁶ *Id.* § 535(c)(2).

²⁷ *Id.* § 535(c)(4).

²⁸ Presumably, the reasonable business needs test ought to be identical at both points it appears in the scheme of taxation, although at least one commentator feels that it is applied differently. *See Canty, supra* note 1, at 264-70. *See also* notes 93-94 *infra* and accompanying text. In any event, it is interesting to note that the situation may exist where the tax is found to be rightly imposed but the accumulated taxable income is zero because of the accumulated earnings credit. It may be for this reason that certain courts have taken the approach of merely addressing the reasonable business needs issue. *See, e.g., Harrison Bolt & Nut Co. v. United States*, 64-2 U.S.T.C. ¶ 9631, 14 A.F.T.R. 2d 5360 (D. Md. 1964); *Duke Laboratories, Inc. v. United States*, 222 F. Supp. 400 (D. Conn. 1963), *aff'd*, 337 F.2d 280 (2d Cir. 1964); *Hattiesburg Compress Co. v. United States*, 60-2 U.S.T.C. ¶ 9552, 6 A.F.T.R. 2d 5012 (S.D. Miss. 1960); *Freedom Newspapers, Inc. v. Commissioner*, 24 T.C.M. (CCH) 1327 (1965); *John P. Scripps Newspapers v. Commissioner*, 44 T.C. 453 (1965); *Vuono-Lione, Inc. v. Commissioner*, 24 T.C.M. (CCH) 506 (1965); *Fotocrafters, Inc. v. Commissioner*, 19 T.C.M. (CCH) 1401 (1960).

²⁹ *See Treas. Reg. § 1.537-1* (1972). The one section not examined in this outline of the mechanism governing the tax is section 536. Simply, it states that accumulated taxable income for a taxable year consisting of less than twelve months shall not be placed on an annual basis for the purpose of applying section 531.

be deemed reasonable.³⁰ The Treasury Regulations now state that "an accumulation need not be used immediately, nor must the plans for its use be consummated within a short period after the close of the taxable year, provided that such accumulation will be used within a reasonable time depending upon all the facts and circumstances relating to the future needs of the business."³¹ However, where such future needs are uncertain or vague or the stated purpose of an accumulation for future use is not specific, definite and feasible, then the need will not be deemed to justify the accumulation.³²

The Tax Reform Act of 1969 specifically approved the two types of redemption transactions in section 537.³³ Significantly, there is absolutely no indication in the legislative history that these are the only types of redemptions that would constitute reasonable business needs.³⁴ Since the accumulated earnings tax is a penalty tax, it should be strictly construed.³⁵ Accordingly, absent any indication by Congress that sections 537(a)(2) and (3) were intended to be exclusive, those provisions should be construed to allow other redemption transactions given favorable treatment under other sections of the Code to occur without concern that the funding of those transactions would lead to a section 531 tax.

III. SELECTIVE LEGISLATIVE AND JUDICIAL HISTORY

A selective legislative and judicial history will be helpful in highlighting whether redemptions not included in sections 537(a)(2) and (3) should

³⁰ See *McCutchin Drilling Co. v. Commissioner*, 143 F.2d 480 (5th Cir. 1944); *J. M. Perry & Co. v. Commissioner*, 120 F.2d 123 (9th Cir. 1941); *World Publishing Co. v. United States*, 72 F. Supp. 886 (N.D. Okla. 1947), *aff'd*, 169 F.2d 186 (10th Cir. 1948), *cert. denied*, 335 U.S. 911 (1949); *Gus Blass Co. v. Commissioner*, 9 T.C. 15 (1947), *appeal dismissed*, 168 F.2d 833 (8th Cir. 1948); *Wilkerson Daily Corp. v. Commissioner*, 42 B.T.A. 1266 (1940), *aff'd*, 125 F.2d 998 (9th Cir. 1942).

³¹ *Treas. Reg. § 1.537-1(b)(1)*, T.D. 7165, 1972-1 C.B. 167. See S. REP. NO. 1622, 83d Cong., 2d Sess. 318 (1954).

³² *Smoot Sand & Gravel Corp. v. Commissioner*, 274 F.2d 495 (4th Cir.), *cert. denied*, 362 U.S. 976 (1960); *Wilcox Mfg. Co. v. Commissioner*, 38 T.C.M. (CCH) 378 (1979); *Faber Cement Block Co. v. Commissioner*, 50 T.C. 317 (1968), *acq.*, 1968-2 C.B. 2; *Treas. Reg. § 1.537-1(b)(1)*, T.D. 7165, 1972-1 C.B. 167. For those taxable years beginning after September 30, 1979, "reasonably anticipated" needs will include "reasonably anticipated product liability losses." I.R.C. § 537(b)(4). This provision, added by the Revenue Act of 1978, was intended to allow taxpayers to accumulate for product liability self-insurance needs. Pub. L. No. 95-600, § 371, 92 Stat. 2763, 2859 (1978). In determining the amounts properly attributable to a product liability loss reserve, the taxpayer's product liability experience, extent of commercial insurance coverage, and deductibility of actual product liability losses suffered will be taken into account. H.R. REP. NO. 1800, 95th Cong., 2d Sess. 189 (1978), *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 6761, 7198.

³³ *Tax Reform Act of 1969*, Pub. L. No. 91-172, § 906, 83 Stat. 487, 714 (1969).

³⁴ See S. REP. NO. 552, 91st Cong., 1st Sess. 115 (1969), *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 1645, 2027.

³⁵ *Ivan Allen Co. v. United States*, 422 U.S. 617, 627 (1975); *Commissioner v. Archer*, 363 U.S. 870 (1959).

be considered reasonable business needs of the corporation. The early history of the tax is a story unto itself successfully recounted in depth by others.³⁶ Briefly, the accumulated earnings tax originated with the Tariff Act of 1913, the first personal income tax statute following the ratification of the sixteenth amendment.³⁷ The act imposed the tax not upon the corporate entity but upon shareholders of any corporation "formed or fraudulently availed of" for shareholder tax avoidance by permitting gains and profits to accumulate instead of being divided or distributed. Imposition of the tax required that each shareholder include his pro-rata share of the gains and profits of the corporation in his taxable income.³⁸

The first major change in the tax was made in 1918. The word "fraudulently" was dropped from the statute because of the difficulties involved in the application of the tax.³⁹ The statute underwent another significant transformation when the tax was shifted from the shareholder to the corporation by the Revenue Act of 1921.⁴⁰

There was discussion concerning further amendment of the tax upon passage of both the Revenue Acts of 1926 and 1928, but no substantial change was enacted. During this period the tax was not often imposed, and some still considered it ineffective in forcing corporate distributions.⁴¹ In 1934, Congress dealt with the obvious deficiencies concerning personal holding companies and at the same time gave corporations the right to deduct dividends paid to their shareholders from "adjusted net income," the forerunner of "accumulated taxable income."⁴²

To silence complaints that the tax was still not achieving its purpose of compelling distributions, Congress amended the subsection dealing with the reasonable business needs presumption.⁴³ Formerly, if earnings and profits accumulated beyond the reasonable needs of the business,

³⁶ See Canty, *supra* note 1, at 244-62; Herwitz, *supra* note 1, at 866-86.

³⁷ Tariff Act of 1913, ch. 16, § 657, 38 Stat. 114, 166 (1913).

³⁸ See S. REP. NO. 617, 65th Cong., 3d Sess. 1 (1918); H.R. REP. NO. 350, 67th Cong., 1st Sess. 6 (1921).

³⁹ Revenue Act of 1918, ch. 18, § 220, 40 Stat. 1057, 1072 (1919). See S. REP. NO. 617, 65th Cong., 3d Sess. 1 (1918).

⁴⁰ Ch. 136, § 220, 42 Stat. 227, 247 (1921). This change was prompted by certain doubts which arose after the decision of *Eisner v. Macomber*, 252 U.S. 189 (1920). See H.R. REP. NO. 350, 67th Cong., 1st Sess. 6 (1921).

⁴¹ See E. GRISWOLD, CASES & MATERIALS ON FEDERAL TAXATION 951 (6th ed. 1966).

⁴² Revenue Act of 1934, ch. 277, §§ 102, 351, 48 Stat. 680, 702, 751 (1934). See S. REP. NO. 558, 73d Cong., 2d Sess. 6 (1934); H.R. REP. NO. 704, 73d Cong., 2d Sess. 14 (1934). The Revenue Act of 1936 substituted for the phrase "gains and profits" the now familiar phrase "earnings and profits." Ch. 690, § 102, 49 Stat. 1648, 1676 (1936). Despite this change in the statute, it is doubtful that the meaning of the phrase changed. See S. REP. NO. 2156, 74th Cong., 2d Sess. 12 (1936).

