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An Evaluation of Equity in the Judicial Administration of the Accumulatedearnings Tax Cases.

Frank Edwin Watkins Jr
Louisiana State University and Agricultural & Mechanical College

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AN EVALUATION OF EQUITY IN THE JUDICIAL ADMINISTRATION OF THE ACCUMULATED EARNINGS TAX CASES

A Dissertation

Submitted to the Graduate Faculty of the Louisiana State University and Agricultural and Mechanical College in partial fulfillment of the requirements for the degree of Doctor of Philosophy in

The Department of Accounting

by

Frank Edwin Watkins, Jr.
B.S., University of Tennessee, 1964
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ABSTRACT

Traynor and Surrey made proposals for judicial reform in 1938. They specifically included recommendations that exclusive original jurisdiction in federal tax cases be vested in a single Tax Court and that a single Court of Tax Appeals be created to hear all tax appeals with appeal from the latter court by certiorari to the Supreme Court. Subsequently, other writers debated the merits of these recommendations.

The purpose of the present study was to make an evaluation of equity in the judicial administration of the accumulated earnings tax cases. This study examined cases at the trial court level for conflicting decisions on each one of three broad topics. Analysis of these conflicts proceeded from the trial courts up to the Supreme Court. The three topics researched were two substantive rules of law, a procedural rule of law, and applications of basic accounting concepts.

The two substantive rules of law investigated were interpretations of the term "purpose" and interpretations of the relationship of "purpose" to the "reasonable needs of the business." During a period of almost four decades, four distinctly different interpretations
of the prohibited purpose were used by the courts. With four different interpretations of purpose in use, inequitable treatment of taxpayers is a highly probable result. An analysis of the relationship of "purpose" to the "reasonable needs of the business" revealed eight paths were available to reach a final decision, assuming only one definition of purpose. A total of twenty-six possible paths are available for a final decision when the four interpretations of purpose are combined with the eight paths presented. Considering this large number of possible paths to a final decision, the probability of equity for past years is quite low.

The procedural rule of law investigated was the operation of the burden of proof under section 534. Inequity has resulted from the Tax Court's failure to make a determination of the section 534 issue in all appropriate cases. However, the magnitude of the inequity is substantially less than in the instance of the substantive rules of law discussed above.

A determination of the reasonable needs of the business requires the application of such basic accounting concepts as earnings, depreciation, working capital, and appropriation of earnings. The confusion over the accounting relationships has been apparent in the cases in which the courts have explained the application of
accounting concepts. Overall, the courts' treatment of accounting concepts is considered to be an additional indication of a lack of equity.

The investigation of final determinations enabled the evaluation, based upon a comparison of identical issues, to be placed in perspective. The increasing percentage of cases taken to the district courts by taxpayers indicates that taxpayers believe they will receive more favorable treatment in the district courts than in the Tax Court. The final determinations of incidents decided by jury trials seems to support this apparent difference in attitudes. The pattern of appeals suggests that both the Commissioner and taxpayers sense the difference in attitudes among the forums. The reversals obtained corroborate the suggestion of bias. Thus the conclusion is made that in the past, equity has been mostly a matter of random chance, rather than the inexorable process of justice.

No individual judge or court can be singled out as being responsible for the lack of equity. The judicial system for federal tax cases must bear the blame. Therefore, the Traynor and Surrey recommendations, that exclusive original jurisdiction in federal tax cases be vested in a single Tax Court and that a single Court of Tax Appeals be established, are endorsed.
CHAPTER I

INTRODUCTION TO THE STUDY

The income tax as it is known today developed from the Sixteenth Amendment to the United States Constitution, which was adopted in 1913. This amendment permitted the assessment and collection of taxes on incomes without requiring apportionment between the states and without regard to any census or enumeration. For several years any litigation arising in income tax cases was handled within the existing federal judicial structure. In 1924 a Board of Tax Appeals was established as an independent agency within the Executive Branch of the Federal Government. At first, the decisions of the Board were not binding upon the parties, and either party could sue in the United States District Court. Any questions of fact determined by the Board were tried de novo by the district court.

In 1926 the law was changed to permit appeals directly from the Board to one of the United States Circuit Courts of Appeals and to prevent the taxpayer from obtaining a retrial in another court once he permitted the case to come before the Board. In 1942 the Internal Revenue Code was amended to change the name of the Board of Tax Appeals to the Tax Court of the United States and
to give the title of "judge" to each of its members. The authority of the Board was expressly stated to remain the same.\(^1\)

Although the Tax Court was not a \textit{de jure} court, it was a \textit{de facto} court.\(^2\) However, the Tax Court was not content with being accepted merely as a \textit{de facto} court and declared its independence from the Courts of Appeals in Edmonds.\(^3\) Later the Tax Court exercised this independence and refused to follow a contrary rule set out by a court of appeals which had jurisdiction to review the decision of the Tax Court.\(^4\) In defense of its position the Tax Court stated:

\begin{quote}
The Tax Court has always believed that Congress intended it to decide all cases uniformly, regardless of where, in its nationwide jurisdiction, they may arise, and that it could not perform its assigned functions properly were it to decide one case one way and another differently merely because appeals in such cases might go to different Courts of Appeals. Congress, in the case of the Tax Court, 'inverted the triangle' so that from a single national jurisdiction, the Tax Court appeals would spread out among eleven Courts of Appeals, each for a different circuit or portion of the United States. Congress faced the problem in the beginning as to whether the Tax Court jurisdiction and approach was to be local or nationwide and made it nationwide. Congress expected the Tax Court to
\end{quote}


\(^2\)\textit{Kav v. Commissioner}, 178 F. 2d 773 (3 Cir. 1950).
\textit{Pelham Hall Co. v. Hassett}, 147 F. 2d 66 (1 Cir. 1945).
\textit{Fairmont Aluminum Co.}, 22 TC 1377 (1948).

\(^3\)\textit{William E. Edmonds}, 16 TC 117 (1940).

\(^4\)\textit{Arthur L. Lawrence}, 27 TC 716 (1953).
set precedents for the uniform application of the tax laws, insofar as it would be able to do that.\textsuperscript{5} Since appeals from the Tax Court go to the various circuit courts, the Tax Court does have a problem with conflicting decisions of the circuit courts. However, the solution of the Tax Court left much to be desired since this solution forced a taxpayer to expend additional effort and money in order to win his case.

The Tax Reform Act of 1969\textsuperscript{6} changed the status of the Tax Court from an "independent agency in the Executive Branch of the Government" to a court of record "under Article I of the United States Constitution."\textsuperscript{7} Furthermore, the name of the court was changed from "Tax Court of the United States" to "United States Tax Court."\textsuperscript{8} Although one can only speculate as to whether these changes had any influence in the recent change from the independent position discussed above in the Lawrence case, the Tax Court explained the shift as follows:

In thus concluding that we must follow Goldman, we recognize the contrary thrust of the oft-criticized case of Arthur L. Lawrence, 27 T.C. 713. Notwithstanding a number of the considerations which originally led us to that decision, it is our best judgment that better judicial administration requires us to follow a Court of Appeals decision

\textsuperscript{5}Ibid., p. 718.
\textsuperscript{7}Int. Rev. Code of 1954, Sec. 7441 (Tax Reform Act of 1969, Sec. 951).
\textsuperscript{8}Ibid.
which is squarely in point where appeal from our
decision lies to that Court of Appeals and to that
court alone. . . . Moreover the practice we are
adopting does not jeopardize the Federal interest
in uniform application of the internal revenue
laws which we emphasized in Lawrence. We shall
remain able to foster uniformity by giving effect
to our own views in cases appealable to courts
whose views have not yet been expressed, and,
even where the relevant Court of Appeals has al­
ready made its views known, by explaining why we
agree or disagree with the precedent that we feel
constrained to follow.9

This change should result in some reduction of the
number of conflicting cases. However, the United States
Tax Court, the United States District Courts and the United
States Court of Claims all share original jurisdiction in
federal income tax cases. The difference is that in the
Tax Court the taxpayer has not paid the deficiency, while
in the other courts he has paid the deficiency and brings
suit for a refund. Furthermore, appeals from the Tax Court
and the District Courts go to the eleven different United
States Courts of Appeals, while appeal from the Court of
Claims is to the United States Supreme Court.10 From all
of the foregoing one should not be surprised to discover
that conflicting decisions occur in federal tax cases.


10Stanley S. Surrey and William C. Warren, Federal
Income Taxation, Cases and Materials (Brooklyn: Foundation
THE PROBLEM

Statement of the Problem

The overall purpose of this study is to relate the above discussion of conflicting decisions to one area of the federal tax law— the accumulated earnings tax cases.

Specific objectives are:

1. to determine the characteristics of conflicting decisions as they exist in accumulated earnings tax cases;
2. to analyze the conflicting cases in order to determine the basis for the court's decisions;
3. to evaluate the equity of the judicial administration in such cases; and
4. to analyze the cases in order to evaluate the future prospects for equity in the accumulated earnings tax cases.

Importance of the Study

There are constant pressures for changes in the tax system. Critics are constantly calling for reforms in the legislative, administrative, and judicial systems. If changes are deemed desirable, then evidence to support these changes must be accumulated; if a change is believed to be detrimental, then evidence must be accumulated to oppose it.

Litigation is expensive in terms of time as well as in money. Accountants and attorneys have a formidable task when the law is clear and only the facts are to be argued and proved. When the potential element of conflicts

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11 These criticisms are summarized in the review of the literature presented later in this chapter.
in the law is added to an already difficult situation, the situation becomes much more difficult and more hazardous for the client as well as for the accountant or attorney advising him. Unfortunately, the existence of conflicts in the law probably encourages litigation because any party has excellent legal authority to support whichever position is to his advantage.

The accumulated earnings tax cases were selected for study for two reasons. First, this tax area is of great concern to corporations and their financial officers and directors as well as to accountants and attorneys. Second, there are numerous cases available which can be analyzed for conflicts.

Scope of the Study

Since this study is concerned with the equity of the judicial administration in the accumulated earnings tax cases, a definition of equity must be developed that applies to the judicial administration of cases in general. Accumulated earnings tax cases will be evaluated to determine if equity does exist in these cases.

The provisions covering the accumulated earnings tax in the 1954 Internal Revenue Code are sections 531 through 537. Section 531 provides for the tax and gives the tax rates. Section 532 provides that the tax shall fall upon every corporation, "formed or availed of for
for the purpose of avoiding the income tax . . . "12
Section 533 states that for operating companies the prohibited purpose exists if the earnings are accumulated "beyond the reasonable needs of the business."13 Another subsection applies to holding companies.14 Section 534 provides for a shift of the burden of proof to the Commissioner in certain instances. Section 535 sets out the adjustments necessary in making a calculation of "accumulated taxable income" including a minimum credit and a general credit for earnings that "... are retained for the reasonable needs of the business."15 Section 536 merely provides for the inapplicability of section 443(b) to Section 531. Section 537 modifies the section 533(a) phrase, "reasonable needs" to include "the reasonably anticipated needs of the business."16

The salient points of the Code provisions have been presented to show that there are three broad elements to be considered in evaluating the accumulated earnings tax cases. First, sections 532 and 533 present two rules of substantive law which could be subject to conflicting

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12 Internal Revenue Code of 1954, section 532(a).
13 Ibid., section 533(a).
14 Ibid., section 533(b).
15 Ibid., section 535(c).
16 Ibid., section 537.
interpretation by the courts. Second, section 534 presents a procedural rule of law which could have some effect upon equity in these cases. Third, a determination of the reasonable needs of the business, as incorporated into sections 533, 534, 535, and 537 requires an application of accounting concepts. While these three elements are substantially different, they are pervasive and must be considered in an evaluation of equity in the judicial administration of the accumulated earnings tax cases.

This study is limited to a case analysis of these three broad topics. In addition, an investigation based upon the final decisions of all the cases is presented. This study will not attempt to evaluate the equity of other judicial areas of either a tax or nontax nature. Neither is this study a research of the legislative history of the accumulated earnings tax or any other topic. However, if some portion of the legislative history of this subject becomes relevant to the case at hand, then it may be discussed. Finally, it is assumed that the reader possesses a knowledge of the accumulated earnings tax as provided for in sections 531 through 537 of the Internal Revenue Code of 1954 and related Regulations. Also, the reader is expected to be well versed in the basic legal and accounting concepts required of a competent tax practitioner. However, this level is presumed to be somewhat below the
level of knowledge expected of an attorney or CPA for their respective fields.

DEFINITIONS OF TERMS USED

The terms below are defined as they are used in the context of this study.

Equity

Ideally, changes in the tax law should enhance equity to taxpayers and promote stability at less expense in achieving political objectives. Sometimes all of these elements cannot be satisfied, and sometimes they may even be at odds. In the latter event, common sense would indicate that the merits and disadvantages of those in opposition be weighed and the element with the most sound support would take precedence in that instance. Equity is recommended as the most important element to be distinguished from the others although it also relates to the others in varying degrees.

Equity takes on different meanings in different situations. One definition of equity, according to Webster, is:

A free and reasonable conformity to accepted standards of natural right, law, and justice without prejudice, favoritism, or fraud and without rigor entailing undue hardship.¹⁷

He lists fairness and impartiality as two synonyms for equity. In defining "fair" Webster says, "EQUITABLE implies a fair and equal treatment of all concerned, suggesting often a less rigid standard than JUST . . . .".

The federal system for collecting income taxes is unique in that the taxpayer assesses himself for his income tax liability. How long can such a system endure if it is unfair? Is it not unfair for similar transactions to be taxed differently throughout the country? One writer believes that the success of this system is due to "the general attitude of most taxpayers that they do not mind paying taxes so long as everyone else is similarly taxed."

Senator Russell B. Long has called for both greater equity and simplification of the federal tax system. Secretary Barr has stated:

The middle classes are likely to revolt against income taxes not because of the level or amount of the taxes they must pay but because certain provisions of the tax laws unfairly lighten the burden of others who can afford to pay. People are concerned and indeed angered about the high-income recipients who pay little or no Federal taxes.

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18 Ibid.
19 Ibid., p. 815.
22 Statement by the Honorable Joseph W. Barr, Secretary of the Treasury, before the Joint Economic Committee, January 17, 1969.
Such statements indicate a concern by responsible government officials that fairness should permeate the tax system.

Another dictionary makes the following comment about equity.

In a more limited application, it denotes equal justice between contending parties. This is its moral signification, in reference to the rights of parties having conflicting claims. . . .

But what does "equal" mean? There are various concepts of equality. In a formal sense equality means that men in similar circumstances should be treated the same.

This thought is a common thread woven throughout the preceding discussion. It is simply stated, easily perceived, and hardly arguable in the abstract. The difficulty arises in a concrete application to the cases.

Consider two high school graduates who desire a college education. One wants to become an engineer and the other an accountant. If both are given scholarships in accounting, then they are treated alike in terms of what they received, but not in terms of what they desired. Suppose that one student has blue eyes, but the other does not. If the one with blue eyes receives a scholarship, but the other does not, then they are treated equally under a


\footnote{For an excellent discussion of equality in social and political theory see, "Equal Protection," Harvard Law Review, 82:1159-1173, 1969.}

\footnote{Ibid., p. 1163.}
rule that says only persons with blue eyes receive scholarships, but they are treated unequally with respect to what each one receives.26

Reasonable Classification

These examples illustrate that the concept of equality is without meaning unless relevant differences are considered. Thus, in granting scholarships one must determine whether or not the academic preference of a student and the color of his eyes are relevant differences in making a decision. Once the concept of relevant differences is wedded to the concept of equality, then the application of this new concept demands an evaluation of the empirical realities and the development of a value system. This system must weigh differences and similarities between alternatives and determine "... the relevance thereof with references to the nature and purpose of the treatment it is proposed that each receive."27

Adam Smith was also concerned with equality and listed it first among the canons that he set forth. His use of the term equity referred to reasonable classification.28 Thus, if the classification does not violate

26 Ibid., p. 1164.
27 Ibid.
the principle of equity then taxpayers may be classified in tax cases. Furthermore, the principle of equity is upheld so long as the classifications are reasonable.

Schultz and Harriss have considered the matter and expressed their thoughts as follows:

Equity—relates differences in treatment to reasonable or relevant bases or sources. Equal treatment is not always equitable—and neither is unequal treatment. The crucial factor in deciding whether inequity is equitable is the adequacy or relevance of the element which accounts for the difference. A reasonable classification derived from relevant differences forms the basis for an evaluation of the judicial administration of income tax cases.

Incident

In order to classify the final decisions in the accumulated earnings tax cases the meaning of the word "case" must be considered. The term "case" is probably most frequently used to denote the citation for a single judicial determination. However, in the accumulated earnings tax cases, a single judicial determination often represents the consolidation for trial of several cases on the docket. Each docketed case usually involves more than one taxable year. Since the accumulated earnings tax is to be determined separately for each taxable year, then the final determination for a given case citation

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could be in favor of the taxpayer for one or more years and also in favor of the Commissioner for one or more years. Thus a cited case cannot necessarily be classified as being in favor of only one of the parties. On the other hand, some cited cases involve several taxable years, while others involve only one taxable year. A classification system which classifies the determination for each taxable year would give undue weight to the cases involving several years in which no significant change occurred. Therefore, for the purposes of this study an incident is defined as a decision in a cited case in favor of one party for one or more taxable years. Consequently, a cited case could contain two incidents.