⁴³ See Herwitz, *supra* note 1, at 870-71.

such accumulation was prima facie evidence of the corporation's intent to avoid a tax upon its shareholders. This merely shifted to the taxpayer the burden of going forward with the evidence. The amendment made such an accumulation "determinative" of the existence of the proscribed purpose and placed the burden upon the taxpayer to show the lack of such intent "by a clear preponderance of the evidence."⁴⁴

From 1938 to 1954 the tax remained virtually unchanged, although some dissatisfaction with enforcement remained and discussions proposing remedies were occasionally still advanced.⁴⁵ Nonetheless, the reforms occasioned by the reenactment of the 1939 Code were favorable to the taxpayer. Those reforms included dropping the word "clear" from the phrase "clear preponderance of the evidence" in section 533, the addition of the section 534 statement giving the taxpayer the opportunity to shift the burden of proof on the reasonable needs issue, and the promulgation of the accumulated earnings credit of section 535. Later, with the 1954 reenactment of the Code, section 537 was added, specifying that reasonable business needs included reasonably anticipated business needs.⁴⁶ In 1969 the winds continued to blow the way of the taxpayer, as the two specific redemption items deemed to be reasonable business needs were added to section 537.⁴⁷ The only legislative changes since 1969 have been to increase the alternative minimum credit to its present \$150,000 and to permit the inclusion of "reasonably anticipated product liability losses" in the determination of the "reasonably anticipated needs of the business" pursuant to section 537.⁴⁸

There were few judicial interpretations of the accumulated earnings tax provisions in the 1920s and 1930s.⁴⁹ The first benchmark was *Cecile B. DeMille v. Commissioner*,⁵⁰ involving the famous motion picture producer. In that case, the Board of Tax Appeals set the focus for the future of the tax, emphasizing that it was "the purpose, the intention

⁴⁴ Revenue Act of 1938, ch. 289, § 102, 52 Stat. 447, 483 (1938). See S. REP. NO. 1567, 75th Cong., 3d Sess. 12 (1938). It was hoped that this amendment would facilitate enforcement in that Congress was concerned at the time with the "incorporated pocketbook."

⁴⁵ See E. GRISWOLD, *supra* note 41, at 951.

⁴⁶ S. REP. NO. 1622, 83d Cong., 2d Sess. 318 (1954).

⁴⁷ Tax Reform Act of 1969, Pub. L. No. 91-172, § 906, 83 Stat. 487, 714 (1969). See S. REP. NO. 552, 91st Cong., 1st Sess. 115, *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 1645, 2027.

⁴⁸ Revenue Act of 1978, Pub. L. No. 95-600, § 371, 92 Stat. 2763, 2859 (1978), *amending* I.R.C. § 537(b); Tax Reduction Act of 1975, Pub. L. No. 94-12, § 304(a), 89 Stat. 26, 45 *amending* I.R.C. § 535(c)(2), (c)(3).

⁴⁹ E. GRISWOLD, *supra* note 41, at 951-52; Canty, *supra* note 1, at 246.

⁵⁰ 31 B.T.A. 1161 (1935), *aff'd*, 90 F.2d 12 (9th Cir.), *cert. denied*, 302 U.S. 713 (1937). In what was an extensive review of case law to the date of the case, the decision mentioned only six other cases. See note 3 *supra* and cases cited therein.

motivating a course of conduct"⁵¹ which was controlling. Thus the court held in favor of the taxpayer that a corporation succeeding a partnership which produced motion pictures was not formed or availed of for the purpose of avoiding taxes with respect to its shareholders. Accordingly, later decisions engaged in much speculation as to the "state of mind" of those in control of the corporate taxpayer.⁵²

The first United States Supreme Court decision involving the tax upheld its constitutionality under the sixteenth amendment.⁵³ In answer to the argument that the tax was a penalty upon one's thoughts, the Court observed that the proscribed purpose was merely a condition precedent to the imposition of the tax and that this was not unusual in determining tax consequences.⁵⁴ The Court went on to hold that the proscribed purpose was present, carefully noting that the evidence was sufficient to reach this conclusion independently of the statutory presumption regarding reasonable business needs.⁵⁵

The Supreme Court's next encounter with the tax was *Helvering v. Chicago Stock Yards Co.*⁵⁶ In a battle for control of the midwest meat packing industry, a renowned entrepreneur, Frederick Prince, formed a New Jersey corporation for the purpose of gaining control of competing stock yards. His goal was to improve his bargaining position with the meat packers. Unsuccessful in his attempt to control the market, he finally decided to align himself with the largest packer, Armour & Company. To that end Prince formed with Armour a second corporation (the taxpayer in the case) with the intention of buying out the original New Jersey corporation. However, Armour subsequently was required under a separate antitrust proceeding to divest itself of its interest in the newly formed corporation, leaving Prince as its sole shareholder. The Supreme Court, reversing the circuit court and upholding the Board of Tax Appeals, concluded that the corporate taxpayer had been availed of for the purpose of avoiding income tax with respect to its sole shareholder.

In reaching this conclusion, the Court scrutinized the justification for the accumulation advanced by the taxpayer—that the New Jersey corporate charter was to expire in 1940 and that it had "what it deemed a moral, and, indeed, a legal obligation to pay off the mortgage debts of

⁵¹ 31 B.T.A. at 1174 (emphasis in original). However, the Board did also state that "[a]dmittedly, circumstances may evidence a purpose . . ." *Id.*

⁵² See Holzman, *Don't Let the Corporation's "State of Mind" Trap It in Section 531 Cases*, 6 J. TAX. 348 (1957); Otto, *Section 102: The Tax on a Corporation's Psyche*, 31 TAXES 432 (1953).

⁵³ *Helvering v. National Grocery Co.*, 304 U.S. 282 (1938).

⁵⁴ *Id.* at 289. Many taxes which depend upon the taxpayer's state of mind are still with us. *E.g.*, I.R.C. § 165(c) (intention to enter a transaction for profit as a pre-condition to loss deduction); *id.* § 2511 (donative intent respecting gifts).

⁵⁵ 304 U.S. at 294.

⁵⁶ 318 U.S. 693 (1943).

the New Jersey company and its subsidiaries and to redeem its outstanding stock."⁵⁷ The Court responded by noting that the same result could have been achieved by Prince himself if the corporate taxpayer's earnings and profits had been distributed to him. Further, the New Jersey corporate charter could have been renewed. The existence of these alternatives to the proposed redemption was held to show that it was not a reasonable need of the business. To date, this decision represents the only comment by the highest court on the accumulated earnings tax in connection with a redemption.⁵⁸

The next word from the Supreme Court involving the accumulated earnings tax came in 1969. In *United States v. Donruss Co.*,⁵⁹ the Court was asked to resolve a split among the circuit courts of appeals over the precise meaning of the proscribed purpose standard. Certain circuits had taken the position that the motive to avoid a tax upon the shareholders must be the dominant, controlling or impelling motive.⁶⁰ Others had rejected that standard and were willing to impose the penalty tax where the proscribed purpose could be said to be one of the motives prompting the accumulations.⁶¹ Still other circuits held to an intermediate position stating that the proscribed purpose must be a "determining purpose."⁶² The Court, after reviewing the legislative history, decided that the motive need only be one of many for the tax to be properly imposed.⁶³

It is crucial to note that this case was not a reasonable business needs case; it was a proscribed purpose case. The Court expressly pointed out that it did not intimate an opinion about the standards governing reasonableness of corporate accumulations.⁶⁴ The Court's care in

⁵⁷ *Id.* at 701.

⁵⁸ The Supreme Court, however, used the word "redeem" in a non-technical sense since the New Jersey corporation was purchasing the stock of an unrelated corporation and not its own stock. See notes 93-100 *infra* and accompanying text.

⁵⁹ 393 U.S. 297 (1969).

⁶⁰ *Apollo Indus., Inc. v. Commissioner*, 358 F.2d 867 (1st Cir. 1966); *Young Motor Co. v. Commissioner*, 281 F.2d 488 (1st Cir. 1960).

⁶¹ *United States v. Duke Laboratories, Inc.*, 337 F.2d 280 (2d Cir. 1964); *Barrow Mfg. Co. v. Commissioner*, 294 F.2d 79 (5th Cir. 1961), *cert. denied*, 369 U.S. 817 (1962); *Trico Prods. Corp. v. Commissioner*, 137 F.2d 424 (2d Cir.), *cert. denied*, 320 U.S. 799 (1943).

⁶² *Kerr-Cochran, Inc. v. Commissioner*, 253 F.2d 121 (8th Cir. 1958); *World Publishing Co. v. United States*, 169 F.2d 186 (10th Cir. 1948), *cert. denied*, 335 U.S. 911 (1949).

⁶³ 393 U.S. at 303.

⁶⁴ *Id.* at 301. Recognizing the important difference between inquiries into reasonable business needs and those into the existence of the proscribed purpose, the Supreme Court stated:

It appears to us that the congressional response to these facts had been to emphasize unreasonable accumulation as to the most significant factor in the incidence of the tax. The reasonableness of an accumulation, while

distinguishing between the two issues supports an analysis regarding the reasonable business needs inquiry as separate and distinct from any consideration of shareholder tax advantage. After this decision it is imperative that the taxpayer prove his reasonable business needs to escape the penalty tax, since failure to justify the accumulation in this manner relegates the taxpayer to the difficult position of proving by a preponderance of the evidence that thoughts of a tax savings never influenced its decision not to distribute. In fact, suspicions could be raised from the taxpayer's mere knowledge that a tax savings to shareholders would result from a failure to distribute.⁶⁵

IV. WHAT IS A REASONABLE BUSINESS NEED?

A. "Reasonable"

Before deciding whether a redemption can be a reasonable business need, the concept of "reasonable business needs" must be analyzed. Some precepts in this area are axiomatic: a reasonable business need is always a question of fact.⁶⁶ Each case presents a unique situation so that what may be a reasonable business need in one instance is not reasonable in another.⁶⁷

First, only those needs which are seen as reasonable will meet the statutory mandate. Accordingly, more than a subjective belief is required in that there must be a demonstration of reasonableness which can be appreciated by others viewing the situation. While management's business judgment should not be second-guessed on the basis of hindsight, the facts and circumstances existing at the time must

subject to honest difference of opinion, is a much more objective inquiry, and is susceptible of more effective scrutiny, than are the vagaries of corporate motive.

Id. at 307.

⁶⁵ The Supreme Court did remark that knowledge of a tax savings would not be sufficient to impose the tax. But, as has been pointed out, it is difficult for a shareholder-officer of a corporation to prove he was not motivated by that thought which he knew to be for his benefit. *Id.* at 311-12 (Harlan, J., concurring in part and dissenting in part). See *JJJ Corp. v. United States*, 576 F.2d 327, 346 (Ct. Cl. 1978); *John B. Lambert & Assoc. v. United States*, 212 Ct. Cl. 71, 85 (1976).

⁶⁶ *E.g.*, *American Metal Prods. Corp. v. Commissioner*, 287 F.2d 860 (8th Cir. 1961); *Battlestein Invs. Co. v. United States*, 302 F. Supp. 320 (S.D. Tex. 1969), *aff'd*, 442 F.2d 87 (5th Cir. 1971); *Dickman Lumber Co. v. United States*, 65-1 U.S.T.C. ¶ 9133, 15 A.F.T.R. 2d 027 (W.D. Wash. 1964), *aff'd*, 355 F.2d 670 (9th Cir. 1966); *James M. Pierce Corp. v. Commissioner*, 38 T.C. 643 (1962), *aff'd in part and rev'd in part on other grounds*, 326 F.2d 67 (8th Cir. 1964); *F. E. Watkins Motor Co. v. Commissioner*, 31 T.C. 288 (1958).

⁶⁷ *E.g.*, *Sears Oil Co. v. Commissioner*, 359 F.2d 191 (2d Cir. 1966); *Wilkerson Daily Corp. v. Commissioner*, 42 B.T.A. 1266 (1940), *aff'd*, 125 F.2d 998 (9th Cir. 1942); *William C. DeMille Prods., Inc. v. Commissioner*, 30 B.T.A. 826 (1934).

show that the need could be clothed with a certain amount of reasonableness.⁶⁸

B. "Business"

The need must be a business need. The word used by the statute is "business" alone, not "trade or business" as used in other Code sections.⁶⁹ No definition of "business" as such is given in either the statute or the Treasury Regulations, although the regulations state that the business of a corporation is not merely that in which it has previously engaged but includes any line of business which it may undertake.⁷⁰ The primary focus appears to be on the operational aspect of the corporation's life, *i.e.*, its product and those things associated with putting that product on the market. Strictly speaking, a redemption is not related to this end. However, since certain redemptions satisfy reasonable business needs,⁷¹ the word "business" should be construed in a broader sense to include all activities related to the corporation's life regardless of direct connection to operational activities. This broader interpretation has been generally accepted.⁷²

The area in which the courts have most often recognized a need to delimit precisely the business needs concept is in its relationship to shareholders' needs. If the corporate taxpayer loses sight of the requirement that accumulations must be used to meet the needs of its business and not to provide for the various exigencies of its shareholders, the tax will properly be imposed.⁷³

The "business needs" versus "shareholder needs" distinction must be

⁶⁸ *E.g.*, *Bremerton Sun Publishing Co. v. Commissioner*, 44 T.C. 566 (1965); *John P. Scripps Newspapers v. Commissioner*, 44 T.C. 453 (1965); *Breitfeller Sales, Inc. v. Commissioner*, 28 T.C. 1164 (1957); *Crawford County Printing & Publishing Co. v. Commissioner*, 17 T.C. 1404 (1952), *acq.*, 1955-1 C.B. 4.

⁶⁹ *E.g.*, I.R.C. § 162(a); *id.* § 1231(b).

⁷⁰ *Treas. Reg. § 1.537-3(a)*, 26 C.F.R. § 1.537-3(a) (1979).

⁷¹ I.R.C. § 537(a)(2), (a)(3).

⁷² *E.g.*, *Treas. Reg. § 1.537-3(b)*, 26 C.F.R. § 1.537-3(b) (1979) (earnings and profits may be put to use in a second corporation if a parent-subsidiary relationship exists). However, in an early decision, the Board of Tax Appeals found that accumulations were not for reasonable business needs where the corporation's president testified: "If you bring that word 'business' down merely, down to the operation of a manufacturing plant, there might be some question as to what more money was needed, but we consider the business, the enterprise, an enterprise involving the interests of stockholders who had a contract to release stock ***." *Trico Prods. Corp. v. Commissioner*, 46 B.T.A. 346, 377 (1942), *aff'd*, 137 F.2d 424 (2d Cir.), *cert. denied*, 320 U.S. 799 (1943).

⁷³ *JJJ Corp. v. United States*, 576 F.2d 327 (Ct. Cl. 1978); *Cadillac Textiles, Inc. v. Commissioner*, 34 T.C.M. (CCH) 295 (1975); *Kirlin Co. v. Commissioner*, 23 T.C.M. (CCH) 1580 (1964), *aff'd*, 361 F.2d 818 (6th Cir. 1966) (per curiam). *See also* *Ted Bates & Co. v. Commissioner*, 24 T.C.M. (CCH) 1346 (1965) (petitioners demonstrated corporate need for redemption).

drawn in considering whether a redemption should trigger the penalty tax. However, it is crucial to remember that a redeemed shareholder will likely have a tax benefit from a redemption by virtue of the redemption's probable treatment as a capital gain.⁷⁴ Since every redemption qualifying for capital gains treatment will have an element of shareholder benefit, the fact of shareholder tax savings only tells, at best, part of the story. It follows that the presence or absence of a motive affirmatively tied to the business needs of the corporation, regardless of the accompanying shareholder tax consequences, is the proper focus of the section 533(a) presumption phase of the determination.⁷⁵

Judicial recognition of the distinction between shareholder and corporate needs finds its roots in two Tax Court cases of the late 1950s.⁷⁶ The more well-known of the two is *Pelton Steel Casting Co. v. Commissioner*.⁷⁷ In *Pelton* the stockholdings were divided between three men, two of whom owned a combined interest of eighty percent. These two were considering the sale of their interests to outsiders. The third shareholder desired to remain in the business and to avoid taking on outside investors. Instead of selling, the two departing shareholders reached agreement with the third to have their shares redeemed. The agreement was reached in November of 1946; the Commissioner assessed an accumulated earnings tax for the fiscal years ending November 30, 1945 and November 30, 1946. The corporate taxpayer argued that a certain amount of the accumulation was necessary to fund the expected redemption which became a reality within that period. Under the 1939 predecessor to section 532, the Tax Court found that the taxpayer's shareholders had availed themselves of the corporation for the purpose of avoiding income taxes by permitting earnings and profits to accumulate instead of being distributed.⁷⁸ The decision thus rested upon a finding of the existence of the proscribed purpose; the reasonable business needs presumption was simply bypassed.

That the court did not rely on the reasonable business needs presumption is made clear by its discussion of the effect of what were then new additions to the Code. The option to shift the burden of proof on the business needs issue through the submission of a section 534 state-

⁷⁴ See notes 94-99 *infra* and accompanying text.

⁷⁵ See Rudolph, *supra* note 1, at 108 n.35. See also notes 85-86 *infra* and accompanying text.

⁷⁶ *Pelton Steel Casting Co. v. Commissioner*, 28 T.C. 153 (1957), *aff'd*, 251 F.2d 278 (7th Cir.), *cert. denied*, 356 U.S. 958 (1958); *Hedberg-Freidheim Contracting Co. v. Commissioner*, 15 T.C.M. (CCH) 1433 (1956), *aff'd*, 251 F.2d 839 (8th Cir. 1958).

⁷⁷ 28 T.C. 153 (1957), *aff'd*, 251 F.2d 278 (7th Cir.), *cert. denied*, 356 U.S. 958 (1958).