REVIEW OF THE LITERATURE

The investigation of the subject at hand is a very small subset of a vast whole. The whole can be described in general terms as a concern over the degree of equity inherent in the entire judicial structure for federal tax cases. Although a concern over equity in federal tax matters is not limited to the judicial administration of those matters, the following discussion is a very brief summary of the major contributions arising out of a concern for equity in the judicial administration of cases in the federal tax area.
The Traynor and Surrey Proposal

The shot that was heard 'round the tax world was fired by R. J. Traynor and Stanley Surrey in 1938. In a comprehensive examination of both the administrative and judicial procedures in federal tax cases, Traynor outlined existing deficiencies, the causes of the deficiencies, and set forth propositions to remedy the deficiencies. Traynor was particularly disturbed by the long delays and uncertainty that is costly to all parties. He found that a typical case in 1934 spent three years with the Internal Revenue Service and another three years in the Board of Tax Appeals—a six year period from the date the return was filed until the first judicial decision was rendered. An appeal to the Circuit Courts of Appeals would add another two years, and a further appeal to the United States Supreme Court would add another year. With the potential requirement of a nine year period in order to ultimately settle tax disputes, one can easily see the virtual certainty of the impairment of tax administration.

Traynor observed that an average of 68.9 percent of the cases closed by the Board of Tax Appeals for three consecutive fiscal years beginning in 1935 were settled.


\[31^\text{Ibid.}\]
administratively without ever coming to trial. The result was unnecessary delay due to the appeal to the Board, and expensive duplication of the administrative functions of the Internal Revenue Service within the judiciary.\textsuperscript{32} Furthermore, the delay in reaching a final determination resulted in a substantial loss due to the inability of the government to collect deficiencies finally determined. Many taxpayers became insolvent during the time the matter was before the Board.\textsuperscript{33}

The Commissioner should look to the decisions rendered by the Board for guidance in administering the Internal Revenue Code. However, the delay means that he must exercise his initiative during the years he is waiting for a determination. Taxpayers must also institute actions in order to safeguard themselves. The delay also hinders Congress in its attempts to strengthen those areas determined by the judges to be weak.\textsuperscript{34}

Traynor found the defects in administrative procedure to be due to overly elaborate provisions for review of decisions made by revenue department personnel and the inability of the Commissioner to obtain necessary factual information which the taxpayer could more easily provide. He pointed out that one cause of inefficiency

\textsuperscript{32}\textit{Ibid.}, pp. 1394-1395.
\textsuperscript{33}\textit{Ibid.}, pp. 1396-1397.
\textsuperscript{34}\textit{Ibid.}, pp. 1397-1398.
in the judicial system was the result of having exclusive original jurisdiction in cases in which taxpayers wish to litigate without payment of the deficiency in the Board of Tax Appeals, while original jurisdiction in taxpayer suits for a refund rests jointly in the district courts and the Court of Claims. Whether or not the claimed deficiency has been paid is irrelevant in determining the issues as to whether or not a deficiency actually exists. Thus, multi-forums for such affairs are unnecessary, and the forum most skilled in such matters should be the only forum. The several forums for original jurisdiction result in a lack of uniformity in tax cases.\textsuperscript{35} Traynor concluded:

\begin{quote}
Instead of being a tribunal to whom both taxpayers and the Commissioner could look for authoritative guidance, the Board is merely one of 87 tax tribunals of original jurisdiction whose decisions have equal rank as precedents.\textsuperscript{36}
\end{quote}

He believed that the high degree of centralization of the Board of Tax Appeals was another factor leading to judicial inefficiency. Finally, he thought the method of appellate review in income, estate, and gift tax cases was a great contributor to the problem.

In support of the latter point Traynor noted that normal judicial theory was analogous to a pyramid.

\textsuperscript{35}Ibid., pp. 1398-1403.
\textsuperscript{36}Ibid., p. 1403.
Original jurisdiction should constitute a broad base with such jurisdiction among many courts. Appeal from these courts would be to a smaller number of courts, and appellate review of these appeals courts limited to one final court. However, in tax cases the pyramid had been inverted with appeals from the Board of Tax Appeals going to eleven Courts of Appeals. Thus, the Board is faced with a dilemma when there is a disagreement among these courts.\(^\text{37}\)

Traynor made several suggestions to correct the administrative and judicial deficiencies. His most significant suggestions in the judicial area were:

1. To transfer the original jurisdiction of the district courts and the Court of Claims to the Board of Tax Appeals, thus giving the Board exclusive original jurisdiction in all income, estate, and gift tax cases;

2. To decentralize the Board of Tax Appeals; and

3. To create a single Court of Tax Appeals and limit appeals to this Court with appeal from the Court of Tax Appeals by certiorari to the Supreme Court.\(^\text{38}\)

He explained the benefits of his suggestions as follows:

Under the proposed system as an issue could reach the Supreme Court only through the Court of Tax Appeals, both the Commissioner and all taxpayers would be forced to acquiesce in a decision of the Court of Tax Appeals if certiorari were denied, so that denial of certiorari would settle a question instead of being an invitation to litigation. The consequent reduction in the number of decisions

\(^{37}\text{Ibid.}, \text{ pp. } 1404-1407.\)

\(^{38}\text{Ibid.}, \text{ pp. } 1425-1428.\)
and hence of precedents, should do much to strengthen the uniformity achieved by consolidation of original jurisdiction in the Board. As Board decisions would no longer be jeopardized by the prospect of running the gauntlet of eleven tribunals, the disruptive factor of legal uncertainty in the administrative state would largely disappear, and controversies between taxpayer and Commissioner would be fewer in number and more readily settled. 39

Criticisms of the Traynor Proposal

E. B. Prettyman presented a contrary view to the Traynor suggestions. He agreed with Traynor and Surrey as to the existence of the problem, but disagreed as to the solution. In support of the existing provision for judicial review he argued against the consolidation of jurisdiction in the Board for several reasons and against the establishment of a Court of Tax Appeals on the basis that conflicting opinions acted as a deterrent to arbitrary or hasty judgment. 40 The reason Prettyman agreed with Traynor as to the problem, but not as to the solution, was because he also disagreed with Traynor as to the causes of the problem. Prettyman believed that three elements—personnel, policy, and procedure—were essential to solve disputes administratively.

Prettyman concluded that since there was a high quality of personnel, the fault must lie in one of the other elements. However, he thought the fault was in the

39 Ibid., pp. 1428-1429.

policy, while Traynor felt that it was in the procedure. In particular the Treasury Department should urge its employees to find the "right answer" in every case regardless of whether or not any tax would be collected. The cause is that the men are required, or think they are required, to collect a tax in every case, according to Prettyman. He believes that subsequent to the adoption of such a policy, a spirit of co-operation would descend upon the land and taxpayers would stop at only perceived abuses of power in submitting to government determination of deficiencies. 41

Other critics 42 quickly spoke out on the subject. Although some of the defects pointed out by Traynor and Surrey were acknowledged, several writers disagreed with the causes and many disagreed with more than one of the suggestions. Angell expressed a fear that the suggested remedies of Traynor would so shatter the confidence of the American taxpayer in his government that the collapse of the tax collection system could be a likely result. 43 Youngquist believed that cases were being heard with sufficient rapidity and that if undue tax litigation did exist

41 Ibid., p. 398.
42 See Traynor, p. 1184.
the fault was a result of the frequent changes made by Congress in the Revenue Acts.\footnote{G. A. Youngquist, "Proposed Radical Changes in the Federal Tax Machinery," \textit{American Bar Association Journal}, 25:353, 1939.}

\textbf{The Griswold Proposal}

The furor over Professor Traynor's Proposal had mostly subsided when Professor Erwin Griswold of the Harvard Law School renewed the controversy.\footnote{Erwin N. Griswold, "The Need for a Court of Tax Appeals," \textit{Harvard Law Review}, 57:1153, 1944.} Six years had elapsed since the Traynor proposal and changes had taken place. First, a decentralization of the Bureau had occurred somewhat along the lines Traynor and Surrey had recommended and some noticeable improvement had been effected. Second, revenues from the federal income tax were expected to increase suddenly to ten times the average of the preceding decade. Such a great increase was expected to bring a large increase in the number and complexity of tax cases.

Griswold had studied both the Traynor proposal and the criticisms of it. He avoided much of the same criticism by omitting several recommendations made by Traynor and Surrey. Instead, he settled upon the single element in their proposal which could bring about a substantial improvement in light of the changes discussed...
above—a Court of Tax Appeals. Of course, Griswold proposed refinements to the suggestion based upon the criticisms that the proposed single court for tax appeals had drawn earlier.

Professor Griswold eloquently covered every facet of the problem in building support for his position. One interesting rebuttal which he made was against the argument for the status quo. The status quo argument was that delays and conflicts are not necessarily undesirable because, "a second consideration by a second tribunal often corrects an initial error." Griswold found the assumption of a "right answer" in tax questions interesting and joined with Surrey in the position that many tax questions were no closer to a "right" decision after four or five circuit courts of appeal had fought over them, than when the first court had rendered judgment.

Criticisms of the Griswold Proposal

Criticism of Griswold's proposal centered around two main points. First, Robert Miller explained how the existing process for settling a tax dispute could be divided into five stages. He noted that Griswold based his position heavily upon the potential total time delay of nine years, and Miller argued that Griswold’s suggestion

46 Prettyman, p. 440.
47 Griswold, pp. 1190-1191.
48 Ibid., p. 1162.
would only save substantial time in the fourth stage while ignoring the longest delays which were in other stages. The other major point made by Miller was that about 96 percent of the cases reaching the circuit courts were disposed of without undue delay. Miller relied upon a study made by Remmlein for this statistic.49

Madeline Remmlein conducted a study50 in an effort to evaluate Professor Griswold's charges. Her study covered a five-year period (October, 1939, to September, 1944) of civil tax litigation of both the Supreme Court and the United States Circuit Courts of Appeals. Remmlein's method of study was to review the Supreme Court decisions for those cases involving civil tax issues and categorize them so as to isolate the conflict cases from the others.51 Then she traced both sets of cases back to their origin to develop a comparison of the time required in the various stages for each class of cases.

One finding of her study was that there were long delays only in unusual cases.52 Remmlein interpreted the data to indicate a fallacy in the charge that

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conflicting circuit court decisions delayed settlement of tax controversies. She also took exception to the charge that there is a lack of certainty in circuit court decisions. To support her contention she points out that only 3.8 percent of the circuit court decisions were reviewed by the Supreme Court because of a conflict and 1.5 percent for other reasons. From this she concluded that almost 95 percent of all circuit court decisions are final and thereby certainty reigns. Although her figures are undoubtedly accurate, she seems to have missed the issue in the lack-of-certainty charge. Obviously, the Supreme Court can only review a small percentage of all cases—either a vain attempt, or a successful one, in reviewing a substantial percentage of cases would frustrate the objectives of the judicial system. The matter is not a lack of certainty in those particular cases, but a lack of certainty in those cases subsequently arising that contain the same issues. Remmlein conducted another study for a three year period immediately following the period of the first study. This latter study merely supported the former, but it did indicate a possible trend toward a greater total elapsed time until final settlement of a case.

53 Ibid.
54 Ibid.
New Comments in the Fifties

One article published in 1953 is interesting because it was written by a judge of the Court of Appeals for the Ninth Circuit. After careful consideration Judge Walter Pope concluded that the objections to the Court of Tax Appeals by the American Bar Association could be reduced to one substantial objection—a fear that the creation of a new court with seven or nine members to be appointed at one time by a single appointing authority would result in the appointment of judges of doubtful judicial qualifications and ability because of political considerations. However, he noted that the great weakness shown to exist by Traynor and Griswold at the circuit court level was still in existence. Judge Pope then set forth a plan for appointing members to a Tax Court of Appeals which would avoid the above objections, and he called upon others to improve his recommendations.56 After expressing the belief that for prospective use a "right" rule does not exist and that one answer is as good as any other for future guidance, he, too, adopted the words of Justice Brandeis in tax matters: "It is more important that the applicable rule of law be settled than that it be settled right."57


57 Ibid., pp. 275, 277.
Peter Nevitt conducted a cursory examination of the results of the appeals from the Tax Court for the four years 1952 through 1955 to all of the courts of appeals. While he acknowledged the danger in making conclusions from a comparison of the number of cases affirmed with the number reversed without particular knowledge of each case, he suggested that taxpayers had a good chance of obtaining a reversal of an adverse Tax Court case (33.7%) and that some circuit courts had a tendency to favor taxpayers, while others favored the government. Such a high percentage of reversals indicated the lack of uniformity in tax decisions. Nevitt recommended increased review of circuit court decisions by the Supreme Court as the most practical way of achieving uniformity.\(^5^8\)

**Comments in the Sixties**

The early 1960's found several writers again discussing a Court of Tax Appeals. All were in favor of such a court.\(^5^9\) One study was made by Professor Lowndes. Lowndes' thesis was simple: "It is time to rescue the Supreme Court from federal taxation; it is time to rescue

\(^{58}\)Nevitt, pp. 311-316.

federal taxation from the Supreme Court."\(^{60}\) In support of his contention Professor Lowndes first reviewed all of the federal income, estate, and gift tax cases going to the Supreme Court since ratification of the Sixteenth Amendment through the 1959 term. He classified the 618 cases into the three categories of criminal cases, constitutional cases, and construction cases. The purpose of this classification was to evaluate whether or not the Supreme Court should retain jurisdiction in tax cases.\(^{61}\)

Professor Lowndes found that only 22 of the cases were criminal cases involving income tax evasion. He believed that since these cases generally involved elements of criminal law rather than technical interpretation of tax laws, the Supreme Court should continue jurisdiction in order to protect the rights of defendants. Twenty-two cases over approximately fifty years should not be considered a heavy burden for the Court. Furthermore, the constitutional cases upholding the tax laws have served to substantially reduce the probability of a significant number of constitutional issues. Since the Supreme Court already has the power to make final determinations in constitutional cases, it should continue to do so regardless of whether they come up through the present system or

\(^{60}\)Lowndes, p. 222.

\(^{61}\)Ibid., p. 223.
through a Court of Tax Appeals. 62

The cases involving the construction of statutes constitute a preponderance of the cases reaching the Supreme Court. An examination of the class prompted Lowndes to comment that such cases are characterized by triviality and futility. Part of the problem was explained as follows:

Apart from exposure to the constant changes of Congressional nullification, Supreme Court cases construing the federal income tax make poor precedents because they frequently involve the application of a statutory standard to a specific factual situation rather than the formulation of a legal rule of general application. 63

His final conclusion was that no reason could be found to have the Supreme Court exercise jurisdiction in these cases instead of a Court of Tax Appeals. 64

Louis Del Cotto conducted a study similar to the one undertaken by Remmlein. Professor Del Cotto's study covered a five year term beginning in October, 1955--16 years after the beginning of the period investigated by Remmlein. 65 This latter study is interesting because the passage of time affords a better answer to some questions raised by the earlier one. A specific example is the question as to whether or not a trend for increasing

62 Ibid., p. 224.
63 Ibid., p. 226.
64 Ibid., p. 257.
65 Del Cotto, p. 12.
the total required time until final settlement of tax cases had developed at the end of the Remmlein study, or whether the increase was the result of a random aberration.

Del Cotto found that the median time for a tax case until final disposition by the Supreme Court had increased by about one year over the earlier study. In the later study the median time was eight years, four months, and nineteen days. He classified all these cases into either the conflict group or the non-conflict group and found a median time of eight years, ten months, and thirteen days for the conflict cases and seven years, eight months, and seventeen days for the others. In comparison to the Remmlein study, the time for the conflict cases has increased considerably (from 7.6 years) while the time required for the others has decreased slightly (from 8.25 years). 66

Professor Del Cotto was quite interested in time periods which he called the "conflict-developing period" 67 and the "conflict-resolving period" 68 as well as the total

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66 Ibid., p. 16.
67 Ibid., p. 24. This period was defined as: "... the time between the first decision of a circuit court of appeals deciding a particular issue and a later decision of another circuit which is reviewed by the Supreme Court, because it conflicts either with that first decision or some intervening court of appeals decision on that issue."
68 Ibid., p. 25. This period is defined as: "... the total time an issue remains unsettled because of the possibility of review by the Supreme Court upon the development of a conflict."
time until the final determination of a case. In his study the conflict-resolving time had increased to 5 1/3 years from the 2 3/4 years of the earlier study. His awareness of the need for rapid, final answers on questions that affect planning by taxpayers and the daily administration of revenue laws led him to make the value judgment that even 2 3/4 years was too long for a tax question to remain in doubt. He commented:

The evidence clearly demonstrates that conflicts do not discriminate as to whether they will develop slowly or rapidly depending on the complexity of the issue, or the number of taxpayers it affects. Conflicts involving the simplest issues, with the most widespread effect, can develop very slowly . . . or very rapidly . . . . And issues involved in slow-developing conflicts are generally decided many times in the courts of appeals before resolution by the Supreme Court. This is not an encouraging situation, especially since conflict-developing periods are becoming substantially longer.69

**Present Status**

The study by Professor Del Cotto is the latest significant work on the judicial system in tax cases. The relatively recent comments by Senator Long and the publicity given by the various new agencies in regard to fairness in tax matters, as the Tax Reform Act of 1969 became part of the law, indicate dissatisfaction still exists. In

69Ibid., p. 31.
a similar vein another circuit court of appeals judge has spoken out on the judicial system in general. He notes that increasing legislation on civil rights and social welfare is also constantly increasing litigation and the burden upon the courts. Rather than calling for more judges, he calls for advanced techniques to produce more and shorter opinions and new methods that simplify and expedite the process of resolving issues because, "Justice delayed, amounts in many cases, to no justice at all--the parties are dead, conditions have changed, opportunities are lost, and time, our most valuable asset, is wasted." 

Collectively, all of these writers reflect the concern of American society for equity in the federal tax system. More particularly, the controversy over the proposal for a single Court of Tax Appeals represents this concern in an important subset of the tax system--the judicial administration of cases. The present study reflects this writer's concern for equity in an even smaller subset of the latter one--the accumulated earnings tax cases. However, it is expected that this study will bear directly upon the issue concerning a Court of Tax Appeals.