⁷⁸ 28 T.C. at 185.

ment was made available retroactively to taxpayers with the result that the taxpayer in *Pelton* was able to take advantage of the option even though the case was decided under the 1939 Code. The Tax Court, forced to comment on the effect of the statement, ruled that even if the section 534 statement shifted the burden of proof with respect to reasonable business needs, the outcome would be the same since the proscribed purpose was found to exist on the basis of the record as a whole and not as a result of the reasonable business needs presumption.⁷⁹ Section 534 does not alter the burden of proving the absence of the proscribed purpose.⁸⁰

Despite the Tax Court's pinpointing of the proscribed purpose as the reason for applying the penalty tax, *Pelton* has sometimes been interpreted as holding that accumulations serving shareholder purposes will not be found to meet the reasonable business needs test.⁸¹ This interpretation confuses two independent concepts. Nevertheless, under *Donruss*, a finding of *any* tax avoidance purpose triggers the tax without reference to the reasonable business needs presumption of section 533(a). Accordingly, assuming the correctness of the *Pelton* court's finding with respect to the ultimate issue of corporate intent, *Pelton* is correctly decided under *Donruss*.

Under that type of analysis, however, the problem of defining "reasonable business needs" does not arise. For example, where the shares of an individual who has had power to influence the corporation's dividend policy are redeemed in the face of a poor past record of dividends, the motivating purpose of the accumulation used to fund the redemption may be directly scrutinized. If the proscribed purpose is found to be one of the motivating factors on the basis of that direct scrutiny, the corporation will be liable for the tax. Of course, resolving the factual question will often be difficult because the proscribed purpose inquiry is inherently subjective. If, on the other hand, recourse is had to the section 533(a) presumption, shareholder tax savings or other benefits become simply irrelevant. Either the intended disposition of the accumulated funds can be justified in terms of the corporation's business needs or it cannot. The fact of a shareholder tax saving does not imply that the transaction will not also fulfill a business need.

An interpretation of the reasonable business needs test of section 533(a) that insists on separating the business needs and shareholder benefit inquiries is in accord with the recognized role of presumptions in the law of evidence. Presumptions are devices allowing "shortcuts" in

⁷⁹ *Id.* at 174 n.6.

⁸⁰ *Id.* at 183-84.

⁸¹ *Ready Paving & Constr. Co. v. Commissioner*, 61 T.C. 826 (1974); *Nodell Motors, Inc. v. Commissioner*, 26 T.C.M. (CCH) 1027 (1967); *Youngs Rubber Corp. v. Commissioner*, 21 T.C.M. (CCH) 1593 (1962), *aff'd*, 331 F.2d 12 (2d Cir. 1964) (per curiam). See *Altman*, *supra* note 1, at 830; *Kahn*, *supra* note 1, at 820.

proof. A presumptive fact is deemed "proved" by proof of the basic fact.⁸² The business needs presumption was added to the framework of the accumulated earnings tax as a "shortcut" around the problem of proving that the corporate taxpayer "intended" a certain result.⁸³ In pursuing subjective inquiry into shareholder's motives (which are relevant to the presumptive fact of the existence of the proscribed purpose and not to the basic fact of whether the needs for which the taxpayer accumulated earnings were reasonable business needs), courts widen the scope of inquiry that Congress intentionally narrowed by adding the presumption.

In the proscribed purpose inquiry, where the presumption does not apply, shareholder purpose and corporate purpose can only be balanced subjectively. A choice therefore had to be made in *Donruss* whether *any* shareholder benefit at this level tainted the reason for the accumulation. Yet *Donruss* also expressly recognized that the reasonable business needs test of the presumption is, in contrast, an objective test. The "state of mind" problem is thus simply inapplicable to the business needs inquiry.⁸⁴ The existence of a shareholder benefit need not disqualify an otherwise reasonable business need from being a proper explanation for an accumulation.⁸⁵ Some practitioners have added to the courts' confusion by not stressing business needs in redemption situations.⁸⁶

⁸² Presumptions have been described as:

involv[ing] a relationship between one fact or set of facts—the basic fact(s)—and another fact or set of facts—the presumed fact(s). Basic facts imply presumed facts, the strength of the implication varying with the presumption. Where a presumption exists, certain advantages usually accrue to a party proving the basic fact which would not accrue absent the presumption. The degree of advantage depends upon the sense in which the term "presumption" is used.

R. LEMPERT & S. SALTZBURG, A MODERN APPROACH TO EVIDENCE 882 (1977).

⁸³ See notes 7-10 *supra* and accompanying text.

⁸⁴ See authorities cited in note 66 *supra*.

⁸⁵ Further, practical considerations militate against sorting of business and non-business needs on this basis:

[A]ny attempt to differentiate between corporate objectives and shareholder objectives in the area of close corporations is likely to prove futile. Such "incorporated partnerships," toward which the accumulated earnings tax is primarily directed, do not have any purposes or objectives completely independent of those of their stockholders. Moreover, a close corporation often represents far more than a mere incorporated venture to its proprietors. It may well constitute their life's work, and the foundation of their planning for the present and future security of their families. It is in this latter connection that redemption transactions, particularly pursuant to stock-restrictions agreements, so often play a key role.

Herwitz, *supra* note 1, at 918.

⁸⁶ See, e.g., *Dickman Lumber Co. v. United States*, 65-1 U.S.T.C. ¶ 9133, 15 Pub. Ent. Rep. 27 (Ct. Cl. 1964), *aff'd*, 355 F.2d 670 (9th Cir. 1966); *Faber*

C. "Need"

Having considered the words *reasonable* and *business*, the last problem is the word *need*. "Need" has many connotations, one of which is urgency.⁸⁷ In part, this is the factor which prompted the early "immediacy" test in applying the penalty tax statute.⁸⁸ The response by Congress to this narrow interpretation was to add section 537, which provided that the "reasonable needs of the business" shall include the "reasonably anticipated" needs of the business as well. The effect of this addition is to add a component of prudent business planning which may stretch over a series of years.⁸⁹

D. The Final Framework

Even if the ambiguities and problems of interpretation posed by the language of the statute could be resolved, the statutory framework of the tax would remain bewilderingly complex. To put the whole system together, consider the following steps:

- (1) The Commissioner sends a deficiency notice, having previously sent a notice pursuant to section 534(b) of the Code, alerting the corporate taxpayer to a finding of unreasonable accumulations by the Internal Revenue Service.
- (2) The taxpayer responds with a statement in an attempt to shift the burden of proof on the reasonable business needs issue to the Commissioner.
- (3) The dispute is brought to the Tax Court, which must first review the statement to determine if it is sufficient to shift the burden of proof.
- (4) If the taxpayer is found to have successfully shifted the burden to the Commissioner on the reasonable business needs

Cement Block Co. v. Commissioner, 50 T.C. 317 (1968), *acq.*, 1968-2 C.B. 2; Youngs Rubber Corp. v. Commissioner, 21 T.C.M. (CCH) 1593 (1962), *aff'd*, 331 F.2d 12 (2d Cir. 1964) (per curiam).

⁸⁷ WEBSTER'S NEW TWENTIETH CENTURY DICTIONARY UNABRIDGED 1201 (2d ed. 1977). The following synonyms are listed: exigency, emergency, strait, extremity, necessity, distress, destitution, poverty, indigence, penury.

⁸⁸ See note 31 *supra* and accompanying text.

⁸⁹ See Treas. Reg. § 1.537-1(b), T.D. 7165, 1972-1 C.B. 167. Further complicating the task of interpreting the "reasonable business needs" language is its use at two different points in the statute. The question arises whether it is possible that a reasonable business need for the purpose of the presumption is not such a need for purpose of the credit. One commentator who approves injecting the proscribed purpose inquiry into the presumption's reasonable business needs test has concluded that the interpretation of reasonable business needs given by some courts in setting the amount of the accumulated earnings credit has not been in accord with that given by other courts in determining the presence of the proscribed purpose. Canty, *supra* note 1, at 270-71. However the disputes over interpretation should be resolved, language should surely be accorded a uniform meaning when used in a single taxing statute.

issue, there must still be a further finding that the Commissioner has not successfully met the burden.

(5) If the Commissioner is unsuccessful and thus the taxpayer is victorious on the reasonable business needs issue, the Tax Court must then determine whether the taxpayer has overcome the presumption of correctness accorded the Commissioner's determination as to the ultimate issue of whether the taxpayer accumulated with the intention (whether or not "dominant") of avoiding tax with respect to its shareholders, there being no burden shifting on this issue.

(6) If the taxpayer fails and the proscribed purpose is found, then the Tax Court must determine the amount of the tax.

(7) Finally, the Tax Court would go back to its earlier reasonable business needs calculations for the purpose of quantifying the accumulated earnings credit and thus calculating the amount of the tax.⁹⁰

What if the court in step seven decided that the reasonable business needs were of such a magnitude that they reduced the accumulated taxable income to zero? It would have engaged in the six preliminary steps for nothing. It is understandable that under these conditions the Tax Court has disposed of some cases by considering the last issue first.⁹¹

However, tackling the last step first is not as simple as it might seem. The Treasury Regulations state that in determining whether any amount of earnings and profits of the taxable year has been retained for the reasonable needs of the business, the accumulated earnings and profits of prior years will be taken into consideration.⁹² Therefore, it is entirely possible that a taxpayer would have reasonable business needs qualifying for the accumulated earnings credit but for prior years' accumulations. Thus, despite the reasonable business needs of the corporation, there would be no reduction in the accumulated taxable income.

V. WHEN IS A REDEMPTION A REASONABLE NEED OF THE BUSINESS

A redemption is defined in the Internal Revenue Code as an acquisition by a corporation of its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.⁹³ A redemption of stock will be treated as an ex-

⁹⁰ This is very similar to the procedure which the Sixth Circuit requested of the Tax Court in the remand of *Shaw-Walker Co. v. Commissioner*, 412 F.2d 858 (6th Cir. 1969), on remand from 393 U.S. 478 (1969).

⁹¹ See note 28 *supra* and cases cited therein, especially *John P. Scripps Newspapers v. Commissioner*, 44 T.C. 453 (1965); *Fotocrafters, Inc. v. Commissioner*, 19 T.C.M. (CCH) 1401 (1960).

⁹² Treas. Reg. § 1.535-3(b)(ii) (1960). See *Rudolph, supra* note 1, at 115-20.

change of stock, the gain thereon being subject to capital gain rates, provided it falls into one of the following categories: 1) the redemption is not essentially equivalent to a dividend, taking into consideration all facts and circumstances;⁹⁴ 2) the redemption is substantially disproportionate with respect to the shareholders on the basis of a mathematical test set forth in section 302(b)(2) of the Code;⁹⁵ 3) the redemption represents a termination of a shareholder's complete interest in the corporation;⁹⁶ 4) the redemption is of a railroad company in connection with certain sections of the Bankruptcy Act;⁹⁷ or 5) The redemption is of stock of a shareholder's estate for purposes of paying certain estate taxes and other qualifying expenses.⁹⁸ If the redemption does not qualify for capital gains treatment by being characterized under one of the approved categories, it is treated as a distribution to which section 301 applies, with the consequence that it is treated as ordinary income to the extent of any gain within certain limitations.⁹⁹

Every distribution with respect to stock is considered to have been made out of the most recently accumulated earnings and profits.¹⁰⁰ To the extent that the distribution is not chargeable to the corporation's capital account, any distribution in excess of that taxable year's earnings and profits will decrease earlier years' earnings and profits.¹⁰¹

When can a redemption be characterized as a reasonable business need? The first complication which comes to mind on the basis of the foregoing description is that qualifying redemptions, *i.e.*, those which will result in capital gains to the shareholders, and non-qualifying redemptions, *i.e.*, those which result in section 301 treatment, ought to be analyzed as different and distinct. A non-qualifying redemption, subjecting shareholder gains to ordinary income treatment, would hardly be motivated by an intent to minimize shareholder tax burdens. This common sense conclusion finds support by extrapolation from the qualifying redemption cases, although supporting authority is lacking since non-qualifying redemptions have not been the subject of litigation.¹⁰²

The other factor complicating the issue is the tendency of courts to

⁹⁴ *Id.* § 302(b)(1).

⁹⁵ *Id.* § 302(b)(2).

⁹⁶ *Id.* § 302(b)(3).

⁹⁷ *Id.* § 302(b)(4).

⁹⁸ *Id.* § 303.

⁹⁹ *Id.* § 302(d).

¹⁰⁰ *Id.* § 316(a).

¹⁰¹ *Id.* § 312.

¹⁰² An interesting situation did arise in the context of the adjustment to accumulated taxable income by subtraction of the dividends paid credit. The taxpayer argued that the redemption of a 50% shareholder gave rise to a dividend under Code section 562 and the amount of the redemption decreased the accumulated taxable income by the same amount. The argument was rejected. *H.H. King Flour Mills Co. v. United States*, 325 F. Supp. 1085 (D. Minn. 1971).

confuse the objective reasonable business needs inquiry with the vagaries of the proscribed purpose issue. Certain early cases linked redemptions to the proscribed purpose issue by reasoning that if the corporation had money enough to redeem its shares, it had accumulated too much money.¹⁰³ That analysis entirely begs the question of whether, under certain circumstances, redemptions might serve reasonable business purposes.

The blanket suspicion of redemptions has been especially persuasive where it is found that a redemption was inconsistent with the other grounds alleged for justification of accumulations.¹⁰⁴ The point is well taken only if the fact of the inconsistency is seen as impeachment evidence bearing on the taxpayer's purported justification of the accumulation. Taken as such, the inconsistency is material to the ultimate issue of corporate intent and the existence of the proscribed purpose. Precisely because it bears on the intent issue, it is not material to the business needs inquiry posed by the section 533(a) presumption.

These complications have caused the courts to reach conflicting decisions. Some opinions reach the conclusion that a redemption can never be a reasonable need of the business.¹⁰⁵ Others, including nearly all recent cases, have taken a middle ground recognizing some situations in which redemptions do serve reasonable business needs.¹⁰⁶ Under that analysis, a redemption is a proper purpose for accumulating earnings and profits if prompted by one or more of these considerations: 1) it is in

¹⁰³ *Dickman Lumber Co. v. United States*, 65-1 U.S.T.C. ¶ 9133, 15 A.F.T.R. 2d 027 (W.D. Wash. 1964), *aff'd*, 355 F.2d 670 (9th Cir. 1966); *KOMA, Inc. v. Commissioner*, 8 T.C.M. (CCH) 1064 (1949), *aff'd*, 189 F.2d 390 (10th Cir. 1951); *W.H. Gunlocke Chair Co. v. Commissioner*, 2 T.C.M. (CCH) 885 (1943), *aff'd*, 145 F.2d 791 (2d Cir. 1944).

¹⁰⁴ *See Pelton Steel Casting Co. v. Commissioner*, 28 T.C. 153 (1957), *aff'd*, 251 F.2d 278 (7th Cir.), *cert. denied*, 356 U.S. 958 (1958) (redemption takes place soon after time in which taxpayer says it needs money for working capital); *KOMA, Inc. v. Commissioner*, 8 T.C.M. (CCH) 1064 (1949), *aff'd*, 189 F.2d 390 (10th Cir. 1951) (utilizing funds for redemption when it was stated they were needed to install new capital equipment); *W.H. Gunlocke Chair Co. v. Commissioner*, 2 T.C.M. (CCH) 885 (1943), *aff'd*, 145 F.2d 791 (2d Cir. 1944) (retirement of preferred stock inconsistent with program to finance a possible change in business due to competition).

¹⁰⁵ In a number of these cases the grounds for rejecting the justification of the accumulation are not clearly delineated. *See, e.g., Fenco, Inc. v. United States*, 234 F. Supp. 317 (D. Md. 1964), *aff'd*, 348 F.2d 456 (4th Cir. 1965) (per curiam); *Youngs Rubber Corp. v. Commissioner*, 21 T.C.M. (CCH) 1593 (1962), *aff'd*, 331 F.2d 12 (2d Cir. 1964) (per curiam); *Trico Prods. Corp. v. Commissioner*, 46 B.T.A. 346 (1942), *aff'd*, 137 F.2d 424 (2d Cir.), *cert. denied*, 320 U.S. 799 (1943).

¹⁰⁶ *See Faber Cement Block Co. v. Commissioner*, 50 T.C. 317 (1968), *acq.*, 1968-2 C.B. 2, where the Tax Court commented that "the courts tend to look askance at such claimed need for the purposes of the accumulated earnings tax, particularly where, as is the case herein, there is no evidence that there were dissenting or competing shareholders factions which threatened corporate

furtherance of corporate harmony, including elimination or avoidance of minority interests;¹⁰⁷ or 2) it is to protect the corporation from liquidation, merger or sale to an outsider.¹⁰⁸ Even those opinions taking this middle ground persist in weighing shareholder benefit relative to corporate purpose. If shareholder benefit outweighs the corporate purpose, it disqualifies the redemption as a reasonable business need.¹⁰⁹

The decision which clearly stands out among this assortment is *Mountain State Steel Foundries, Inc. v. Commissioner*.¹¹⁰ The corporation against which the tax was assessed by the Commissioner had been owned by its two founders, each holding fifty percent of the stock. One shareholder died; his stock was left in the hands of the beneficiaries of his estate, who then demanded that the business be sold. The remaining shareholder attempted to satisfy the beneficiaries by locating a buyer but was not able to find an interested party at the asking price. As an alternative, it was suggested that the beneficiaries' stock be redeemed with a plan of payment to be negotiated. The agreement to do so was reached in September, 1950, with payments to be made over a period of forty-four years. The Commissioner assessed the penalty tax for the first three fiscal years that the corporation accumulated earnings to pay the debt that arose as a result of the redemption. The Commissioner was successful in the Tax Court on the theory that this case was indistinguishable from *Pelton*.¹¹¹ The Fourth Circuit reversed on the broad grounds that the Tax Court's premise that no corporate purpose was served by the disbursements associated with the redemption was incorrect.¹¹² The court indicated the point in its analysis at which the redemption became relevant:

For a long time there was controversy over the tax consequence to shareholders when a corporation made disproportionate distributions in partial redemption of its stock. Congress finally acted in this field. Among other things, it specifically pro-

¹⁰⁷ *Wilcox Mfg. Co. v. Commissioner*, 38 T.C.M. (CCH) 378 (1979); *Farmers & Merchants Inv. Co. v. Commissioner*, 29 T.C.M. (CCH) 705 (1970); *Oman Constr. Co. v. Commissioner*, 24 T.C.M. (CCH) 1799 (1965); *Dill Mfg. Co. v. Commissioner*, 39 B.T.A. 1023 (1939), *nonacq.*, 1939-2 C.B. 47.