71 Ibid., p. 31.
THE METHODOLOGY

All of the aforementioned research on conflicting cases was done vertically from the top to the bottom. Such an approach serves two purposes: (1) It substantially reduces the number of cases that must be reviewed due to the inherent filtering of cases that takes place before a case can reach the Supreme Court; and (2) the problem of classification is solved because the Supreme Court generally states whether or not the case is being reviewed due to a conflict. A particular advantage of this approach is that all of the areas of taxation that contain a conflict have a possibility of being reviewed by the Supreme Court. Thus, one is somewhat assured that his study will cover a broad range of tax issues. Unfortunately, this approach has some severe inadequacies. Due to the manner in which cases are selected for review by the Supreme Court, one has no way of knowing whether or not the cases selected are actually representative of all the types of conflicts that exist. One can only assume that they are. More importantly, one has no idea as to the extent of the existence of conflict cases at the trial court level.

This study is predominantly one involving a horizontal analysis at the level of original jurisdiction in tax cases--the Tax Court, the United States District Courts, and the Court of Claims. Vertical analysis is
is made from this level to the Supreme Court in contrast to the earlier studies. The court decisions constitute the original data for the study. The sample size will be the whole universe. This study has been limited as explained previously.

All of the issues in any lawsuit can be classified as either questions of law, questions of fact, or mixed questions of law and fact. The heterogeneous nature of the cases presents a considerable obstacle to a comparison based upon the final decisions. This type of comparison would be the best one possible for an evaluation of equity, but the constraint of reasonable classification is extremely difficult, if not impossible, to satisfy in accumulated earnings tax cases. However, cases may be examined for the existence of a given issue. Cases having a common issue may be compared for the judicial treatment of that issue and satisfy the criteria of equity and reasonable classification as to that issue. This method of comparison could be expected to result in a comparison of issues outside of the context of the entire case. Consequently, an evaluation of equity in specific cases based upon a comparison of the judicial treatments of a single issue would be as questionable as a similar evaluation based upon a comparison of cases having heterogeneous issues and facts in violation of the principle of reasonable classification. Yet, a comparison of the judicial treatments of a specific issue in conformity to equity and reasonable classification
under an assumption of ceteris paribus does have a sig-
nificant advantage. The advantage is that an objective
comparison may be made. By deduction from this type of
comparison within a framework of the acknowledged signi-
ficance of the specified issues by the courts, a general
evaluation of equity may be made for the past and for the
future, too. Perhaps the validity of this general evalu-
ation is somewhat based upon this reasoning: If cases
could be found that were compatible with the requirements
of reasonable classification, but with contrary results,
the logical explanation would be that the judicial atti-
tudes toward the given issues and facts were different.
The objective comparison described above permits judicial
attitudes to be ascertained for an evaluation of equity,
and it is utilized in this study.

ORGANIZATION OF THE STUDY

CHAPTER I has presented an introduction to the
study, the problem, definitions of some terms, a review
of the literature and the methodology to be utilized.
The presentation of the problem included a statement
thereof and an explanation of the importance and scope
of the study. The terms equity, reasonable classification,
and incident have been defined specifically for this
study. The review of the literature noted various propo-
sals and criticisms relevant to the present study.
CHAPTER II presents the development of two substantive rules of law. The legislative history is briefly reviewed for applicable provisions and potentially significant changes. This chapter investigates the two rules of law that involve "purpose" and its relationships to the "reasonable needs of the business."

CHAPTER III investigates the development of sections 534 and 535. Particular attention is given to the early controversy that surrounded the judicial treatment of section 534. This chapter traces the development of section 534 through the cases litigated since the early controversy. Also, the chapter presents the courts' increasing awareness of section 535. Finally, a proposal is presented for the interaction of the two sections.

CHAPTER IV examines the application of accounting concepts in the determination of the reasonable needs of the business. Particular attention is given to the judicial misunderstanding of basic accounting concepts. The specific accounting concepts which are analyzed are accumulated earnings, depreciation, working capital, and appropriation of retained earnings. In addition to the examination of these concepts, an accounting rationale to support the courts' approach to analyze the reasonableness of accumulations is presented.

CHAPTER V is an investigation of the final determinations in the accumulated earnings tax cases. Tables are presented with the decisions classified by various
jurisdictions. Although such tabulations violate the principle of reasonable classification, the results still provide limited insight into judicial attitudes.

CHAPTER VI contains the summary and conclusions for this study. The conclusions include an evaluation of past equity, an evaluation of future equity, and recommendations. The recommendations are based upon previous recommendations and criticisms examined with regard to the results of the present study.
CHAPTER II
THE DEVELOPMENT OF TWO RULES OF LAW

INTRODUCTION

The ultimate step in evaluating equity would be to compare cases in which the facts conform to the constraint of reasonable classification. If one assumes that the facts in all of the accumulated earnings tax cases are exactly alike, one would expect the same outcome in all cases because every case arising during a specified time interval would be governed by the same Internal Revenue Code provisions. This expectation is contingent upon the Code being interpreted exactly the same in each case. If the Code is not interpreted exactly the same, the results in the cases might not be the same—a potentially inequitable result.

In accumulated earnings tax cases the applicable Code sections have not been interpreted the same, and the different constructions have been noted. A presentation

of the different interpretations is sufficient to establish the fact of their existence. However, such presentations do not reveal the interplay between the trial courts and the appellate courts. Also, they do not reveal the extent of their adoption by the trial courts. This chapter traces the full development of two rules of law that are essential to an evaluation of equity in accumulated earnings tax cases. The two rules of law to be considered are: (1) the definition of "purpose," and (2) the effect of a determination of the "reasonable needs of the business" upon "purpose."

LEGISLATIVE HISTORY

The first personal income tax statute passed after the Sixteenth Amendment was ratified contained the original accumulated earnings tax provision. However, instead of imposing the tax upon the corporation, Section II(A)(2), 38 Stat. 166 imposed the tax upon the shareholders of any corporation "formed or fraudulently availed of for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed . . . ." One should note that the word "fraudently" modifies "availed of." A provision was made that accumulations beyond the reasonable needs of the business "shall be prima facie evidence of a fraudulent purpose to escape
such tax . . . . 2

In the 1918 Act the modifier "fraudently" was omitted. 3 The Revenue Act of 1921 shifted the burden of the accumulated earnings tax from the taxpayer to the corporation, and the accumulated tax rate was 25 percent as seen below:

Sec. 220. That if any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 25 per centum of the amount thereof, which shall be in addition to the tax imposed by section 230 of this title . . . . The fact that any corporation is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the tax in such case unless the Commissioner certifies that in his opinion such accumulation is unreasonable for the purposes of the business . . . . 4

Section 220 of the Revenue Acts of 1924 and 1926 and Section 104 of the Revenue Acts of 1928 and 1932 are essentially identical. Although the arrangement of the wording in this series of acts differs somewhat from the Revenue Act of 1921, the most significant change appears to be an

2Tariff Act of 1913, 38 Stat. 167. One should note "a" preceding "fraudulent purpose."

3Revenue Act of 1918, Sec. 220, 40 Stat. 1072.

4Revenue Act of 1921, Sec. 220, 42 Stat. 247.
increase in the accumulated tax rate to 50 percent beginning with the Revenue Act of 1924.\(^5\)

The 1934 Act excluded personal holding companies from the accumulated earnings tax, but they became subject to a tax on undistributed income regardless of the purpose for the accumulation. Another change was a decline in the 50 percent rate to graduated rates of 25 and 35 percent. Finally, the word "escape" was changed to "avoid" in the provision for the prima facie evidence clause.\(^6\)

The 1936 Act was essentially similar to the 1934 Act. However, the Revenue Act of 1938 made a change in the prima facie evidence rule. A review of the 1921 Act quoted above shows that the prima facie evidence provision applied to both holding companies and operating companies that accumulated earnings beyond the reasonable needs of the business. The 1938 Act removed the latter group from the clause and provided for it as follows:

Sec. 102(c) Evidence Determinative of Purpose. The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary.

In this evidentiary clause "purpose" is preceded by "the," while in the prima facie evidence clause "purpose" is still preceded by "a" as in the 1921 Act. This is the second


\(^6\)Revenue Act of 1934, Sec. 102, 358, 48 Stat. 680, 751.
time that this difference in the articles used before purpose has been pointed out. A general reading of the statutes seems to indicate that the change was most likely inadvertent. However, one may argue that the difference was intentional. The Internal Revenue Code of 1939 contained provisions similar to those in the Revenue Act of 1938. The next substantial changes came in the Internal Revenue Code of 1954.

The significant changes in the 1954 Code included a new burden of proof provision for Tax Court cases, a minimum and general credit against the tax, and the express extension of the reasonable needs of business to include the reasonably anticipated needs of the business. Thus one can see that there has been no significant change to indicate a congressional intent to alter the original meaning of purpose. Instead, the changes have been to affect the application of purpose indirectly through changes in the "reasonable needs of business" and burden of proof provisions.

The brief legislative history above reveals the close relationship of "purpose" and "reasonable needs of the business." This relationship is examined in a later section. Since this writer believes that the relationship

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8Internal Revenue Code of 1954, sections: 531-537.
can be best understood after one has a full understanding of the various views of "purpose," the next section examines the development of "purpose" in detail.

THE DEVELOPMENT OF PURPOSE

An extrication of a judicial view of purpose from the greater relationship is not always feasible. In those instances, the reader should concentrate his attention on the definition of purpose. The two early cases below illustrate this problem. In United Business Corporation, which was promulgated in 1930, the calendar year 1921, governed by Section 220 of the Revenue Act of 1921, was under scrutiny. The Board of Tax Appeals grappled with the statute and expressed this opinion:

The emphasis in the statute is placed upon the purpose, and if this purpose clearly appears, the corporation is subject to the tax, whether the accumulation be large or small. Accumulations in excess of the needs of the business are evidence of the purpose but are not necessary to subject the corporation to the tax.9

Taxes were collected in R.C. Tway Coal Sales Co. v. U.S. for the years 1922 and 1923 under the 1921 Act. However, this District Court viewed the matter as follows:

Even if it should clearly appear that the accumulations were in excess of the reasonable needs of the corporate business, section 220 would not apply unless it further appears that the accumulations were intentionally permitted for the

9United Business Corp. of America, 19 BTA 809, 828 (1930).
express purpose of enabling the stockholders to evade the surtax. 10

One may find it difficult to blot out the "reasonable needs of the business" and concentrate on "purpose." If one is able to do so, then in the former quote the idea is that the tax applies if the purpose "clearly appears," and in the latter quote it applies if the accumulations were for the "express purpose."

Certainly an express purpose would be the one that clearly appears. Yet "express" can also have a meaning that goes beyond "clear" to indicate limitation. Express can mean: "Of a special sort; . . . Adapted to or intended for a particular purpose." 11 If this shade of difference in meaning seems to be too fine, then another reading in the full context of the quotes shows the obvious attitude of the district court to be more reluctant in applying the accumulated earnings tax than the Board. Thus, inferentially, the Board would be apt to find a clear purpose existing with other legitimate business purposes, while the district court would be disposed to conclude that the prohibited purpose did not exist if other legitimate business purposes were present. This latter construction would be most favorable to taxpayers.

10 12 AFTR 1073, 1076 (DC, Ky.; 1933), 3 F. Supp. 688.

One should note that in the former case the Board held for the government and that in the latter case the district court held for the taxpayer. Furthermore, upon appeal both decisions were affirmed.\(^\text{12}\)

Another early district court decision implied that the prohibited purpose could exist with legitimate business purposes and that if there was "a" purpose or "any" purpose the tax would be applicable. This deduction was required because the court did not deal directly with any of the possible constructions of purpose. In contrast to the cases above, the district court stated in referring to the taxpayer:

> It took no action whatsoever for the purpose of preventing the imposition of surtaxes upon its shareholders . . . . Neither the plaintiff nor its officers or directors entertained at any time a purpose to avoid the imposition of surtaxes upon its shareholders.\(^\text{13}\)

Any illegal purpose is further refuted by the fact . . . .\(^\text{14}\)

I am of the opinion . . . that neither the petitioner nor its officers entertained a purpose to avoid the imposition of surtaxes upon its shareholders. Accordingly, it follows that the petitioner was not formed or available of . . . for the purpose of preventing the imposition of the surtax upon its shareholders. . . .\(^\text{15}\)

\(^{12}\)11 AFTR 1373 (2 Cir. 1933); 15 AFTR 189 (6 Cir. 1935).


\(^{14}\)Ibid., p. 60.

\(^{15}\)Ibid., p. 61.
A direct, positive adoption of the "a" or "any" purpose construction for the purpose would normally lead one to conclude that the court's position was the most unfavorable one possible for the taxpayer. Should an indirect adoption of the same interpretation usually lead to the same conclusion? One would think so. Yet the approach evidenced here resulted in a district court decision just as favorable to the taxpayer as the preceding district court decision by negating this unfavorable construction of purpose. However, not all district court decisions are favorable to taxpayers in either legal interpretation or factual determination.

The Beim Company was found to be a holding company, and the tax was assessed for the years 1932 and 1933. District Court Justice Nordbye took the position that the evidence indicated the primary purpose of the corporation was to keep dividends from going to the shareholder, Mr. Beim. In another case a district court acknowledged the Board's view in United Business while holding against the taxpayer.

In National Grocery Company the Board found as

16. Beim Co. v. Landy, 26 AFTR 1189, 1195 (DC, Minn.; 1939).


18. 35 BTA 163, 167 (1936).
a fact that earnings had been accumulated far beyond a corporation's reasonable business needs. The Board formed the opinion that the prima facie evidence of purpose resulting from this fact and the statute had not been rebutted. Upon appeal the Third Circuit substituted its judgment for that of the Board in handing down a reversal. On the matter of purpose this appellate court found proof that the dominant purpose for the accumulation was to expand the size of an already large grocery store chain. The dissenting opinion pointed out that such purpose could exist with the proscribed purpose. The United States Supreme Court granted certiorari and reversed the Third Circuit for exceeding its limited power of review in substituting its judgment for that of the Board. However, the contrary views of the majority and dissenting opinions on purpose were ignored.

Slightly more than a year before Beim, the Board had a holding company case before it. The R. L. Blaffer and Company case was promulgated in 1938 for fiscal years ending in 1932, 1933, and 1934. On this occasion the Board took an especially strong position in evaluating the prima facie evidence rule with the purpose as follows:

Drastic as the tax may be, the statute clearly

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expresses the legislative intent to apply it to a mere holding or investment corporation unless the corporation succeeds in establishing its purpose to be wholly other than that of preventing surtax upon its shareholders—not only that there was another purpose, but that there was a complete absence of the disapproved purpose. Obviously, a holding or investment corporation may be formed or availed of for several purposes, but it cannot escape this tax unless it proves that it had no purpose to enable the escape of surtax. 21

The First Circuit examined the Board's position in Blaffer and commented in Chicago Stock Yards.

Perhaps this is too strong a statement; but at least it is clear that section 104 would apply if in the totality of reasons which induced the continuing of the accumulation the forbidden motive of surtax avoidance played a substantial part. 22

This case also went to the Supreme Court after the Circuit reversed the Board. Again, the Supreme Court reinstated the Board's decision. Without taking a positive position on the correct interpretation of purpose the Supreme Court did say:

A corporate practice adopted for mere convenience or other reasons, and without tax significance when adopted, may have been continued with the additional motive of avoiding surtax on the stockholders. The Board's conclusion may justifiably have been reached in the view that, whatever the motive when the practice of accumulation was adopted, the purpose of avoiding surtax induced or aided in inducing the continuance of the practice. 23

This passage was also quoted by the Second Circuit as it

2137 BTA 851, 856 (1938).
22Chicago Stock Yards Co. v. Commissioner, 29 AFTR 1013, 1014 (1 Cir. 1942).
23Helvering v. Chicago Stock Yards Co., 30 AFTR 1091, 1094 (1934), 318 U.S. 693.
rejected the dominant purpose definition in 1934.\textsuperscript{24} Five years later the Tenth Circuit adopted a test which seems slightly different in effect than this view. The Court said, "Such purpose need not be the sole purpose behind the accumulation. It is sufficient if it is one of the determining purposes."\textsuperscript{25} The Eighth Circuit\textsuperscript{26} adopted the same test as did several district courts.\textsuperscript{27} The word "determining" creates a test that requires more than just the one or any purpose test, but less than is required by the primary or dominant purpose test. In other district court cases the jury has been charged with the one purpose test.\textsuperscript{28}

The Blaffer case apparently represents a crystallization of the Board's position on the subject as that view.

\textsuperscript{24}Trico Products Corp. v. Commissioner, 31 AFTR 394, 396 (2 Cir. 1943).

\textsuperscript{25}World Publishing Co. v. U.S., 37 AFTR 150, 153 (10 Cir. 1948).

\textsuperscript{26}Kerr-Cochran, Inc. v. Commissioner, 1 AFTR 2d 1109 (8 Cir. 1958).


was cited approvingly in several subsequent decisions.\textsuperscript{29} However, almost fifteen years later the Tax Court made some digression from the above view in \emph{Gazette Telegraph Company}.\textsuperscript{30} In \emph{Gazette} the Tax Court said: "There were bona fide business reasons . . . . We cannot find on the facts that the dominant motive in formation of petitioner was to avoid surtax."\textsuperscript{31} This departure seems to be limited to this particular case. Yet it was another six years in \emph{Young Motor Company} before this Court expressly reaffirmed its former position.\textsuperscript{32}

In remanding the \emph{Young Motor Company} case, the First Circuit Court observed comments in the Tax Court's opinion that preventing the imposition of the surtax upon stockholders was "one" of the taxpayer's purposes and that the accumulated earnings tax would apply even though legitimate business purposes could justify an accumulation of earnings. In finding the prohibited purpose the Tax Court seemingly attributed heavy weight to the taxpayer's knowledge of the tax results of accumulating earnings. The First Circuit then concluded:

\textsuperscript{29}Mead Corporation, 38 BTA 687, 697 (1938); Trico Products Corporation, 46 BTA 346, 374 (1942); Whitney Chain & Manufacturing Co., 3 TC 1109, 1120.