¹⁰⁸ *Mountain State Steel Foundries, Inc. v. Commissioner*, 18 T.C.M. (CCH) 306 (1959), *rev'd*, 284 F.2d 737 (4th Cir. 1960). *See also* *Gazette Publishing Co. v. Self*, 103 F. Supp. 779 (E.D. Ark. 1952); *Penn Needle Art Co. v. Commissioner*, 17 T.C.M. (CCH) 504 (1958); *cf. Fred F. Fischer v. Commissioner*, 6 T.C.M. (CCH) 520 (1947) (Redemption is proper purpose for accumulating earnings and profits if prompted by protecting corporation from liquidation, merger, or sale to an outsider).

¹⁰⁹ Two very good examples of this approach are *John B. Lambert & Assoc. v. United States*, 212 Ct. Cl. 71 (1976) and *Cadillac Textiles, Inc. v. Commissioner*, 34 T.C.M. (CCH) 295 (1975).

¹¹⁰ 284 F.2d 737 (4th Cir. 1960), *rev'g*. 18 T.C.M. (CCH) 306 (1959).

¹¹¹ 18 T.C.M. (CCH) at 312. For a discussion of the facts of *Pelton* see notes 76-79 *supra* and accompanying text.

¹¹² 284 F.2d at 744.

vided that partial redemption of the shares held by an estate would be treated as a sale, not as a distribution of earnings, if the amount of the distribution did not exceed the estate's liabilities for estate and inheritance taxes, interest and funeral and administration expenses [section 303]. When Congress specifically provided favorable tax treatment for such transactions and sought to encourage them to facilitate the administration of estates, it hardly could have intended to penalize the corporation for doing the favored act.

We need not say that under no circumstances may a stock purchase be relevant to a question arising under § 102 of the 1939 Code [predecessor to sections 531-537.]. *When it is done out of cash accumulations which reasonably may be thought excessive, such a purchase, along with other factors, may be considered appropriately in arriving at ultimate findings.* The fact of redemption, of itself, however, furnishes no basis for imposition of the § 102 tax. *In the circumstances in which they were made, the disbursements in payment for the stock, themselves, do not support a finding that they were withdrawn from excess funds accumulated from earnings beyond reasonable corporation need.* Nor is the situation altered by the fact that [the founders] may have been aware that travel along another route would have cost something more in taxes. If they had a choice of routes, they were not required to choose the one which would be most costly to them in taxes.¹¹³

Although the language quoted is dictum given the primary holding in the case, the message of *Mountain State* is this: consideration of benefits to shareholders resulting from a redemption is relevant in reaching "ultimate findings" concerning the existence of the proscribed purpose. However, the bare fact that a redemption has occurred is not relevant to the reasonable business needs inquiry, the "trigger mechanism" of the section 533 presumption.

VI. SOME COMMON PROBLEMS

A. *Distinction Between Majority and Minority Redemptions*

Some cases have noted that a redemption will be considered a reasonable business need if it is a redemption of a minority interest.¹¹⁴ The rule seems logical when stated: minority interests do not control the corporation; therefore, any intent associated with producing a tax benefit for the minority interests cannot be attributed to the corporation. This rule apparently stems from *Pelton*. In dealing with the majority

¹¹³ *Id.* at 745 (dictum) (emphasis added).

¹¹⁴ *Farmers & Merchants Inv. Co. v. Commissioner*, 29 T.C.M. (CCH) 705 (1970). See *Wilcox Mfg. Co. v. Commissioner*, 38 T.C.M. (CCH) 378 (1979); *Hedberg-Freidheim Contracting Co. v. Commissioner*, 15 T.C.M. (CCH) 1433 (1956), *aff'd*, 251 F.2d 898 (8th Cir. 1958).

redemption in that case, the Tax Court sought to distinguish two earlier decisions favorable to the taxpayer¹¹⁵ by pointing out that these were minority redemptions. However, the Tax Court in *Pelton* was careful to enumerate additional grounds for distinguishing those cases.¹¹⁶

In addressing the issue of whether this is a valid distinction, first it must be decided what is a "majority" or "minority" interest. Will the rules of constructive ownership apply?¹¹⁷ This is crucial in accumulated earnings cases since they often involve family-owned companies.¹¹⁸ Furthermore, does "majority" here refer to the total amount of stock redeemed or to the total amount of stock owned by the shareholder desiring the redemption? In at least one case where the shareholder owned more than a majority of the stock but was not completely redeemed, the court did not find the proscribed purpose.¹¹⁹ If the redemption is completed in a series of separate transactions, must they be aggregated to decide whether a majority or minority redemption has taken place? A further complication exists in those situations where there are two or more classes of stock, one of which may be non-voting.¹²⁰ Finally, a special problem is associated with the fifty percent interest because it often means the corporation is subject to deadlock.¹²¹

Leaving these difficulties to one side, it may be that the distinction could be useful in deciding whether a redemption is indicative of the re-

¹¹⁵ *Gazette Publishing Co. v. Self*, 103 F. Supp. 779 (E.D. Ark. 1952); *Dill Mfg. Co. v. Commissioner*, 39 B.T.A. 1023 (1939), *nonacq.*, 1939-2 C.B. 47.

¹¹⁶ *Dill* was distinguished on these additional facts: 1) the burden of proof was upon the Commissioner in that case; 2) the Commissioner was never able to prove that there was a scheme planned for many years to buy out the minority interest; 3) there were reasons to justify the accumulations on other grounds. *Gazette Publishing Co.* was distinguished on the fact that the officers of the taxpayer knew that a sale to an outsider was imminent. *Pelton Steel Casting Co. v. Commissioner*, 28 T.C. 153, 176 (1957), *aff'd*, 251 F.2d 278 (7th Cir.), *cert. denied*, 356 U.S. 958 (1958).

¹¹⁷ See I.R.C. § 318.

¹¹⁸ *E.g.*, *John B. Lambert & Assoc. v. United States*, 212 Ct. Cl. 71 (1976) (husband and wife owners); *Cadillac Textiles, Inc. v. Commissioner*, 34 T.C.M. (CCH) 295 (1975).

¹¹⁹ *Ted Bates & Co. v. Commissioner*, 24 T.C.M. (CCH) 1346 (1965).

¹²⁰ *KOMA, Inc. v. Commissioner*, 8 T.C.M. (CCH) 1064 (1949), *aff'd*, 189 F.2d 390 (10th Cir. 1951); *Walhup Drayage & Warehouse Co. v. Commissioner*, 4 T.C.M. (CCH) 695 (1945); *W.H. Gunlocke Chair Co. v. Commissioner*, 2 T.C.M. (CCH) 885 (1943), *aff'd*, 145 F.2d 791 (2d Cir. 1944); *Trico Prods. Corp. v. Commissioner*, 46 B.T.A. 346 (1942), *aff'd*, 137 F.2d 424 (2d Cir.), *cert. denied*, 320 U.S. 799 (1943).

¹²¹ *E.g.*, *John B. Lambert & Assoc. v. United States*, 212 Ct. Cl. 71 (1976); *Cadillac Textiles, Inc. v. Commissioner*, 34 T.C.M. (CCH) 295 (1975); *Penn Needle Art Co. v. Commissioner*, 17 T.C.M. (CCH) 504 (1958); *Hedberg-Freidheim Contracting Co. v. Commissioner*, 15 T.C.M. (CCH) 1433 (1956), *aff'd*, 251 F.2d 839 (8th Cir. 1958).

quired state of mind.¹²² A tax-savings motivation attributable to majority shareholders may ultimately be attributed to the corporate taxpayer. However, in considering the question of what is a reasonable business need, the majority/minority distinction is not as useful. At this level, the focus is not on the corporate state of mind but on what the corporation needs. A redemption may serve a reasonable need of the business in a variety of situations not affected by relative size of shareholder interests, such as insuring corporate harmony, promoting efficiency, or preserving loyalty of management. There does not seem to be a good reason to be more suspicious of a redemption merely because it is a redemption of a majority interest.