\textsuperscript{30}19 TC 692 (1935).

\textsuperscript{31}Ibid., p. 707.

\textsuperscript{32}32 TC 1336, 1344-45 (1959).
The statute does not say "a" purpose, but "the" purpose. The issue is not what are the necessary, and to that extent contemplated consequences of the accumulation, but what was the primary or dominant purpose which lead to the decision . . . . The Tax Court's test was altogether too favorable to the government.  

Thus this Court changed the wording that it used previously in *Chicago Stock Yards*. An interesting contrast to this value judgment was given by the Fifth Circuit in *Barrow Manufacturing Company*. There the Court found no error in a failure of the Tax Court to apply the primary or dominant purpose test and said,

> The utility of the badly needed presumption arising from the accumulation of earnings or profits beyond the reasonable needs of the business is well nigh destroyed if that presumption in turn is saddled with requirement of proof of the primary or dominant purpose of the accumulation.

This issue was presented in *Donruss Co. v. U.S.* to the Sixth Circuit. In that case the District Judge had refused to clarify the interpretation of purpose. Instead, he insisted upon giving only the exact statutory wording in his charge to the jury. The Circuit Court believed that the charge in its entirety might have induced the jury to think that tax avoidance would have to be the only purpose in order to assess the accumulated earnings tax. The Sixth Circuit concluded that "tax avoidance must

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33 *Young Motor Co., Inc. v. Commissioner* 6 AFTR 2d 5350 (1 Cir. 1960), 281 F. 2d 488.

34 *Barrow Manufacturing Co., Inc. v. Commissioner* 8 AFTR 2d 5330, 5333 (5 Cir. 1961), 294 F. 2d 74.

35 20 AFTR 2d 5505 (6 Cir. 1967).
be the dominant, controlling, or impelling motive behind an accumulation in order to impose the accumulated earnings tax."

The Supreme Court granted a petition for certiorari by the Government due to the conflict among the Circuit Courts of Appeals. In reaching a decision the Supreme Court examined the legislative history in detail including various committee reports in an attempt to discern the intent of Congress. The "one of the purposes" test was adopted. A part of the Court's analysis follows:

Respondent would have us adopt a test that requires that tax avoidance purpose need be dominant, impelling, or controlling. It seems to us that such a test would exacerbate the problems that Congress was trying to avoid. Rarely is there one motive, or even one dominant motive, for corporate decisions. Numerous factors contribute to the action ultimately decided upon. Respondent's test would allow taxpayers to escape the tax when it is proved that at least one other motive was equal to tax avoidance. We doubt that such a determination can be made with any accuracy, and it is certainly one which will depend almost exclusively on the interested testimony of corporate management. Respondent's test would thus go a long way toward destroying the presumption that Congress created to meet this very problem.

Finally, we cannot subscribe to respondent's suggestion that our holding would make purpose totally irrelevant. It still serves to isolate those cases in which tax avoidance motives did not contribute to the

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36 Ibid., p. 5500.
decision to accumulate. Obviously in such a case imposition of the tax would be futile. In addition, "purpose" means more than mere knowledge, undoubtedly present in nearly every case. It is still open for the taxpayer to show that even though knowledge of the tax consequences was present, that knowledge did not contribute to the decision to accumulate earnings. 37

Although this 1969 decision finally laid the matter to rest, the case contained one final touch of irony in the dissent. The surprising thing is not that Justices Harlan, Douglas, and Stewart dissented from the construction of purpose by the majority, but that they suggested yet another test as follows:

... the jury should be instructed to impose the tax if it finds that the taxpayer would not have accumulated earnings but for its knowledge that a tax saving would result. This "but for cause" test would be consistent with the statutory language... 38

Thus, after almost four decades, a clear interpretation of purpose became the settled law of the land.

In spite of the various interpretations of "purpose" presented in the preceding cases, a view represented by a significant proportion of the cases has not been mentioned. That view is the lack of any stated construction of purpose. These cases merely use the language of the statutes in finding that the purpose did or did not exist. Typically, the opinions in these decisions devoted a substantial amount of attention to the matter of the reasonable needs

38 Ibid., p. 69-425.
of the business. One may now consider the effect of the "reasonable needs of the business" upon the "purpose." This relationship will be considered without regard to any specific interpretation of "purpose."

THE RELATIONSHIP OF THE REASONABLE NEEDS OF THE BUSINESS TO THE PURPOSE

As a prelude to the investigation of this relationship, one might consider the ways that these two factors may be jointly or severally utilized in reaching a decision in an accumulated earnings tax case. Table 1 sets out the eight paths in diagram form. Although there are eight possibilities in an abstract consideration of the matter, once an interpretation of the relationship is made only some of the paths are available to reach a decision. Each time a different interpretation of the relationship is introduced by a court opinion the appropriate paths required will be noted.

Returning to the early cases, one can see that this relationship was the focal point of controversy. One will recall this part of an earlier quote from the Board of Tax Appeals in United Business Corporation, "Accumulations in excess of the needs of the business are evidence of the purpose but are not necessary to subject the corporation to the tax."\[19 BTA 809, 828.\] The Court also said, "Although the
TABLE 1

The Joint and Several Ways that the Issues of the "Reasonable Needs of the Business" and the "Purpose" May Be Related

<table>
<thead>
<tr>
<th>WERE ACCUMULATIONS BEYOND THE REASONABLE NEEDS OF THE BUSINESS?</th>
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<tr>
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<th>WERE ACCUMULATIONS FOR THE PROHIBITED PURPOSE?</th>
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</thead>
<tbody>
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</tr>
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<th>THE REASONABLE NEEDS OF THE BUSINESS</th>
<th>WERE ACCUMULATIONS FOR THE PROHIBITED PURPOSE?</th>
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<tbody>
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<td>No (7)</td>
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<tr>
<td>Yes.</td>
<td>Yes (8)</td>
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</tbody>
</table>
statute provides that certain facts shall be **prima facie** evidence of the purpose, the same purpose may appear from other facts." The Board found the purpose without making a determination of the reasonable needs of the business. Thus, this decision indicates paths seven and eight are to be followed.

This position on the reasonable needs of the business was the chief subject of the dissenting opinion. Judge Trammell pointed out that this interpretation would apply the accumulated earnings tax, not only without consideration of reasonable business needs, but also to small accumulations. He believed that the issue of purpose did not become important until accumulations surpassed reasonable business needs. He stated:

The real question for consideration, in my opinion, is whether or not the corporation was formed or availed of for the purpose of preventing the imposition of the surtax upon the stockholders through the medium of permitting the profits to accumulate beyond the reasonable needs of the business. In my opinion both intent or purpose and an overt act are necessary to bring a corporation within the penal provisions, and the overt act is the accumulation beyond business needs, not simply an accumulation, except in a case where it is shown that a corporation is formed for the prohibited purpose.

This view of the relationship would require paths one,

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40 **Ibid.**

41 **Ibid.**., p. 833.

42 **Ibid.**., p. 837.
five, and six to be taken.

The District Court in \textit{R.C. Tway} did not have as much difficulty with this matter as the Board did, but the District Court still claimed to have given the matter adequate attention in this statement:

A careful study of section 220 discloses that before there can be an assessment under its provisions, there must be not only an accumulation of gains and profits beyond the reasonable business needs of the corporation, but such accumulation must have been for the purpose to evade the payment of surtaxes.

Upon the appeal of \textit{United Business Corporation} the Second Circuit explicitly considered both constructions of the relationship and concluded that such accumulations were not necessary in order to find the purpose. They were deemed to be presumptive evidence of the purpose. The Court commented upon the relationship in this manner:

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, but the test remains the state of mind itself, and the presumption does no more than make the taxpayer show his hand.

When \textit{R.C. Tway} was appealed, the Sixth Circuit acknowledged the soundness of the Second Circuit's view and said:

The practical application of the interpretation may, however, in most circumstances be of little importance.

\footnote{12 AFTR 1073, 1076.}

\footnote{11 AFTR 1373, 1374.}
The condemned purpose in the forming or utilization of corporations described in the section is the avoidance by stockholders of surtaxes. This purpose may be proved unaided by presumption, but the fact that the surplus is not unreasonably large in respect to the needs of the corporation's business is repugnant to the existence of such purpose, and, while not conclusive, must be accepted as substantial evidence in denial of proofs or inferences that it exists.45

This appeal indicates that paths three, four, five, and six should be followed.

In fairness to the rejected construction it should be noted that Article 352, Regulations 45, adopted for section 220 of the Revenue Act of 1918 presented the test and the presumption as though both were required. Justice Trammell presented this and other support for his own position.46 At this point the two constructions seem to be mutually exclusive. That is, the reasonableness issue is a condition that must be met before the purpose becomes an issue, or purpose is an issue, even though accumulations are reasonable. The two views are not compatible.

When this matter came before the Third Circuit in the National Grocery Company appeal, that Court's position was difficult to reconcile with one or the other of the preceding views. The Court said:

The taxes here involved are for the year 1930, and from the above-quoted terms of the law it is clear that Congress did not force the distribution with penaliza-

45 15 AFTR 189, 190.
46 19 809, 833-39.
tion of all corporate profits but only where the profits 'are permitted to accumulate beyond the reasonable needs of the business.' Such being the conditions warranting taxation, it follows that the basic question is whether the profits here involved were accumulated beyond the reasonable needs of its business. If this basic fact is established, then, and then only, is such accumulation by the statute made 'prima facie evidence of a purpose to escape the surtax.'

Until the last sentence above, the distinct impression is given that both elements are required before the tax can be levied. Then, as if there was no way around the presumptive evidence aspect of the statute, the Court recognized it as such. Did this Court deliberately combine the two views discussed above? That is, did the Third Circuit intend to make accumulations beyond the reasonable needs of the business a condition precedent to a finding of the purpose, and then, upon an affirmative showing of this element, also make this element presumptive evidence of the purpose? The apparent inconsistency is an illusion. The two views are incompatible when the accumulations do not exceed the reasonable needs of the business, but are compatible once accumulations become excessive.

In the original decision eight members of the Board of Tax Appeals united to render a decision in favor of the government while seven members joined in a dissent. The disagreement was in weighing the evidence. The dissenters agreed with the majority and the Second Circuit

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4720 AFTR 347, 348.
Upon appeal the majority of the Third Circuit agreed with the dissent below as to the result, but not as to the law. Thus the Third Circuit adopted an interpretation of law at odds with that of the Second and Sixth Circuits. A dissent on appeal was in favor of the pure presumption construction. The Supreme Court reversed the Third Circuit in this case without discussion of this issue although the evidentiary provision, section 104(b), was referred to as a "presumption."49

In the Chicago Stock Yards case the First Circuit adopted the presumption construction of the Second Circuit, but reversed the Board on other grounds.50 The Supreme Court reversed the First Circuit to reinstate the Board's judgment in favor of the government. This time the Supreme Court expressly acknowledged the existence of the issue, but said: "We find it unnecessary to consider this contention, since we think the Board's decision may be supported apart from any presumption arising under the Act."51

In some subsequent cases the views of the courts

48 35 BTA 163, 167-72.
49 20 AFTR 1269, 1275.
50 29 AFTR 1003, 1016-19.
51 30 AFTR 1090, 1093.
on this relationship are much more difficult to determine. For example, if phraseology is used in a case in one place to indicate only the presumption construction, but in another place phraseology is used to indicate the reasonable needs of the business is determinative of the matter, what does one conclude?

One explanation could be that this development of a shift in emphasis is due to the change in statutory language in the Revenue Act of 1938. Previously, section 102(b) of the 1936 Act provided that the fact that accumulations were beyond the reasonable needs of the business was prima facie evidence of the prohibited purpose. Section 102(c) of the 1938 Act made the same fact determinative of the purpose unless the contrary could be proven by the clear preponderence of the evidence. In United Business the Second Circuit said that the prima facie rule only made the taxpayer "show his hand."\textsuperscript{52} Given this interpretation, the later rule seemingly requires the corporation to go beyond a showing of its hand and bear the burden of persuasion upon the factual showing required. The First Circuit has twice analyzed the difference in the statutory language of the two rules and has concluded that the only effect of either provision is to increase the taxpayer's burden of proof by an

\textsuperscript{52}11 AFTR 1373, 1374.
Although this difference in language may seem great, its practical significance diminishes greatly in the face of a finding on reasonableness. One must remember the part of the comment in R.C. Tway, under the prima facie rule, that reasonableness "must be accepted as substantial evidence . . . ." This comment sounds similar to this statement under the determinative rule in Young Motor Company:

While the ultimate question here is not the reasonable needs of the business, the answer to that question may well be the single most important consideration in concluding whether taxpayer acted with a proper purpose in mind, or the proscribed one.

However one views this matter, it is still a significant step from either of these positions to an assumption that the reasonable needs of the business disposes of the purpose issue.

In a memorandum opinion of the Board of Tax Appeals the Court used appropriate statutory language in the findings of fact, but in the last paragraph of the opinion the Court seems to have disposed of the purpose automatically in deciding the issue of the reasonable needs of the business. The Court said:


54 15 AFTR 189, 190.

55 6 AFTR 2d 5350, 5353.
The evidence does not overcome the determination of respondent that petitioner was availed of for the purpose of preventing the imposition of surtax upon its shareholders by permitting gains and profits to accumulate beyond the reasonable needs of the business instead of being distributed.56

The reader can easily see the distinct difference in meaning by rereading this quote and omitting the phrase, "beyond the reasonable needs of the business." The Ninth Circuit vacated and remanded this case57 upon a misinterpretation of the significance of the Commissioner's determination. The fact that two of the appellate judges concentrated their attention upon this relationship of the burden of proof to the reasonable needs of the business is significant. The third judge wrote a brief concurring opinion in order to emphasize that a determination of purpose must be made after the reasonable needs issue has been decided.58

In Universal Steel Company the Board claimed to have considered the "whole picture" in concluding that the petitioner

... has proven by a clear preponderance of the evidence that it did not permit its earnings or profits to accumulate beyond the reasonable needs

56 Hemphill Schools, Inc., ¶42,285 P-H Memo TC.
57 Hemphill Schools, Inc. v. Commissioner, 31 AFTR 610 (9 Cir. 1943).
58 Ibid.
of the business. It follows [emphasis supplied] that it has justified the nonpayment of dividends . . . and that petitioner is not subject to the provisions of section 102."

Yet, in the next paragraph the Board found some confirmation of the absence of the purpose due to a lack of evidence that the purpose existed. In Wilson & Greene Lumber Co. the District Court adequately explained the relationship in part of the charge to the jury, but only submitted one issue to the jury as follows:

Ladies and gentlemen, in order to keep it as simple as possible, your verdict will take this form: You will find a verdict for the plaintiff if you find that the plaintiff has established that the accumulation of profits for the year 1946 was reasonably necessary for the transaction of this company's business according to the circumstances existing.

If you find it was not, then your verdict will be for the defendant. 60

For a view that contains a hedge on the matter, one may turn to World Publishing Co. v. United States. 61 There the District Court said:

When it has been determined that the failure of a corporation to distribute earnings to shareholders does not result in an accumulation in excess of the reasonable business needs of the corporation, it is not necessary to inquire into the motive and purpose of such accumulation. Upon the theory, however, that this view of the court may not be accepted, a finding has been made upon consideration of all of

60 Wilson & Greene Lumber Co., Inc. v. Shaughnessy, 44 AFTR 1259, 1265 (DC, N. Y.; 1953).
61 42 AFTR 67 (DC, Okla.; 1952).
the evidence in the case that the retention by the World in its treasury of its net earnings for 1944 was not for the purpose of avoiding the imposition of a surtax on its sole shareholder.\textsuperscript{62}

Of course this view is also compatible with the condition interpretation since the accumulations are reasonable. Other cases seem to treat the reasonable needs of business as determinative of purpose without elaboration.\textsuperscript{63} Thus, some courts seem to indicate that paths one and two are to be followed.

Some cases provide limited insight for taking that view. In Smcot Sand & Gravel Corp.\textsuperscript{64} the Tax Court noted the lack of any proof by the petitioner to contravert the presumption of purpose if accumulations should be found to be beyond reasonable business needs. The comment on the respondent was of greater interest:

\ldots respondent apparently concedes that if petitioner has shown that the surplus was not in excess of the reasonable needs of the business, nothing further is required.\textsuperscript{65}

The use of the word "apparently" indicates that such position was not expressly taken, but that the Court inferred the position from something that the respondent did or said. In a later opinion the same judge expressed

\begin{itemize}
\item \textsuperscript{62}Ibid., p. 70.
\item \textsuperscript{64}56,082 P-H Memo TC.
\item \textsuperscript{65}Ibid., p. 56-341.
\end{itemize}
a belief that both parties had litigated the case as though a determination of reasonable needs would settle the matter. A court could become confused on the relationship by looking too closely at the wording in the Commissioner's notice of deficiency to the taxpayer. Such notices have been known to associate the two issues as though they were one. But in a footnote in Smith, Inc. v. Commissioner the Ninth Circuit explained that the Commissioner's answer to the taxpayer's petition, rather than the notice of deficiency, led it to conclude that the Commissioner had based his determination of purpose upon unreasonable accumulations.

In Donruss the Sixth Circuit was faced with evaluating contradictory statements made by the trial court as to the law on the relationship. In part of the charge to the jury, the trial court stated the law to be that a determination of the reasonable needs of the business would settle the matter. However, that court also correctly explained that an accumulation beyond the reasonable needs of the business would be determinative of the purpose, unless the taxpayer proved the contrary.

68 8 AFTR 2d 5119, 5122 (9 Cir. 1961).
by a preponderance of the evidence. The Circuit Court
did not believe that the charge had misled the jury on the
issue. However, two important factors mitigate the Cir­
cuit Court's stand. First, the government's counsel
failed to object and thus was deemed to have waived the
objection. Second, the Court reversed based on the
District Court's failure to interpret purpose. 69

Although the language in some cases was confusing,
clear statements making only the presumption construction
were handed down in others. 70 In still others positive
statements were made making accumulations beyond reason­
able business needs a condition precedent to a considera­
tion of the purpose issue. 71

There is one other event that must be considered
for its impact upon this relationship. That event was
the adoption of the 1954 Code because it contained sec­
tion 535. Section 535(c) provides for a general credit
in computing the accumulated earnings tax. The gen­
eral credit is "equal to such part of the earnings
and profits for the taxable year as are retained for the

69 20 AFTR 2d 5505, 5506-7, 5510.

70 Pelton Steel Casting Co., 28 TC 153 (1957);

71 Hattiesburg Compress Co. v. U.S., 6 AFTR 2d 5012
(DC, Miss.; 1960); Harrison Bolt & Nut Co. v. U.S., 14
AFTR 2d 5360 (DC, Md.; 1964); Times Publishing Co., Inc.
reasonable needs of the business . . . ."72 Strictly construed, this provision has no direct effect upon the relationship. As set forth in the Code, it should only come into play after a determination has been made that the accumulated earnings tax is to applied. Then this credit would be considered in calculating the actual tax due. However, the indirect result of the provision is to give effect to the dissenting Board opinion in United Business Corporation and makes the majority position a rather moot view. The relevant paths for decision now seem to be one, five, and six.

Some of the cases cited previously in footnotes for the various interpretations were tried after the 1954 Code took effect. The section 535 credit was not mentioned in any of them, so one can only wonder whether it had any effect upon the positions taken. In others cases the credit definitely played a part.

In Fotocrafters, Inc.,73 a memorandum decision, the judge concluded that earnings had not been accumulated beyond the reasonable needs of the business. He acknowledged that the taxpayer still had the burden of proving an absence of the purpose and that the reasonableness of the accumulation would be a strong indication the purpose

72 Internal Revenue Code of 1954, Sec. 535(c).
73 #60,254 P-H Memo TC.
was not present. He stated further that the problem had been "simplified" due to the credit, which made the accumulated taxable income "zero."\textsuperscript{74} In other cases no consideration was given to the purpose issue due to the section 535 credit.\textsuperscript{75} This issue, however, is just beginning to reach full development. The entire matter has been clouded by the addition of section 534 at the same time. The effect of the section 535(c) credit upon the relationship of the reasonable needs of the business to the purpose is uncertain, and therefore the effect of section 534 upon all of this is also uncertain.

\textbf{SUMMARY}

The legislative history shows that there has been no significant change in the statutory language as to "purpose" since the first application of the accumulated earnings tax to corporations in the Revenue Act of 1921. However, there have been notable attempts to influence the operation of "purpose." The taxation rates have been altered several times. Personal holding companies were separately provided for in the 1934 Act. A questionable attempt was made in the 1938 Act to increase the taxpayer's

\textsuperscript{74}Ibid., pp. 60-1562-63.

\textsuperscript{75}John P. Scripps Newspapers, \textsuperscript{44} TC 453 (1965); Faber Cement Block Co., Inc., \textsuperscript{50} TC 317; Magic Mart, Inc., \textsuperscript{51} TC 775 (1969); Dielectric Materials Company, \textsuperscript{57} TC No. 61 (1972). Also, see: Sorgel v. U.S., \textsuperscript{29} AFTR 2d 70-1035 (DC, Wis., 1972).
burden of proof as to "purpose." Previously, accumulations beyond the reasonable needs of the business were prima facie evidence of the "purpose," but such a showing became determinative of the "purpose" in that Act. The Internal Revenue Code of 1954 made extensive changes in the operation of the tax. All were aimed at shifting the emphasis from the subjective test of "purpose" to the more objective test of the "reasonable needs of the business."

During a period of approximately four decades, several different interpretations of purpose were in vogue. They are, in the order of decreasing favorableness to the taxpayer, as follows:

1. The "sole" or "express" purpose test,
2. The "primary" or "dominant" purpose test,
3. The "one of the determining purposes" test, and
4. The "a," "any," or "one of the purposes" test, compatible with the "complete absence of purpose" test.

The Supreme Court settled the issue in favor of the fourth construction in 1969 in Donruss.

The development of eight possible paths for a final determination of the accumulated earnings tax has been presented. The relationship of the "reasonable needs of the business" to the "purpose" has been partially settled. However, the burden of proof under section 534 and the general credit provided under section 535(c) have
raised new questions. The influence of these two sections are considered in the next chapter.
CHAPTER III

THE DEVELOPMENT OF SECTION 534 AND ITS RELATIONSHIP TO SECTION 535

The adoption of the Internal Revenue Code of 1954 signaled the beginning of a new era in the accumulated earnings tax cases. This chapter investigates the development of sections 534 and 535 of the Internal Revenue Code in an attempt to determine their effect upon equity as defined in CHAPTER I. Section 534 governs the operation of the burden of proof in accumulated earnings tax cases before the Tax Court. Since the burden of proof is a procedural rule of law, its effect upon equity differs from substantive rules of law and offers a contrast to the preceding chapter.

Section 534 became controversial rather quickly. This chapter presents the controversy, the case development of section 534, and an inquiry into the relationship of section 534 to section 535. The criticism leveled at the Tax Court and the Commissioner is considered in the light of pertinent cases. A critical analysis will be made of this controversy and relevant cases as a basis for the development of a proposal for settling the controversy through the interaction of section 534 and section 535.
The First Level

The burden of proof in cases before the Tax Court is normally upon the taxpayer. Section 534 of the Internal Revenue Code of 1954 contains provisions whereby the burden of proving the reasonableness of accumulations for the needs of the business may be shifted from the taxpayer to the Commissioner. The conditions apply only to cases coming before the Tax Court. However, in such cases the burden of proof shifts automatically to the Commissioner unless he takes action to prevent it. The action required of the Commissioner is that he must give notice of his intent to render an assessment under section 531 before he sends a notice of deficiency. If the Commissioner takes such action, then the taxpayer is given an opportunity to shift the burden to the Commissioner in spite of the notice. In order to do so, however, the taxpayer must timely answer the Commissioner's notice with a statement of the grounds upon which he is relying to establish that earnings and profits have not been allowed to accumulate beyond the reasonable needs of the business. This statement must include sufficient facts to show the

1 Rule 32, Rules of Practice of the Tax Court of the United States.
basis for the grounds upon which the taxpayer relies.\textsuperscript{2} Thus, it is possible that some grounds (and/or facts) might be inadequate to shift the burden of proof to the Commissioner, while others would adequate, and only a partial shift in the burden of proof would result.

When compared to the basic provision that the taxpayer bear the burden of proof, the complexity of section 534 causes one to wonder why such an involved statute was enacted. The answer is that Congress was thereby attempting to eliminate the cause of various complaints. The reasons were summarized in a Senate report which agreed with the House as follows:

The poor record of the Government in the litigated cases in this area indicates that deficiencies have been asserted in many cases which were not adequately screened or analyzed. At the same time taxpayers were put to substantial expense and effort in proving that the accumulation was for the reasonable needs of the business. Moreover, the complaints of taxpayers that the tax is used as a threat by revenue agents to induce settlement on other issues appear to have a connection with the burden of proof which the taxpayer is required to assume. It also appears probable that many small taxpayers may have yielded to a proposed deficiency because of the expense and difficulty of litigating their case under the present rules.\textsuperscript{3}

The controversy arose over the effect given to section 534 by the Commissioner and the Tax Court. The typical pattern that developed was a refusal by the Tax Court to

\textsuperscript{2}Internal Revenue Code of 1954, section 534(a), (b), and (c).

rule positively on whether or not the burden of proof had shifted to the Commissioner. This refusal was effected in several ways.

In *Pelton Steel Casting Co.* the Tax Court found that it was not necessary to determine whether or not accumulated earnings were beyond the reasonable needs of the business as other evidence was sufficient to show the presence of the prohibited purpose. The Court further stated that even if the matter (section 534) were important and if the burden had shifted, the evidence affirmatively proved that the accumulations were quite excessive. In *Breitfeller Sales, Inc.* the decision was for the taxpayer, but the Tax Court found it unnecessary to determine where the section 534 burden of proof rested as the decision was based "on the record as a whole." The taxpayer did not seem to fare much better on this issue when the Tax Court made a decision in the matter. The taxpayer found the hedge coming after a conclusion that his statement was inadequate to shift the burden of proof in *J. Gordon Turnbull, Inc.* The Court explained that regardless of the burden of proof the record

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428 TC 153 (1957).
528 TC 1164 (1957).
Ibid., p. 1168.
demonstrated that the accumulations were unreasonable and that the purpose existed. Taxpayers have had difficulty in drafting adequate statements to effectuate a shift both as to the grounds and the facts. 8

These approaches show only one aspect of the problem. They reveal the methods of disposing of the issue upon a trial of the case. This is a corollary of the practice of refusing to dispose of the matter before trial. Kopperud and Donaldson have pointed out that the Commissioner had followed the practice of opposing preliminary motions to settle this issue. They have found that the Tax Court supports the Commissioner. 9 Other critics have also strongly opposed the behavior of the Tax Court and the Commissioner on the section 534 issue. The general tenor of the complaint is that Congressional intent has been thwarted by the failure of the Tax Court to determine this issue. 10 The best way to interpret section 534 to give effect to that intent is subject

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to significant disagreement, and the confusing nature of the burden of proof provides a basis for the opposing views.

In essence there are actually two conceptually distinct aspects of the burden of proof. One element is the burden of persuasion and the other is the burden of producing evidence, or going forward with the evidence. Often, as in section 534, no distinction is made in these two elements. In most tax cases the distinction is not required because one party must bear the whole burden. However, the position of the Tax Court had made it definitely clear that the burden of producing evidence had not shifted to the Commissioner. And it is questionable that the burden of persuasion passed when a determination that it had passed was made after hearing all the evidence.

Percentages may be used to explain the burden of persuasion. If a party bearing the burden of proof is able to present evidence in support of his position that is only worth 25% of all the evidence, then he will fail. Even though the same party is able to show that 50% of the evidence is in favor of his position, he must still fail because he must go beyond 50% in order to carry the

12 Barker, p. 952.
burden of proof. Thus in a 50-50 case the burden of proof determines the outcome. Since the taxpayer normally must carry the burden, one can understand the reluctance of the Commissioner to have the burden placed upon himself.\textsuperscript{13}

Kipperman analyzed the statutes and the cases and developed a strategy for taxpayers. He believed that in strong cases the result would be the same, regardless of whether or not either party took any action required by section 534. Also, in weak cases he would expect the same result. However, in close cases the burden of proof becomes important, and he believed the taxpayer would benefit by meeting the conditions required by section 534.\textsuperscript{14} A subsequent analysis in this chapter shows that the taxpayer benefits only if the tribunal making the final determination recognizes that the case is a close case.

The Second Circuit Court of Appeals has also spoken out on the subject of close cases and the section 534 issue. In \textit{R. Gsell & Co., Inc.},\textsuperscript{15} the Tax Court had found that the accumulations were beyond reasonable business needs. However, in so doing the Tax Court

\textsuperscript{13}Holzman, p. 332.


\textsuperscript{15}34 TC 41 (1960).
refused to make a determination as to the adequacy of the taxpayer's statement to shift the burden of proof. The Second Circuit reversed and reprimanded the Tax Court for its position and said:

 Although in some cases where the proof is convincing that there is no justification in a taxpayer's business for the alleged accumulations it may be unnecessary to determine whether the Commissioner or the taxpayer has the burden of proof on the question, ... in close cases the determination of who has the burden of proof on the unreasonable accumulations issue must be resolved. The party having the burden of proof does not merely have the burden of coming forward with evidence; it has the burden of persuasion and once fixed that burden does not shift ... .

An observation may be made concerning this appeal. Although the Court has acknowledged that the burden of producing evidence and the burden of persuasion shift together, the emphasis seems to be placed upon the latter burden. The case gave some hope to those who thought that the Congressional intent had been frustrated.17

Although the critics were concerned that both burdens pass under the appropriate conditions, the greater concern was that the burden of producing evidence should pass. The weight of this burden was the one primarily believed to put the taxpayer to substantial expense and effort. Furthermore, this burden provided a powerful weapon in the hands of revenue agents to

16 8 AFTR 2d 5507, 5511 (2 Cir. 1961), 294 F. 2d 321.
17 Holzman, p. 352.
induce settlement on other issues. There seems to be some suggestion that the expense and effort of preparing for a trial in which one must produce the evidence is substantially greater than if one merely has to negate the evidence produced by the other side. If it is difficult for a taxpayer to develop an affirmative case with the information at his disposal, how much more difficult would it be for the Commissioner to acquire that information to build a comparable case? Nevertheless, the critics were not unanimous in their views on this point.

Wagman made a case for the view that Congressional intent is best served by interpreting section 534 so that only the burden of persuasion could be passed to the Commissioner, while the taxpayer would always have the burden of going forward with the evidence. Wagman noted that: (1) the section 534(b) notice would not constitute the first awareness of the taxpayer to the danger of a section 531 penalty, and (2) a significant amount of expense and effort would have to be incurred before the receipt of the section 534 notice in order to meet the time and quality requirements of section 534(c) for a statement.

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18 Hall, p. 849; Kopperud and Donaldson, p. 827; Barker, p. 949.
19 Wagman, p. 578.
All the equities are not on the side of the taxpayer. Critical purpose is really only within the taxpayer's ken (or those responsible for its actions) . . . .

It is not to be realistically expected that Congress would enact legislation that would negate the penalty aspects of the accumulated earnings tax. All Congress must have sought was that justice be done in accumulated earnings tax cases . . . .20

Wagman recognized the taxpayer's need for some bargaining leverage at the conference stages. He believed that the section 535 credit along with section 534 would provide that leverage.21

The Gsell case roughly marks the dividing line between two eras. Most of the controversy discussed above arose in the light of cases in which section 534 was evaluated with respect to the 1939 Code, rather than to the 1954 Code. Gsell was one of the last of such cases, yet the Second Circuit's opinion indicated how decisions on cases involving 1954 Code years might be treated. The section 535 credit could logically be expected to make a significant difference from the prior law that levied the tax upon all the earnings accumulated during the year if even a small part was accumulated for the forbidden purpose. The stage was set for the next level in the burden of proof controversy.

The Second Level

At this level attention was focused upon the rela-

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20 Ibid., p. 579.

21 Ibid.
tionship of section 534 to section 535. The question was: Does section 534 determine who must bear the burden of proof as to the extent that earnings accumulated were for the reasonable needs of the business in order to compute the credit allowed under section 535(c)? Berger believes that Regulation 1.534-1 was a concession that the Commissioner must bear the burden of proving the extent of the credit if the burden of proof shifts to him under section 534. More specifically, the question is an extension of the "burden of producing evidence/burden of persuasion" considerations to the section 535 credit. Goldfein believes that the burden of producing evidence is significant only if the Commissioner must bear the burden of persuasion as to the credit. He has explained how a trial would probably proceed depending upon where the burden of proof lies with respect to the section 535 credit.

More than a decade has elapsed since the Second Circuit's decision in Gsell. In the intervening years the vast majority of cases coming before the Tax Court

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23 Pye, "Section 534 statements: how they can be used to blunt the IRS' 531 attacks," *Journal of Taxation*, 25:148 (1966).

have involved taxable years governed by the 1954 Code. Such cases provide an opportunity to evaluate the effect that section 534 and the Gsell case have had. The following two sections are devoted to an investigation and evaluation of these cases and the appeals resulting from these cases.

CASE DEVELOPMENT SINCE GSELL

The Classification

After screening all of the cases decided by the Tax Court (including memorandum decisions), those having two characteristics were collected. The two requirements were: (1) that taxable years in issue be governed by the 1954 Internal Revenue Code, and (2) that taxpayers had made an apparently bona fide attempt to shift the burden of proof to the Commissioner with the required statement. This process produced 29 cases. Since the Tax Court had been heavily criticized for not making a determination on this issue, one objective in this study was to evaluate the Court on this point. As noted earlier, there were several ways of refusing to give effect to the statute. Thus, three categories were chosen for further classification. They are: (1) undecided,

25 Thus Charles Turner 65,100 P-H Memo TC was omitted. Taxpayer had submitted a statement, but on brief expressly stated a lack of contention that it was adequate to shift the burden of proof to the Commissioner.
(2) decided-but, and (3) decided.

The undecided cases are those in which the issue was not determined, regardless of the reasons given. Perhaps a statement peculiar to none, but representative of all would be: "It is unnecessary to decide whether the statement was adequate to shift the burden of proof for assuming that it was, the respondent has successfully carried his burden." The decided-but cases are those in which a determination was made, but some type of qualifying statement was made that seemed to detract from the significance of the determination. This position could be expressed as follows: "Petitioner's statement was adequate to shift the burden of proof. However, we need not rely upon the burden of proof because the record as a whole is sufficient to determine that petitioner's accumulations were reasonable." The decided cases are those in which the Court appeared to consider the burden of proof as an issue to be determined separately from the weighing of the evidence.

A problem with this classification scheme was that some parts of a statement were adequate to shift the burden as to some of the grounds, but not as to others. Consequently, one was faced with cases in which the Court

27See Vuono-Lione, Inc., 65,096 P-H Memo TC.
had decided the shift issue on some grounds, but had not made a determination on others. Rather than attempt a fractional measurement which would imply an unfounded accuracy, the procedure used was to evaluate the entire case to determine which of the alleged grounds (and facts) that the Court seemed to emphasize the most. The case was then classified based upon the Court's treatment of those grounds.