B. *Redemption of Dissenting Shareholders*

Another common distinction drawn for the purpose of classifying redemptions is to bless those which are for the purpose of eliminating dissent. Where continued business operation is threatened by dissension between incompatible shareholder groups, there is a business purpose for the redemption.¹²³ To what degree the conflict must have jeopardized corporate operations is uncertain.

Certain early decisions raised the hope that the differences need not be too severe before a redemption could be justified.¹²⁴ However, these cases concerned unplanned redemptions. Each corporation involved had originally advanced different reasons for the accumulations. When the accumulated funds subsequently were used to complete redemptions, such action was explained on the basis that the redemptions were unanticipated.¹²⁵

Recent decisions indicate that the conflict may require corporate paralysis before the funding of a redemption will be an accumulation which is in furtherance of the reasonable needs of the business. In *John B. Lambert & Associates v. United States*¹²⁶ the redemption was of the

¹²² See *John B. Lambert & Assoc. v. United States*, 212 Ct. Cl. 71 (1976); *Cadillac Textiles, Inc. v. Commissioner*, 34 T.C.M. (CCH) 295 (1975).

¹²³ *Mountain State Steel Foundries, Inc. v. Commissioner*, 284 F.2d 737 (4th Cir. 1960); *Faber Cement Block Co. v. Commissioner*, 50 T.C. 317 (1968), *acq.*, 1968-2 C.B. 2; *Kirlin Co. v. Commissioner*, 23 T.C.M. (CCH) 1580 (1964), *aff'd*, 361 F.2d 818 (6th Cir. 1966) (per curiam); *Youngs Rubber Corp. v. Commissioner*, 21 T.C.M. (CCH) 1593 (1962), *aff'd*, 331 F.2d 12 (2nd Cir. 1964) (per curiam); *Dill Mfg. Co. v. Commissioner*, 39 B.T.A. 1023 (1939), *nonacq.*, 1939-2 C.B. 47.

¹²⁴ *Gazette Publishing Co. v. Self*, 103 F. Supp. 779 (E.D. Ark. 1952); *Penn Needle Art Co. v. Commissioner*, 17 T.C.M. (CCH) 504 (1958).

¹²⁵ In *Gazette Publishing Co.*, the redemption "was a complete surprise to the president and board of directors of the corporation." 103 F. Supp. at 782. In *Penn Needle Art Co.*, the trouble "came about suddenly and the decision to [redeem] . . . was not the result of some long term planning or desire to distribute earnings . . ." 17 T.C.M. (CCH) at 509. See Herwitz, *supra* note 1, at 906-07.

¹²⁶ 212 Ct. Cl. 71 (1976). It is notable that because the forum is the Court of Claims, no Code section 534 burden of proof statement was permitted.

wife's fifty percent interest in the corporation, where the husband owned the remaining interest. The redemption took place in 1969, and the taxable years in question were the calendar years 1967 and 1968. The taxpayer argued that in the years prior to the redemption the wife had become conservative in her business philosophy and requested redemption so that she could devote more time to her family. She was opposed to a policy of expansion and made that known. While the actual redemption did not occur until 1969, there were a number of preliminary arrangements made with her redemption in mind.

The United States Court of Claims reviewed the matter on the taxpayer's request for a refund. An opening remark in the opinion was that the taxpayer and the Commissioner agreed that "under certain circumstances . . . an accumulation of earnings to fund a stock redemption may constitute an accumulation for a 'reasonable need of the business' within the meanings of Sections 535(c) and 537."¹²⁷ Despite this agreement by the litigants, the court's own assessment of when a redemption serves a reasonable business need appeared to be narrower. It fixed upon "the concept of a protective redemption" which is apparent only in those situations where there is a threatened liquidation, an unexpected serious rupture or the strong possibility of a sale to outsiders who would be hostile to present corporate policies.¹²⁸ Here, the wife's position was held not to have created the need for such a protective redemption.

Similar is *Cadillac Textiles, Inc. v. Commissioner*,¹²⁹ in which two brothers had had a disagreement over a scheme to invest in a new type of power loom. The Tax Court nevertheless found that the redemption was more closely related to the older brother's personal health and to the treatment of the proceeds of the redemption as a capital gain than to satisfaction of reasonable business needs. There was testimony that the brothers were on the best of terms, but it is not clear whether that was in respect of their personal feelings for one another or as businessmen.¹³⁰ The Tax Court stated that "[t]his is not a situation where the operation of the business would come to a stand-still or the company would be threatened with liquidation if the conflict among the shareholders were [*sic*] permitted to continue."¹³¹

These cases should be contrasted with *Farmers & Merchants Investment Co. v. Commissioner*,¹³² where an accumulation to meet the corporate obligations to a minority shareholder redeemed in a year prior to the assessed years was held to be a reasonable need of the business.

¹²⁷ *Id.* at 79.

¹²⁸ *Id.* at 81.

¹²⁹ 34 T.C.M. (CCH) 295 (1975).

¹³⁰ *Id.* at 308.

¹³¹ *Id.*

¹³² 29 T.C.M. (CCH) 705 (1970).

The description of the circumstances surrounding the redemption show that it was at the insistence of one shareholder alone and not tied to any argument over corporate policy.¹³³ In fact, as in *Cadillac Textiles* there was a finding that the shareholders were on good terms with one another. Nonetheless, it was held: "The promotion of harmony in the conduct of the business is a proper business purpose. If redeeming the stock of one stockholder in a closely held corporation is designed to secure it against dissension amongst those who determine business policy, the redemption is justified as a business need."¹³⁴ This holding sanctions a redemption in a situation of less than imminent doom for the corporation.

In a recent well-reasoned tax court memorandum opinion, *Wilcox Manufacturing Co., Inc., v. Commissioner*,¹³⁵ Judge Tannenwald cited *Mountain State*¹³⁶ for the proposition that redemptions of the stock of minority shareholders to promote harmony in the business met the reasonable business needs test. *Wilcox* involved two separate shareholder redemptions. The first redemption was of a dissenting minority shareholder's interest. The shareholder, who had carried significant management responsibility in the corporation, had determined to leave because of longstanding policy disagreements with the corporation's president and majority shareholder.

In touching on the issue of the degree of corporate disruption required to legitimate accumulations for redemption of dissenting shareholders as "reasonable business needs," the opinion notes:

A.G. Wilcox, Jr., disagreed with Todd on a number of policy questions. Although the fact that Todd tried to persuade him to stay on raises some question as to the severity of the rift between the two men, we are satisfied that serious differences did exist. Given that A.G. Wilcox, Jr., insisted on leaving the company, it is clear that it served the interests of Wilcox [the corporate taxpayer] to redeem his shares. The alternative would have been to risk his selling to an undesirable third party or, in the event he was unable to find a buyer, to suffer the disruption that would undoubtedly be caused by, in effect, forcing him to remain a shareholder.¹³⁷

Rather than speculating on the intensity of the conflict in the minds of the principals' as was done in *Cadillac Textiles* and *Lambert*, the focus of Judge Tannenwald's analysis is the foreseeable effect of the dispute on the business.

¹³³ *Id.* at 711.

¹³⁴ *Id.*

¹³⁵ *Wilcox Mfg. Co. v. Commissioner*, 38 T.C.M. (CCH) 378, 394 (1979).

¹³⁶ *Mountain State Steel Foundries, Inc. v. Commissioner*, 284 F.2d 737 (4th Cir. 1960).

¹³⁷ 38 T.C.M. at 394.

Under the *Wilcox* rationale, a bona fide decision on the part of an independent minority shareholder to get out of the business would be sufficient to qualify a redemption as undertaken to meet a reasonable business need. However, courts will often be faced with dissension between shareholders who are bound by close personal ties, as in *Lambert* and *Cadillac Textiles*, where the dissenter might be unwilling to subject the majority to the worst effects of corporate discord. In such cases, courts will still be forced to choose between speculating on the willingness of the dissenter to actually disrupt corporate operations and denying the reasonableness of the accumulation until actual damage has occurred.

The dissenting shareholder problem is often framed in terms of redeeming the estate of a deceased shareholder. To the extent that the earnings and profits are accumulated in the year of the shareholder's death and thereafter fund a redemption in connection with section 303, this problem no longer exists. Section 537 as amended by the Tax Reform Act of 1969¹³⁸ specifically provides that such a redemption is a reasonable business need. However, prior to the 1969 act, authority existed that such a redemption would not be considered a reasonable business need since it was prompted by a shareholder purpose.¹³⁹ In instances where a corporation desires to fund a redemption program before a shareholder dies, the situation still arises.

The second of the two redemptions in *Wilcox* involved the estate of the majority shareholder. He had been killed in an air accident just three months after the redemption of the minority shareholder's interest. The court held the corporation liable for the accumulated earnings tax with respect to the later redemption. Liability was based directly on the presence of the prohibited purpose, determined without recourse to the section 531(a) presumption.¹⁴⁰ The opinion notes the potential for abuse "that would exist if a corporation could accumulate large amounts to redeem stock of deceased shareholders far in advance of the likelihood of their deaths, especially where life insurance is a realistic alternative."¹⁴¹ Where insurance cannot be obtained on the

¹³⁸ Pub. L. No. 91-172, § 906, 83 Stat. 487, 714 (1969).