The results revealed that eight cases were classified as undecided, seven cases were classified as decided-but, and fourteen cases were classified as decided. In this last class there are six cases in which the decision was that the burden of proof did not shift. In seven cases the burden did shift, and one case held that section 534 did not apply to holding companies. The 29 cases were also examined to see if the final outcome of the decision was in favor of the taxpayer or the Commissioner. The result was then checked against the holding on the section 534 issue to see if any discernible pattern existed. In the undecided and decided cases none was found. However, in the seven decided-but cases there was perfect correlation between the resolution of this proof issue and the outcome. That is, in the four cases

28 Ted Bates & Co., Inc., 465,251 P-H Memo TC, was particularly difficult, but was classed as decided since the burden did not shift on the two items requiring most of the accumulations.

29 Rhombar Co., Inc., 47 TC 75.
in which the burden shifted to the Commissioner, the taxpayer won. In the three cases in which the burden did not shift, the Commissioner won. The appeals taken upon the 29 cases provide additional insight.

Eight appeals were taken upon the 29 cases. Of the eight appeals one was from the undecided group, one was from the decided-but group, and six were from the decided group. Of the eight appeals four were to the Second Circuit, three to the Sixth Circuit, and one to the Tenth Circuit.

The Second Circuit

Apparently the position of the Second Circuit on section 534 as set out in Gsell was well noted by the Tax Court. All four of the cases going to the Second Circuit were from the decided group. The Second Circuit affirmed three of the decisions. In two\(^3\) of those affirmed by the Second Circuit, the Court noted that the Tax Court had determined that the section 534 statements were adequate to shift the burden to the Commissioner and that he had carried his burden.

In the third affirmed case, Rhombar Co., Inc. v. Comm.,\(^3\) the Tax Court did not decide whether the statement

\(^3\) Factories Investment Corp. v. Comm., 13 AFTR 2d 880 (2 Cir. 1964), 328 F. 2d 781; Youngs Rubber Corp. v. Comm., 13 AFTR 2d 1251 (2 Cir. 1964), 331 F. 2d 12.

\(^3\) 20 AFTR 2d 5764 (2 Cir. 1967).
was adequate to shift the burden as to the reasonable needs of the business. Instead it found that Rhombar Company was a holding company and that section 534 could not be used by the petitioner to prove that it was not a mere holding or investment company. Therefore, the proper presumption to be determined was under section 533(b), rather than under 533(a). The Second Circuit approved the Tax Court's determination of this matter. Also, it focused attention on the taxpayer's contention as to the relationship between section 534 and the section 535 general credit. The Second Circuit said:

It is conceded that if a proper section 534 statement had been submitted, the Commissioner had the burden of proving the amount of the credit to which the taxpayer was entitled, i.e., the amount of the accumulation retained for reasonable business needs. Rhombar argues from this that if the credit is to be limited because a taxpayer is a mere holding or investment company, the burden of proving this must be on the Commissioner 'since it is a necessary part of the ... admitted burden of proving the amount of the credit to which a taxpayer is entitled under section 535(c)(1).' 32

Primary attention was upon the section 534-535 relationship as it applied to a holding company. Yet the first sentence quoted affirmatively answered the query presented earlier as to the extension of the section 534 burden of proof to section 535. A further comment in this case provides additional insight into the Court's view in the matter. The Court commented that Code provisions could seldom be

32 Ibid., p. 5767.
interpreted as if they were in a vacuum and said:

In any event, it is hardly likely that Congress intended that section 534 and section 535, enacted at the same time, would work at cross purposes. Indeed, to permit the credit section to overpower or submerge and dilute the burden of proof section would be to permit the tail to wag the dog.33

These comments give a clear indication that in an appropriate operating company case the Commissioner will have to carry the burden of proof as to the extent of the reasonableness of the accumulations.

Electric Regulator Corp. v. Comm.34 is the case reversed by the Second Circuit. The Tax Court had determined that the petitioner's statement was adequate to shift the burden of proof to the Commissioner on the stated grounds. However, the Tax Court found that the Commissioner had discharged that burden and that the statutory presumption of purpose arose. The Tax Court held the petitioner had failed to meet his burden on the ultimate question of purpose. This determination was buttressed by finding factors indicating the existence of the prohibited purpose.35

The Second Circuit held that the Tax Court had erred in concluding that the Commissioner had carried his burden of proof and in concluding that the petitioner was

33 Ibid.
34 14 Aftr 2d 5447 (2 Cir. 1964), 233 F. Supp. 543.
35 Electric Regulator Corp., 40 TC 757 (1953).
availed of for the proscribed purpose. The facts found to support the first finding of error can be described broadly as having been derived from: (1) a determination of the elements that qualified as reasonable business needs, and (2) the interpretation of the accounting concepts used to determine the value of those elements. Of course this holding removed the support of the section 533(a) presumption from the Tax Court's decision, but left untouched the regular burden of the petitioner to prove lack of purpose. The Second Circuit's finding of error on the issue of purpose was supported by noting that the absence of unreasonable accumulations is the most persuasive fact that could show a lack of the purpose. Furthermore, other factors were present that indicated a lack of the purpose.36

Some significance must attach to the Court's use of this traditional manner of disposing of purpose. The section 535 general credit was ignored. The year was 1964, and adding another potentially controversial element to the case would not have been wise. The risk in developing the boundaries of the reasonable needs of the business and in applying accounting concepts is great. A reversal predicated in part by criticism of the trial court's use of accounting might be justified. However, the Second Circuit's use of an erroneous calculation of "net cash

36 14 AFTR 2d 5447.
available" in order to partially support its reversal of the Tax Court is at least mildly disturbing.\(^{37}\)

The Sixth and Tenth Circuits

Three appeals were taken to the Sixth Circuit Court of Appeals. Two were from the decided category and one was from the decided-but category. The former two were affirmed. One case affirmed was The Kirlin Company.\(^{38}\) The Tax Court noted that the petitioner's statement contained no dollar amounts to indicate the extent of the business needs, but concluded that the statement was adequate to shift the burden to the Commissioner. The section 535 credit was noted, too. The Tax Court then methodically evaluated each ground alleged and determined the amount of the need thereof. An analysis of the company's liquidity in the light of its reasonable business needs revealed that accumulations were unreasonable. Finally, the Court found that the petitioner had failed to carry his burden of proof on the ultimate issue of purpose. The Sixth Circuit\(^{39}\) held that the decision was supported by substantial evidence and was not clearly erroneous. Novelart Mfg. Co. v. Comm.\(^{40}\) was similarly affirmed.

\(^{37}\)Ibid., p. 5451.

\(^{38}\)64,260 P-H Memo TC.

\(^{39}\)The Kirlin Corp. v. Comm., 17 AFTR 2d 1266 (6 Cir. 1966).

\(^{40}\)26 AFTR 2d 70-5837 (6 Cir. 1970), affirming 52 TC 794 (1969).
The only case appealed in the decided-but group was the Shaw-Walker Company case. The taxpayer's statement contained five grounds attempting to justify the accumulations. The Tax Court found that the alleged facts were deficient in specificity and definiteness and that the burden did not shift. Then came the hedge, "However, regardless of where the burden of proof lies, the affirmative evidence of record is sufficient to determine this case on its merits." That evidence showed the accumulations to be excessive, and it failed to negate the prohibited purpose.

The Sixth Circuit evaluated the case under these four headings: (1) burden of proof, (2) determination of working capital, (3) intent, and (4) accumulated earnings credit. Under the burden of proof heading, the Court analyzed the taxpayer's statement. The Tax Court was sustained as to four of the grounds, but the Circuit Court found that the ground claiming a need for working capital was adequate to shift the burden of proof to the Commissioner. This rejection of the Tax Court's finding led into an evaluation of the Tax Court's failure to make a detailed study of the working capital as it had done on the four other grounds. The result was a holding of error for this failure. In turning to the matter of intent, the

41 WR 65,309 P-H Memo TC.
42 Ibid., p. 1896.
Sixth Circuit was unable to determine which purpose test had been applied and held the Tax Court had not made adequate findings of fact on this issue. Finally, the section 535(c) credit was considered. The Tax Court was upheld on the credit determined for three items, but some bewilderment was expressed over the manner in which the credits were applied. The case was remanded to the Tax Court to make further findings of fact consistent with the appellate opinion.

The single appeal from the undecided category went to the Tenth Circuit. That decision was affirmed without discussion of the section 534 statement and the Tax Court's treatment thereof.

Other Relevant Appeals

Motor Fuel Carriers, Inc. v. U.S. was an appeal from a nonjury district court decision. The taxpayer had tried the case as though the entire accumulation was reasonable. The taxpayer made no effort to prove that it was entitled to accumulate some part of the earnings if not entitled to all of them. The claim for a section 535

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43 This decision was appealed to the Supreme Court and was remanded to the Sixth Circuit on the issue of the purpose test. See Comm. v. Shaw-Walker Co., 23 AFTR 2d 69-523, 393 U.S. 197.

44 Henry Van Hummell, Inc. v. Comm., 18 AFTR 2d 5500 (10 Cir. 1966), 364 F. 2d 746, affirming $64,290 P-H Memo TC.

45 12 AFTR 2d 5554 (5 Cir. 1963), 322 F. 2d 576.
credit was raised for the first time in the appeal. The Fifth Circuit forgave the lateness of the claim and remanded in part because the Court felt the case might be a pilot case on that issue. Although section 534 was not applicable to the case, the Fifth Circuit's comment on the burden of proof and section 535 is interesting. The Court said, "The burden is no less as to a part than as to the whole."\(^{46}\) In spite of the substantial difference in the burden of proof in the district courts and the burden of proof under section 534, this comment could apply just as well to a section 534 case. Thus, if the burden of proof on the reasonableness of the accumulations shifts to the Commissioner, then it would appear that he should also bear the burden of proving the extent of the reasonableness.

_McNally Pittsburg Manufacturing Corp. v. U.S._\(^{47}\) was a district court trial by jury. The taxpayer presented an exhibit that included the annual figure for cost of goods sold as a part of the current operating needs for a year. This computation showed that funds were not available to pay dividends. The government introduced a similar exhibit except that cost of goods sold was excluded from current operating needs. This approach showed a substantial amount of funds available

\(^{46}\) _Ibid._, p. 5558.

\(^{47}\) 15 AFTR 2d 484 (10 Cir. 1965), reversing 11 AFTR 1578 (DC, Kans. 1963).
to pay dividends. The instructions to the jury approved the taxpayer's approach. The jury decided in favor of the taxpayer. The Tenth Circuit\textsuperscript{48} recognized that the inventory turnover and collection period for accounts receivable did not support the taxpayer's method of calculation. The Court reversed and remanded for a new trial due to the erroneous instructions to the jury.

\textbf{Apollo Industries, Inc.}\textsuperscript{49} was a Tax Court case that was appealed to the First Circuit. A significant part of the appeal opinion was devoted to the development of an operating cycle approach to analyze working capital needs, which was merely suggested to the Tax Court in the remand. The last paragraph is an excellent summary of the basis for the remand.

The case must be remanded for answers, for each of the two taxable years, to the following questions: (1) was the reconstituted tobacco project a reasonably anticipated business need of Alles? (2) if so, what were its reasonable dimensions? (3) what were the practical needs of Alles for working capital? and (4) even if accumulated earnings did not exceed reasonably anticipated business needs in one or both years, was avoidance of taxes on shareholders nevertheless a dominant purpose? In the meantime, we will retain jurisdiction.\textsuperscript{50}

Item one evidences a concern in determining an element of the reasonable needs of business. Items two and three reflect a concern over the application of section 535 and

\textsuperscript{48}\textit{Ibid.}, p. 486.

\textsuperscript{49}TC 1 (1965).

\textsuperscript{50}\textit{Apollo Industries, Inc. v. Comm.}, 17 AFTR 2d 518, 525 (1 Cir. 1966).
the necessity for using accounting concepts therefore. Item four must be taken as an indication that section 535 will not apply to shield earnings accumulated for the reasonable needs of the business if the prohibited purpose also exists.

The approach in item four would be contrary to the Tax Court cases which have disposed of the purpose issue by applying section 535. Obviously, if purpose can be ignored when accumulations are made for reasonable business needs, then section 534 becomes significantly more important. A related question would be: If the reasonable needs of the business are greater than the earnings accumulated, but a part of those earnings are used for something other than the reasonable needs of the business, how does section 535 apply? This problem confronted the Fifth Circuit in Mead's Bakery.

The Tax Court had utilized the taxpayer's normal burden of proof in a roundabout approach to the decision. The Tax Court said, "Petitioner has failed to prove that its reasonable business needs . . . exceeded the amount of earnings retained . . . minus the amounts advanced Angus . . . ." A logical extension of this expression would be that upon a showing of reasonable needs in excess of accumulated earnings, the earnings could be

51 John P. Scripps Newspapers, 44 TC 453 (1965).
52 Mead's Bakery, Inc., ¶64,104 P-H Memo TC.
put to any use without incurring the tax. Perhaps the Fifth Circuit recognized this possible construction for the Court said:

This holding is not supported by the Court's finding of needs which, added, exceed $4,000,000.00 and of retained earnings of only $550,000.00. The Tax Court didn't question the bona fides of these needs. Instead, the gist of the Court's opinion . . . is that regardless of the extent of taxpayer's needs (or the fact that they mathematically exceed retained earnings), that part of its earnings advanced to Angus was not retained for the purpose of meeting those needs.53

The Fifth Circuit reversed for the taxpayer without resolving this issue and held that its reasonable needs were greater than its accumulations. The Tax Court's finding that Angus was not actively engaged in a business was approved, but the Court noted that similar cases had been determined by whether the accumulations were being held for business needs or the prohibited purpose. Here the expenditures were believed to be a manner of holding funds for future business needs.54

Sears Oil Co., Inc.55 was remanded to the Tax Court by the Second Circuit "with particular attention to the question of reasonable needs."56 This mandate required an evaluation of the extent of the reasonableness.

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54 Ibid., pp. 5209-10.
55 #65,039 P-H Memo TC.
56 Sears Oil Co., Inc. v. Comm., 17 AFTR 2d 833, 838 (2 Cir. 1966).
EVALUATION OF THE CASES

The largest number (14) of the Tax Court cases investigated fell into the decided category. This represents a substantial overt attempt to give some effect to the congressional intent of section 534. The interpretation of the other two categories is not as clear. The eight undecided cases could be taken as an indication that there is still a significant reluctance to permit the operation of section 534. The seven decided-but cases are the most difficult to interpret. The semantics used indicate a hedge or qualification of the section 534 determination. This view would place the decided-but cases next to the undecided cases in terms of the attitude expressed. The perfect correlation between the 534 determination and the final decision prompts another possible explanation. Perhaps the evidence in these cases was so one-sided that it was reflected in the section 534 statement. The Tax Court determined the section 534 issue, weighed the evidence, and was thereby moved to make some comment in passing. This explanation would place these cases next to the decided cases in terms of the attitude expressed.

Several suggestions may be made from the appeals taken in these cases. By tracing the appeals taken between the circuit courts and these three categories, one senses that the Second Circuit's position in Gsell has been a strong influence in causing the Tax Court to make
a finding on the section 534 issue. An objective in reviewing the appeals was to acquire some feeling for the significance placed upon the Tax Court's treatment of this issue. The reversals are generally more suitable for this task because of the greater discussion given to explain the decision.

The reversals have presented some difficult problems. One problem is to determine whether or not a given factor is a reasonable need of the business. Another problem is to choose the proper accounting concepts to be applied in determining the extent of those needs. The solution of the former problem is essential to a proper weighing of the evidence. Both problems must be solved in order to correctly apply the section 535 credit. Arguably, these matters have had a greater influence in effecting a reversal than the burden of persuasion has had. Support for this conclusion is found in the survey of the other appellate cases. Although the section 534 statement was not an issue, reversals were predicated upon the same types of problems. Indeed, the overwhelming concern was with these problems and the section 535(c) credit. As these two types of problems are solved, the next logical step would be to devote attention to defining the relationship between sections 534 and 535. The weight of opinion examined above indicates that an adequate section 534 statement should shift the burden of determining the extent of the credit to the Commissioner.
However, a clear indication of how the dual burdens will operate upon section 535(c) is not even upon the horizon. The remainder of this chapter is devoted to an analysis as to how these burdens should operate so as to best give effect to the Congressional intent. To this end, the close case language of Gsell must be carefully analyzed in the light of Holzman's conceptual explanation of the burden of persuasion.

THE BURDEN OF PERSUASION IN CLOSE CASES

The theory of the operation of the burden of persuasion in close cases is easy to understand. Its pragmatic application is another matter. Two cases have specifically adopted the "close case" concept in making a determination under section 534.

Gsell & Co., Inc. v. Comm.\textsuperscript{57} was the first case in which the close case concept was wedded to the section 534 burden of proof. This case raises some perplexing questions: Was Gsell a close case? If it was, then why did the Tax Court fail to recognize it as such? Why did the Second Circuit fail to expressly say that Gsell was a close case?

The quote from Gsell presented earlier leaves little room to doubt that it is a close case: The Second

\textsuperscript{57} 578 AFTR 2d 5507.
Circuit's findings that the taxpayer's statement was sufficient to shift the burden and that the Commissioner had not met his burden support the inference. Also, the Court relied in part upon the Commissioner's failure to meet his burden to support its finding that the taxpayer was not availed of for the proscribed purpose. Yet, there are contrary indications.

The Second Circuit criticized the Tax Court for:
(1) basing its determination of unreasonable accumulations upon inadequate evidence, (2) overly emphasizing the surtaxes saved by the stockholders, and (3) relying upon the taxpayer to arrange financing from a sister corporation. If the evidence were truly weighted 50-50, there would be no need for these criticisms for the shift in the burden of persuasion to the Commissioner would effectively determine the issue of reasonableness for the taxpayer. Of course the determination of this issue in favor of the taxpayer fails to raise the section 533(a) presumption of purpose in the Commissioner's favor, and the taxpayer must meet only his regular burden of proving the lack of the prohibited purpose. Furthermore, in Gsell the Second Circuit restated the view that "a determination that accumulations were not unreasonable . . . amounts to

59 Ibid.
a finding favorable to the taxpayer on the most persuasive fact which would show that the corporation was not availed of for the purpose . . . ." However, the first criticism noted above appears to be addressed to a new weighing of the evidence to show clearly that the accumulations are reasonable. The last two criticisms appear to be addressed to a new weighing of the evidence to show clearly that the proscribed purpose is absent. Thus the criticisms are an indication that Gsell is not a close case, but that the evidence had been incorrectly weighed. If the taxable years in Gsell had been under the 1954 Code and its provision for the section 535 credit, would the decision have been different? Shaw-Walker provides some insight for an answer to this question.

The earlier discussion of the Shaw-Walker case showed that section 535(c) was a factor to be considered. The Sixth Circuit's opinion seems to strongly indicate that a remand would have been in order regardless of the Tax Court's determination on the 534 issue. Yet, the Sixth Circuit adopted the Second Circuit's language in Gsell on close cases. Is this an indication that Shaw-Walker was a close case? What else does Shaw-Walker have in common with Gsell?

In Gsell the Tax Court had failed to determine the section 534 issue. In Shaw-Walker the Tax Court ruled
that the statement did not shift the burden and then added the familiar qualifying statement. Thus in both cases the Tax Court's position weakened the effectiveness of section 534. However, in Shaw-Walker the determination of section 534 was necessary to fix the burden of persuasion upon the Commissioner on the working capital issue upon the remand.

Can a rational theory be developed to help explain the apparent contradiction in Gsell, the significance of the Tax Court's three basic positions as seen since Gsell, and other related problems? To this end, the conceptual relationship of the burden of persuasion to close cases is developed beyond the state presented above. Further development requires a definition of a close case. Holzman's comments make it clear than an example of a close case would be one in which the evidence is split 50-50 between the parties. Likewise, he indicates that a split of 25-75 in the evidence would mean that a case is not close. A case in which the evidence is split 49-51 between the parties would be close in the sense that there is very little difference in the evidence in favor of each party. Although it would be difficult to measure evidence that precisely in practice, a determination of any difference, however small, would be adequate to render

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61 Holzman, p. 332.
a decision in favor of one party without calling upon the burden of persuasion.

The confusion in this matter seems to arise at the appellate level. It seems to involve the difference between a review by a circuit court as to whether there is "substantial evidence" to sustain the trial court's findings of fact, and a review by a circuit court as to whether the trial court's findings are "clearly erroneous." "Substantial evidence" is evidence of such quality and weight that a reasonable person would be justified in making the same conclusions of fact that the trial court made.62 The Supreme Court has explained "clearly erroneous" as follows:

A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed.63 Reasonable men might differ as to whether the evidence in a case is weighted 49-51, or 51-49, between the respective parties. In such a case, there is substantial evidence to support either decision. However, an appellate court could reverse a trial court decision under the clearly erroneous rule, if the trial court weighed the evidence between the parties as being 49-51, while the review court

weighed the evidence as being 51-49, between the respective parties. Considering the preceding analysis and the fact that the clearly erroneous rule governs the scope of review of Tax Court cases, the following definition of a close case is adopted for the remainder of this chapter: A close case is one in which the evidence is weighted exactly 50-50 between the parties.

Conceptually, there are two distinct steps in weighing evidence. The first step is to assign some amount of weight to each element of the evidence. The second step requires a simple addition of the weights of the elements in favor of each party. A comparison of the weights will dictate a decision in favor of the party with the greatest weight of evidence. If there is no difference in the weights, then the burden of persuasion is called into play to reach a decision. An incorrect determination can result from an error made in weighing the evidence in the first step, the second step, or both steps. The relationship of possible errors in weighing evidence, the burden of persuasion in close cases, and the clearly erroneous rule seems to be shrouded in misunderstanding. The following hypothetical case should help clarify the matter.

64 Rule 52(a) of the Federal Rules of Civil Procedure.
The taxpayer, T, had filed a section 534 statement. The Tax Court had failed to determine whether T's statement was adequate to shift the burden of proof to the Commissioner, C. The Tax Court erroneously weighed the evidence in favor of T as 30% and in favor of C as 70%. Consequently, the decision was in favor of C. T appealed knowing that a circuit court will reverse only if the Tax Court decision is clearly erroneous. Given the situation, one of three basic situations would occur upon a weighing of the evidence by an appellate court.

**Case 1.** Perhaps the evidence in favor of T is 45% and the evidence in favor of C is 55%. Since the error did not alter the outcome of the decision, there would be no reason to reverse. There would still be substantial evidence in support of the decision, and it would not be clearly erroneous.

If T's section 534 statement were to be deemed adequate by either court to shift the burden to C, then by either weighting C carried his burden and the outcome would not be changed. If T's statement were to be deemed inadequate by either court, then by either weighing T failed to carry his burden, and the final result would be the same. Therefore, a determination by the Tax Court on the section 534 issue in this case is irrelevant to a decision upon appeal.

**Case 2.** Perhaps the evidence in favor of T is 60% and the evidence in favor of C is 40%. This means
the decision was in favor of the wrong party. Such a situation would leave the appellate court "with the definite and firm conviction" that the Tax Court had erred. The clearly erroneous rule would be used to reverse the decision and insure a just result.

Once again assumptions could be made about specific determinations of the 534 issue, but the weight of the evidence would work to insure a just result. Thus, in this case a determination on the section 534 issue by the Tax Court would be irrelevant to a decision upon appeal.

Case 3. Perhaps the evidence is split 50-50. In this instance the burden of persuasion must be determined. If the Tax Court should determine the section 534 issue in favor of either party, its erroneous weighting of the evidence would work to determine the outcome in favor of C. The appellate court would have to examine the section 534 statement to see whether the burden of persuasion had been properly placed because it will determine the outcome of the case. Even if the Tax Court had correctly weighed the evidence, the appellate court would have to examine the section 534 statement for the same purpose and reason. Therefore, if the Tax Court were to correctly determine the section 534 issue and correctly weigh the evidence, its decision would be sustained, but if the Tax Court were to incorrectly determine the section 534 issue while correctly weighing the evidence
its decision must be reversed in order to give the correct result. Thus the Tax Court's determination of the section 534 issue in this case would be irrelevant to an appellate decision.

A Restricted Theory

A theory can be developed from this example: Regardless of whether the Tax Court makes a correct determination, an incorrect determination, or fails to make a determination of the adequacy of a section 534 statement, the final result of an appellate decision will be unaffected.

There is support for this theory. Gsell fits the third case situation rather well. Also, a comment by the Ninth Circuit in Smith, Inc. v. Comm.65 is consistent with the above analysis. The Court stated:

But if we should assume that the Tax Court incorrectly determined that the burden of proof here rested with the taxpayer, no prejudice would have resulted unless a finding of fact adverse to petitioner was predicated only on petitioner's failure to sustain the burden of proof....66

Perhaps the strongest support comes from the Second Circuit in a pre-Gsell case, Casey v. Comm.67

Both Gsell and Casey strongly indicate the Second

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65 8 AFTR 2d 5119 (9 Cir. 1961), 292 F. 2d 490.
66 Ibid., pp. 5122-23.
67 3 AFTR 2d 1440 (2 Cir. 1959).
Circuit's concern over the Congressional intent expressed in section 534. However, immediately after the expression of that concern in *Casey*, the Court analyzed the clearly erroneous rule in detail. The Court supported its belief that reviewing courts have used language indicating a restricted scope of review only when they agreed with the trial court decision. The conclusion is that the "definite and firm conviction" subjective test makes the clearly erroneous rule a powerful tool for reversal. One must realize that a close case is in the eye of the beholder. An exhortation for the Tax Court to make a determination of the section 534 issue is meaningless, if the Tax Court is unable to see that a specific case is close.

There are two things that this theory does not suggest. There is no suggestion that the burden of persuasion is totally irrelevant. This burden is a very necessary instrument for the orderly and just disposition of close cases. It must be determined by the Tax Court when a close case is recognized. It must also be independently determined by a reviewing court when that court recognizes a close case. Nor is there a suggestion that the Tax Court may ignore this burden in non-close cases. The importance of the theory and the attendant analysis is in clearly understanding the conceptual operation of the burden in order to make a better evaluation of its significance in practice.
Standing alone, the burden of persuasion appears useless as a practical matter because, in spite of the rhetoric, no obviously close case can be found in this area. The pragmatic explanation might be that no court has had the courage to base its decision solely upon the burden of persuasion due to the difficulty in weighing the evidence—particularly the assignment of weights to the elements. The probability that a true close case would ever occur is infinitesimal due to the infinite number of possible variables. Therefore one may be reasonably certain that in any given case the evidence does preponderate in favor of one party or the other. However, in a case weighted, perhaps 45-55, one may be unable to determine which party should be assigned which proportion. Thus the measurement problem blurs a substantial number of cases such that the practical dilemma is the same as if the case could be exactly weighed as 50-50. The burden of persuasion may be secretly called upon to remove the blur. Then one can see clearly how the weights should be assigned to the parties, subsequently, one may announce that since the case was not a close case there was no need to determine who had the burden of persuasion.

Perhaps the biggest problem is in determining whether the burden of producing evidence should be drawn to the burden of persuasion. Given the wide margin for error in assigning weights to the evidence the presence
or absence of a single piece of evidence can completely alter the final decision in a case. The high cost to the taxpayer of producing evidence and the substantially greater difficulty to the Commissioner of producing evidence was set out earlier. Thus it becomes extremely important to determine who has the burden of persuasion before trial if the burden of producing evidence shifts with it.

A Proposal

One may agree that Congress intended to correct abuses, and that the purpose of section 534 was to give effect to that intent. The part of the Senate report quoted previously indicates two distinctly different causes for the complaints. They were: (1) the Commissioner's failure to carefully evaluate the cases, and (2) the Commissioner's use of the tax as a weapon. One will notice that the former results from passive behavior while the latter results from active behavior. Either one will make the taxpayer incur heavy costs. A solution designed to correct one type of behavior will not necessarily correct the other type. If this duality had been recognized, perhaps the controversy would have led to an effective solution.

Most of the critics have focused upon the second cause. They have correctly recognized that the burden of producing evidence must be allowed to pass to the Commissioner in order to deprive him of a powerful weapon.
Wagman and the courts seem to have concentrated upon the first cause. A knowledge that one must carry only the burden of persuasion should be adequate to make him carefully review his case. Furthermore, the burden of producing evidence becomes a more powerful weapon in the hands of the taxpayer than it is when it is in the hands of the Commissioner—a result not likely intended by Congress. Finally, as guardians of justice, the courts are interested in weighing all of the evidence. All of the evidence is more likely to be presented if the taxpayer has the burden of producing it.

The key to the solution appears to be in the "weapon" aspect of the burden of producing evidence. That is, if this burden could be neutralized as a weapon in the hands of the taxpayer, there would seem to be no substantial reason to prevent the burden of producing evidence from shifting with the burden of persuasion to the Commissioner. Such a method should eliminate both causes of the abuses mentioned in the Senate report. Hopefully, with little to be gained through maneuvering for a weapon, both parties would seriously evaluate the case and reach a settlement without resort to litigation.

The Tax Court took a cautious step forward in Chatham Corp. and held that the taxpayer's section 534

6848 TC 145 (1967).
statement had shifted the burden of proof to the Commissioner. The significance of this step was that this holding was made prior to trial. A similar motion had been denied in Shaw-Walker Co. The difference was that in Chatham the motion was heard by the judge who was to try the case while in Shaw-Walker the motion judge was not to be the trial judge. Regardless of the soundness in the reasoning for making the differentiation, the change was a significant one.

Goldfein has reasoned that little benefit will accrue to the taxpayer unless the burden under section 534 extends to section 535(c). The cases reviewed indicate that a specific determination of this relationship may be expected at any time. If a satisfactory solution is not found new criticism will probably be forthcoming. Therefore the following proposal is submitted for consideration: Although the weight of authority is not conclusive, it does indicate that the section 534 burden of proof should extend to section 535(c). The reasoning of that authority is sound and this extension of the burden is recommended. The practice of ruling on motions for a determination under section 534 prior to trial should be expanded to all appropriate cases. Specifically, this burden of proof must be interpreted as including the two

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6939 TC 293 (1962).
70Goldfein, p. 4.
burdens in order to take the weapon from the Commissioner. The weapon can be negated in the hands of the taxpayer by permitting a full interplay between sections 534 and 535. If the two sections are to work together because "The burden is no less as to a part than as to the whole . . . ." then it follows that the "facts supporting the grounds" should be interpreted to require an estimate of the dollar amount for each need claimed. Arguably, this interpretation of the section 534-535 relationship substantially reduces the burden placed on the Commissioner from affirmatively proving the dollar amount of the need to disproving the dollar amount of the need as claimed by the taxpayer. The idea is that the section 534 statement displays the taxpayer's hand to the Commissioner and that the burden of proof makes the Commissioner carefully analyze that hand. As noted, others have urged that the Commissioner be saddled with the full load—the burden of persuasion and the burden of producing evidence as to the extent of the needs. A simple standard of fairness requires that the taxpayer at least display his full hand. The taxpayer must always be required to disclose the dollar amounts for every business need upon which he relies.

This system should work for several reasons.

71 12 AFTR 2d 5554, 5558.
When the taxpayer knows that he must state specific amounts in his statement, he must carefully analyze his needs for he faces the possibility of having to subsequently prove the extent of those needs. When the Commissioner is confronted with having to disprove a specific amount, he must carefully analyze the case to determine his odds. If the statement is subsequently deemed adequate to shift the burden of proof to the Commissioner, he must produce the first evidence. Once he comes forward with sufficient evidence to controvert the claimed amount, the burden of producing evidence shifts to the taxpayer. The taxpayer must then go forward with evidence for the claimed amount. The Tax Court will then weigh the evidence with the burden of persuasion in mind.

The critical feature of this proposal is that the Tax Court take an unequivocal position on fixing the burden of persuasion and shifting the burden of producing evidence. The conditional certainty of facing the burden of producing evidence is necessary to make both parties bargain in good faith. The degree of difficulty for the Commissioner to shift the burden of producing evidence back to the taxpayer is viewed as being roughly proportional to the reasonableness of the taxpayer's claim.

The system has advantages for the Tax Court. If the Court supports the shifting nature of the burden of producing evidence, maximum opportunity for the presentation of all the evidence is maintained. By fully using
the 535(c) credit, the magnitude of any error made in
weighing the evidence is reduced because of the oppor-
tunity to secretly make an adjustment in the amount of
the credit, commensurate with the difficulty in weighing
the evidence. This advantage should tend to reduce the
possibility of being reversed because it should be less
clear and definite that a mistake had been committed.
Most importantly, the system offers an opportunity to
give full effect to the intent of Congress.

The Tax Court has acknowledged the significance
of dollar amounts in a section 534 statement, but has
refused to make them a necessary requirement. As early
as 1960, the Tax Court noted that the dollar amounts al-
leged in the section 534 statement as needed for inven-
tory were completely out of proportion to the largest
inventory held. In Kirlin Co., presented above, the
Tax Court noted the absence of dollar amounts, but deter-
mined that the statement was adequate to shift the bur-
den. Hopefully, these various acknowledgements are a
prelude to an appreciation of the impact a full interplay
between section 534 and section 535(c) might have.

72 Ted Bates & Co., Inc., 465,251 P-H Memo TC.
73 American Metal Products Corp., 34 TC 89, 100
(1960).
74 464,260 P-H Memo TC.
SUMMARY

Section 534 was enacted by Congress in response to numerous complaints by taxpayers. It provides for a shift in the burden of proof from the taxpayer to the Commissioner under certain conditions. However, critics have charged that the Tax Court's treatment of this section has frustrated the intent of Congress. The controversy that developed involved the two elements of the burden of proof—the burden of persuasion and the burden of producing evidence.

Often the Tax Court made no determination of the section 534 issue. At times the Tax Court refused to rule on the shift in the burden of proof until after the trial of the case. This practice insured that the burden of producing evidence did not shift to the Commissioner, and it was questionable that the practice permitted the burden of persuasion to pass.

The Second Circuit duly noted the Congressional intent for adopting the provision and the Tax Court's treatment in Gsell. This Court of Appeals admonished the Tax Court of the necessity for making a determination of the 534 issue, especially in close cases.

Several years after the first round of criticism the critics became aware of the potential impact of the relationship between section 534 and section 535. The
significant difference in the two elements of the burden of proof was again noted. The writers suggested that the burden of proof should extend to section 535 so that the Commissioner would have the burden of proving the extent of the reasonableness of accumulations in appropriate cases.

The cases since Gsell reveal a substantial change in the attitude of the Tax Court. The primary result has been a trend in determining the burden of persuasion aspect of the burden of proof. The burden of producing evidence has received relatively less attention. Arguably, the cases appealed since Gsell provide a suggestion that further development has been impeded by the preoccupation of the courts in determining the boundaries for the reasonable needs of the business and the proper application of accounting concepts. These factors are essential for a determination under section 535.