¹³⁹ *Kirlin Co. v. Commissioner*, 23 T.C.M. (CCH) 1580 (1964), *aff'd*, 361 F.2d 818 (6th Cir. 1966) (per curiam); *Youngs Rubber Co. v. Commissioner*, 21 T.C.M. (CCH) 1593 (1962), *aff'd*, 331 F.2d 12 (2d Cir. 1964) (per curiam).

¹⁴⁰ Judge Tannenwald expressed doubt as to whether a corporate purpose was served by the corporation's shareholder agreement, which provided that each shareholder's stock would be redeemed upon his death whether or not he had been active in the conduct of the business and "without regard to the effect of [the shareholder's] death on corporate operations." *Wilcox Mfg. Co. v. Commissioner*, 38 T.C.M. (CCH) 378, 394 (1979). A demonstrated corporate policy of building up the equity interest of management through distribution of the redeemed shares to individuals active in the business might have allayed Judge Tannenwald's doubts.

¹⁴¹ *Id.* at 394-95.

shareholder's life or the block of stock is so large that reliance on future years' earnings may not be prudent, accumulations prior to death may be the only feasible alternative.

There is some precedent to support the position that the inherent conflict between living shareholders active in management and estate holding stock for income purposes provides a valid business reason to plan for a redemption. In *Mountain State* it was remarked that closely held corporations are worth substantially more to those who operate the business than to outside shareholders:

This sort of situation leads to demands for dividends out of consideration of the stockholders' personal financial need, perhaps without appropriate regard for the need of the corporation to make capital expenditures in order to maintain a competitive position. On the other hand, those stockholders active in the management of the business deriving salaries from it may be able to afford indulgence of an ambition to enlarge future earnings through still larger current capital expenditures, an indulgence which other stockholders may ill afford.¹⁴²

In accord with *Wilcox* and *Mountain State* is *Oman Construction Co., Inc., v. Commissioner*.¹⁴³ There two brothers had an understanding that in the event of the death of one, his stock would be redeemed by the corporation. The purpose of the agreement was to ensure that the deceased brother's widow and children would not be dependent upon the corporation's future earnings. The surviving shareholder would then be able to continue the business without following conservative policies to protect those individuals.¹⁴⁴ One of the brothers died unexpectedly, and his interests were redeemed with insurance proceeds paid to the corporation plus cash. Without considering whether the "understanding" was for a shareholder or corporate purpose, the Tax Court stated that "[r]edemption of stock of a minority stockholder is a valid business purpose, and funds retained for such a purpose are retained for the reasonable needs of the business."¹⁴⁵ It should also be noted that the court was of the opinion that the untimely death of a key man was not the time for making dividends or otherwise reducing the corporate surplus.¹⁴⁶

The cases of *Mountain State*, *Farmers & Merchants*, *Oman Construction* and *Wilcox Manufacturing* seem closer to an appropriate conception of reasonable needs of the business than the more narrowly drawn decisions. First, the reasonably *anticipated* needs of the business are specified by the statute as the appropriate standard. In this light a rule sanctioning only redemptions consummated at the eleventh hour before

¹⁴² 284 F.2d at 744-45.

¹⁴³ 24 T.C.M. (CCH) 1799 (1965).

¹⁴⁴ *Id.*

¹⁴⁵ *Id.* at 1810.

corporate chaos seems too restrictive. Second, those decisions which view redemptions involving dissenting shareholders skeptically because the conflict between shareholders was not of "sufficient" intensity, share an underlying notion that the redeemed shareholders have been significantly benefitted in that they are withdrawing their corporate interest at capital gains rates. As has already been stated, the reasonable business needs issue is best decided without reference to shareholder benefit.

C. *Buy-Out Agreements and Other Forms of Stock Redemption Plans*

Several courts have stated that to qualify as a reasonable business need a redemption must not only be shown to have served a business purpose but that the taxpayer must also have had a specific, definite and feasible plan concerning the prospective redemption.¹⁴⁷ The Treasury Regulations lend support to this position, but there are no hard and fast rules as to the extent of formality required of the plan.¹⁴⁸ In any event, the popularity and desirability of buy-out agreements and other forms of stock redemption plans as business and estate planning tools has led to much speculation as to whether they serve a reasonable business need.¹⁴⁹ While a written plan would evidence the seriousness of the corporation's commitment to the redemption and counteract charges of vagueness, it seems unlikely that the mere existence of a plan would bootstrap what was otherwise not a reasonable business need into the reasonable business need category.¹⁵⁰

Certain early cases dealt with redemptions in connection with preferred stock redemption programs. In those cases, to the extent that the redemptions were inconsistent with other purported needs of the business, the use of funds for redeeming such shares was held to evidence the existence of the proscribed purpose.¹⁵¹ One later case came to a different conclusion when considering the type of redemption plan utilized to reward key management.¹⁵² The redemption plan was structured in a fashion allowing the majority stockholder to be redeemed in

¹⁴⁷ *JJJ Corp. v. United States*, 576 F.2d 327 (Ct. Cl. 1978); *Cadillac Textiles, Inc. v. Commissioner*, 34 T.C.M. (CCH) 295, 309 (1975).

¹⁴⁸ *Treas. Reg. § 1.536-1(b)(1)* (1960). *See Empire Steel Castings, Inc. v. Commissioner*, 33 T.C.M. (CCH) 155, 165 (1974); *Bremerton Sun Publishing Co. v. Commissioner*, 44 T.C. 566, 584-85 (1965). *But see John P. Scripps Newspapers v. Commissioner*, 44 T.C. 453, 469 (1965), where the Tax Court remarked that "a closely-held corporation cannot be held to the same strict formalities of large public corporations."

¹⁴⁹ *See Kahn, supra* note 1, at 3-9.

¹⁵⁰ *See Herwitz, supra* note 1, at 916-20. *See also* notes 142, 144 *supra* and accompanying text.

¹⁵¹ *KOMA, Inc. v. Commissioner*, 8 T.C.M. (CCH) 1064 (1949), *aff'd*, 189 F.2d 390 (10th Cir. 1951); *W.H. Gunlocke Chair Co. v. Commissioner*, 2 T.C.M. (CCH) 885 (1943), *aff'd*, 145 F.2d 791 (2d Cir. 1944). *But see Metal Office Furniture Co. v. Commissioner*, 11 T.C.M. (CCH) 1066 (1952).

¹⁵² *Ted Bates & Co. v. Commissioner*, 24 T.C.M. (CCH) 1346 (1965).

part and to sell another part of his stock to members of the corporate management. As part of this stock realignment, the stockholder requested and received a private letter ruling stating that the redemption qualified as a substantially disproportionate redemption pursuant to section 302(b). It was found that the stockholder reluctantly allowed his stock to be redeemed, recognizing it was in the best interest of the corporation. The business reasons advanced for the redemption included the threat to corporate financial stability that would occur upon the death of the majority stockholder, which would trigger an obligation by the corporation to redeem his stock pursuant to an unrelated stock redemption agreement, and the welding of top management personnel to the corporation by increasing their equity interest.¹⁵³ The Tax Court held that the redemption of the stock did not evidence any unlawful intent on the part of the taxpayer, the transaction not being undertaken for personal reasons.¹⁵⁴ Interestingly enough, the court stated in a footnote that the taxpayer was not allowed any increase in its accumulated earnings credit as a result of the existence of the redemption plan. This was so because the amounts the taxpayer received from the sale of its stock to certain employees exceeded the amount the taxpayer became obligated to pay pursuant to the terms of the plan.¹⁵⁵ Nonetheless, the note stated that "[i]t is clear that under appropriate circumstances, the retention of earnings to create a reserve to fund a corporate obligation to redeem or repurchase some of its stock may constitute a reasonable business need."¹⁵⁶

VII. CONCLUSION

In the accumulated earnings tax, Congress has saddled practitioners and the courts with an unwieldy statute, difficult at best to apply in practice and subject to frequent misinterpretation. The practitioner's problem is exacerbated by the magnitude of the penalty tax that results from a finding of liability. In dealing with redemptions, the courts should take care to distinguish between factors which are relevant to the proscribed purpose issue and those relevant to the reasonable business needs issue. The determination of whether the proscribed purpose exists is inherently subjective and consideration by the courts of shareholder benefit at this level is appropriate. However, this factor is of no import to the determination whether the accumulation was for the reasonable business needs of the corporation. Therefore, the tax should not be imposed on accumulations to fund a redemption which serves a reasonable business need of the corporation. A lack of uniformity in decisions in this area is a direct result of the courts' failure to discern this distinction. Continued confusion on this point will make what is already complicated almost inscrutable.

¹⁵³ *Id.* at 1355.

¹⁵⁴ *Id.* at 1364-65.

¹⁵⁵ *Id.* at 1363 n.9.