The disparity between the comments of the critics and the opinions of the courts led to a critical analysis of the positions taken. From that analysis this restricted theory was developed: Regardless of whether the Tax Court makes a correct determination, an incorrect determination, or fails to make a determination of the adequacy of a section 534 statement, the final result of an appellate decision will be unaffected. This theory enhances an awareness of the importance of the burden of producing evidence, but does not negate the reasons for the Tax Court to deter-
mine the section 534 issue. An examination of the Senate Report on the complaints leading to the enactment of section 534 revealed that the Commissioner’s passive behavior as well as his active behavior was responsible for the complaints. Arguably, a failure to recognize this difference helps explain judicial solutions which emphasize the burden of persuasion, while critics emphasize the burden of producing evidence.

A proposal was tendered to accommodate the various factions. The proposal calls for a full interplay between sections 534 and 535. The essential features require that an adequate section 534 statement include a dollar amount for estimated needs, that such a statement will shift both elements of the burden of proof to the Commissioner, and that the burden of producing evidence will shift back to the taxpayer upon the Commissioner’s presentation of evidence disproving the amount of the need claimed in the section 534 statement.
CHAPTER IV

THE APPLICATION OF ACCOUNTING CONCEPTS IN THE DETERMINATION OF THE REASONABLE NEEDS OF THE BUSINESS

The proper application of accounting concepts in the determination of the reasonable needs of the business requires a comprehensive understanding of those concepts. An understanding of accounting concepts requires knowledge as well as intelligence. While the intelligence and legal acumen of judges may be presumed by virtue of the position they have attained, a similar presumption of accounting knowledge may not be made. The judicial treatment of accounting concepts, which is presented herein, is limited to the most basic ones. Although the concepts of earnings, depreciation, working capital, and appropriation of earnings are basic, they are not necessarily easy to understand. The definitions of these terms may appear simple, but the difficulty in understanding seems to involve the development of an awareness of the relationship of each account to all other accounts. This chapter presents an examination of the apparent judicial understanding of the nature of earnings, depreciation, working capital, and appropriation of retained earnings. A rationale, based upon accounting, is presented to support the court's
assumption of the relationship between liquidity and retained earnings.

ACCUMULATED EARNINGS

A thorough understanding of economic and accounting concepts of income is essential for an understanding of the various definitions of income in the tax law area. An integral part of the law providing for the accumulated earnings tax is a matter of accounting. The following excerpts show the pervasiveness of income concepts in this tax. Section 531 imposes the tax "for each taxable year on the accumulated taxable income," as presently defined in section 535. Section 535(a) provides for various adjustments to "taxable income" in arriving at "accumulated taxable income." The adjustment provided by subsection (c)(1) is a general credit for operating corporations equal to the portion of the "earnings and profits for the taxable year as are retained for the reasonable needs of the business." In addition to the emphasis on income or earnings, one should notice that although several taxable years may be subject to the tax, the tax is calculated upon the earnings of a particular year without inclusion of the earnings of any prior years. However, the significance of accumulations from prior years has not been overlooked. The Regulations expressly acknowledge the importance of prior accumulations as follows:
In determining whether any amount of the 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. Thus, for example, if such accumulated earnings and profits of prior years are sufficient for the reasonable needs of the business, then any earnings and profits of the current taxable year which are retained will not be considered to be retained for the reasonable needs of the business . . . .

The Nature of Earnings

The most basic misunderstanding of the nature of earnings stems from an assumption that "earnings" is a synonym for "cash." Even though a taxpayer elects to account for income on a cash basis, he may be required to reflect certain accrual adjustments in computing taxable income. A notable example is the accrual adjustment required for depreciation. Therefore care must be taken to avoid confusing the term "earnings" with the term "cash."

Once the distinction between these two terms is overlooked, a number of erroneous statements appear plausible. Perhaps the most common expression alludes to paying dividends "out of earnings." Of course, cash dividends must be paid in cash. The cash is provided by operations which also result in earnings. From this observation one may make the erroneous assumption that the terms

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1Income Tax Regulations, Section 1.535-3(b)(1)(ii).
are synonymous. An example of this error is found in the memorandum decision, *Hanovia Chemical & Mfg. Co.*, as follows:

Of the net income of $94,976.47, $21,600 was paid out in dividends to stockholders and $10,605.09 was paid for income taxes which were not deductible from gross income. The addition to surplus was only $62,725.39. Of this amount $42,218.82 served only to restore the surplus as it stood at December 31, 1929.2

A logical extension of this type of reasoning is to erroneously assume that earnings can "pay for" other needs as well as dividends. For example, in *Battlestein Investment Co. v. U.S.*3 the taxpayer sought to justify an accumulation of earnings by claiming a need for long-term debt retirement. As a partial answer, the court said:

These annual payments of $50,000 were made without impeding the steady growth of the plaintiff's net earnings . . . plaintiff . . . could easily pay off its long-term obligations out of current earnings as each installment came due.4

If one assumes that earnings may be used to pay off debts, then earnings may be used to make loans. The Tax Court has said:

Even if we assume that Princeton did require funds from petitioner, such loans as would have been required could easily have been made out of petitioner's accumulated earnings and profits of $289,054.15, as they existed at July 1, 1957, the beginning of the taxable years here involved . . . .

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2 43,435 P-H Memo TC.

3 23 AFTR 2d 69-784 (DC, Tex.; 1969).

4 Ibid., p. 69-788.
The evidence convinces us that petitioner's earnings of such years were not required for loans to Princeton.\(^5\)

The part of the quotation from *Battlestein* which suggests that there is a direct connection between the annual payments on debt and the company's annual income is an additional indication of misunderstanding. The words "without impeding" lead this writer to suspect that the Court was under the false impression that the annual payment on the principal of $50,000 was a deduction from revenues on the firm's annual statement of income. Thus, in spite of this "impediment," the annual income continued to increase.

The Tax Court made a similar error in *Gazette Telegraph Co.*\(^6\) The difference was that in this case the Tax Court was comparing the total payments to the total accumulations instead of comparing annual payments to annual earnings. The Court said:

\[ \ldots \] petitioner accumulated a surplus of $97,633.03 in fiscal 1947 which had increased to $236,266.08 by the end of fiscal 1948 despite the payments on principal of the Bank of America note.\(^7\)

In this quotation the use of the word "despite" is construed to indicate a belief by the Tax Court that the principal payments constitute a charge against the

\(^5\) The Factories Investment Corporation, 39 TC 908, 918 (1963).

\(^6\) 19 TC 692 (1953).

\(^7\) Ibid., p. 707.
surplus, or retained earnings account. This mistake could result from incorrect reasoning that does not directly involve the statement of income. For example, the payment of a cash dividend does result in a reduction of the balances in the cash account and the retained earnings account. This knowledge could improperly be taken as support for the notion that earnings are equal to cash. Therefore, since the payment of a cash dividend reduces the retained earnings, one might erroneously deduce that the cash payment of a debt would reduce the amount of retained earnings.

Of course words may be subject to more than one interpretation. The following quote from Southland Industries, Inc. is an example.

When petitioner carried $86,925.46 of its earnings for the taxable year (1940) to surplus, it then had a surplus theretofore acquired of $145,847.22, and in addition assets (much of same liquid) many times that amount.\footnote{\textit{Ibid.}, p. 903.}

The words "in addition" could mean that the Tax Court literally meant for the balance in the surplus account to be added to the balance of the asset accounts. Yet, the words "in addition" constitute a transitional phrase and could have been used to indicate merely that the assets are another factor to be considered. Nevertheless, several paragraphs later the former construction\footnote{\textit{\textsuperscript{46,262 P-H Memo TC.}}}
clearly appears as follows:

If the reasonable needs of petitioner's business had required an expenditure for new equipment, expansion or installation of additional facilities, no reason was shown why, in addition to the $145,000 surplus theretofore acquired, all or a substantial part of its large nonoperating assets could not have been used for this purpose.10

Although the cases presented above indicate a shallow comprehension of the nature of earnings, some courts have made laudable attempts to understand the nature of earnings. Particularly noteworthy is this comment by the Fourth Circuit in Smoot Sand & Gravel Corp. v. Comm.:

Thus, the size of the accumulated earnings and profits or surplus is not the crucial factor; rather, it is the reasonableness and nature of the surplus. Part of the surplus may be justifiably earmarked in the form of reserves, for specific, necessary business needs. Again, to the extent the surplus has been translated into plant expansion, increased receivables, enlarged inventories, or other assets related to its business, the corporation may accumulate surplus with impunity . . . . Where, on the other hand, the accumulation of surplus is reflected in liquid assets in excess of the immediate or reasonably foreseeable business needs of the corporation, there is a strong indication that the purpose of the accumulation is to prevent the imposition of income taxes upon dividends which would have been distributed to the shareholders . . . . 11

This statement represents a recognition that earnings can only be expressed in the form of assets. Unfortunately, the decision provides no instructions as to how the earnings can be related to specific assets. This Court

10 Ibid.

11 5 AFTR 2d 626, 630 (4 Cir. 1960). The ellipses represent the omission of the authorities cited.
just assumes that excess liquid assets are evidence of
excess accumulated earnings.

The Second Circuit has realized that the retained
earnings account does not represent a source of funds
for making payments. This Court has learned the relation­
ship of retained earnings to specific assets. In Electric
Regulator Corp. v. Comm. 12 the Court said:

As a practical matter, a retained earnings account
may embody a cross-section of the assets of the
company. See Paton & Dixon, Essentials of
this true where, as here, the corporation's growth has been financed through its own earnings
rather than through additional shareholder invest­
ment or borrowing. 13

The practical impossibility of tracing retained earnings
to specific assets creates a dilemma for the courts. If
a corporation has assets that are not needed or used in
the business, as well as assets that are needed, how may
one determine the extent to which earnings, versus paid-
in capital, have provided for either group of assets in
order to assess the accumulated earnings tax? Is the
assumption that excess liquid assets should be matched
with accumulated earnings consistent with accounting con­
cepts? The answer to this query is presented after the
nature of earnings, depreciation, working capital, and
appropriation of earnings have been examined.

12 14 AFTR 2d 5447 (2 Cir. 1964).
13 Ibid., p. 5450.
The Nature of Depreciation

The preceding examination of the nature of earnings revealed that the chief difficulty for the courts is a lack of understanding of the relationship of earnings to the liquid assets—especially the cash account. Interestingly, the chief difficulty in understanding the nature of depreciation is in understanding its relationship to the liquid assets. The interesting point is that earnings and depreciation share a common obstacle to understanding although their conceptual natures are completely different. The treatment of depreciation as a deduction on the income statement in determining the earnings for a period seems to be adequately understood by the courts. The lack of comprehension seems to be primarily limited to its effect upon the asset and equity accounts on the balance sheet.

In fairness to all concerned parties, the accounting profession must bear at least a small part of the blame for the confusion about depreciation. For an indeterminable number of years the balance sheet account, related to the depreciation charges on the income statement, had the word "reserve" associated with the word "depreciation" in its title. An example of this title would be "Reserve for Depreciation." The unfortunate thing about the use of the word "reserve" in the account title was that "reserve" was also being used in the title of four other different types of accounts. The five types of "reserves" used were:
1. To value asset accounts,
2. To disclose an estimated liability,
3. To recognize a contingent liability,
4. To distribute equitably certain costs and expenses, and
5. To disclose the extent earnings have been retained.

The treatment of the effect of depreciation upon the balance sheet falls within the first category listed. The modern terminology for this account is "Accumulated Depreciation."\(^1\) The use of the word "reserves" is discouraged, but if it is used at all it should be limited to the fifth category. The preferred title for usage in this last category would be "Appropriation of Retained Earnings for . . . ."\(^2\)

The word "reserve" has a general meaning in which it refers to "money or its equivalent kept in hand or set apart usually to meet liabilities."\(^3\) Perhaps this meaning was partially responsible for this improper statement.

Petitioner had theretofore made depreciation reserve of $152,299 on its transmitter which could have been


used in buying and installing a new transmitter if it had desired to do so.\textsuperscript{17}

The erroneous application of the general meaning of reserve can be seen more clearly in this expression:

A corporation is not required to use, as operating capital, the funds set aside for depreciation reserve but rather it should be permitted to save and accumulate earnings and profits and retain them in some form of liquid assets in an amount equal to the reserve for depreciation.\textsuperscript{18}

Besides the impression that accumulated depreciation represents a cache of cash, the idea that the taxpayer "should be permitted" to set aside liquid assets equal to the accumulated depreciation is especially interesting. How did such an idea occur? What implications does it have for the present context?

A clue to answering both questions is found in Mohawk Paper Mills, Inc. v. U.S.\textsuperscript{19}

Mohawk did not set aside as permitted by law a separate depreciation reserve but carried this deduction under 'working capital'. Thus, working capital had to finance its daily operations as well as its additions to fixed assets.\textsuperscript{20}

The first sentence in the quotation reveals that the answer to the first question posed is to be found some-

\textsuperscript{17}Southland Industries, Inc., 1846,262 P-H Memo TC, p. 900.

\textsuperscript{18}Churchhill Construction Co. v. U.S., 17 AFTR 2d 045, 048 (1965).

\textsuperscript{19}18 AFTR 2d 6111 (DC, N.Y., 1966).

\textsuperscript{20}Ibid., p. 6116.
where in the law. The statement probably arises out of the Court's interpretation of the provision permitting a deduction of depreciation for tax purposes. The second sentence is an example of reasoning from an erroneous premise. Hopefully, an understanding of the topics presented in following subdivisions will enable one with a limited knowledge of accounting to appreciate the effect of depreciation upon working capital.

The preceding quotations regarding depreciation show relatively obvious errors. As a judge's understanding of the matter increases, it becomes more difficult to ferret out the degree of understanding that he possesses. This is one reason that the quotation below is longer than usual. Another reason for the length is that the quotation is a part of the charge to the jury in The Donruss Co. v. U.S. which was given to guide the jury in making its decision on the ultimate section 531 issue of "purpose."

This concept of allowing a taxpayer a deduction over a period of time on the cost of the equipment is called depreciation. Under the concept of depreciation, . . . a taxpayer is permitted to use any benefits therefrom in any manner he desires.

During the Donruss Company's years ending January 31, 1960 and January 31, 1961 it, as the Court understands from the proof, claimed and was allowed by way of depreciation aggregate amounts of $137,634.98 and $150,437.74, respectively, these amounts were not included in the plaintiff corporation's accumulations of earnings and profits. These benefits, when claimed by the taxpayer, may be utilized by the taxpayer for

\[21\]

15 AFTR 2d 896 (DC, Tenn. 1965).
replacement of plant equipment or diversification purposes, among other things.

As of the end of January, 1961 the Donruss Company, it is contended by the defendant, could expect to recover similar depreciation deductions for future years in amounts in excess of $120,000 per year. Such deductions, as I say, could be utilized for replacement of equipment or other purpose of the corporate taxpayer.

So, it is necessary that you understand . . . that each tax year in question The Donruss Company was allowed deductions as depreciation on equipment it owned and was free to take advantage of same as it saw fit in the operation of its business. The purpose of the depreciation allowance, to further explain, is to afford the owner of a wasting asset used in any trade or business, a means of recouping, tax-free, his investment in that property.22

Several observations are made. The Court has not used the words "cash" or "liquid assets" in reference to depreciation. This is some indication that the Court was aware of the false assumption that "cash" equals "depreciation." The specific words used in several references to depreciation were "benefits" and "deductions." These words seem appropriate in the sense that they are general enough to allow the reader to either draw from his knowledge the proper interpretation, or assume the Court understands the nature of depreciation. Such a ploy will not stand a close scrutiny. For example, "deductions" cannot be used "for replacement of equipment." This idea is expressed twice, and it is construed as revealing a mistaken belief that depreciation does directly relate to cash or liquid assets, or that the Court has a shallow

22Ibid., pp. 902-03.
understanding of depreciation. Finally, the Court recognized that the purpose of the depreciation deduction is to permit a qualified taxpayer to recover his investment free of taxes. Although the tax-free recovery of investment results under the law, it is not the conceptual basis in accounting for the depreciation deduction.\(^{23}\)

The Steele's Mills v. Robertson\(^{24}\) case is one in which the facts seem to have had a direct bearing upon the Court's manner of expressing the pertinent accounting concepts. Briefly, the relevant facts for present purposes are: The plaintiff spent over $110,000 on plant and equipment during 1938, the taxable year in dispute. During 1938, the expenditures permitted for section 531 needs were greater than earnings plus depreciation charges. For a ten year period, 1932-41, the plaintiff expended over $900,000 for plant and equipment. Finally, there had been no significant increase in the plaintiff's quick assets since 1923. Thus the Court's findings of fact appear adequate to support its decision for the plaintiff. However, the Court's reasoning expressed in its other findings is subject to question. The Court stated:


\(^{24}\) 32 AFTR 1734 (DC, N.C.; 1943).
that it was in accordance with sound business practice and a reasonable need of the business to withhold from distribution to its shareholders assets in cash to equal its reserve for depreciation for the purpose of having the funds readily available with which to replace machinery and other items.

Later the Court reaffirmed this view and said:

If the corporation is forced to use the funds set aside for reserve for depreciation for operating capital, there will be no assurance that it will have funds to replace machinery; and while the corporation has been able to operate successfully by using its reserve for depreciation as operating capital, the court does not think it should be forced to do this, and that it should be allowed to carry liquid assets to equal its reserve for depreciation.

The unanswerable question is whether this Court would also sanction an accumulation of liquid assets equal to accumulated depreciation in a situation in which there was no reasonably anticipated need to replace plant and equipment assets. In such a case it would appear that the answer should be "no."

The courts have had an irksome task in disposing of the fact that replacement cost is greater than either original cost or accumulated depreciation. The Tax Court in Metal Office Furniture Co. made the accumulated depreciation equals liquid assets error in stating, "The

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25 Ibid., p. 1735.
26 Ibid., p. 1736.
27 452,313 P-H Memo TC.
amount of the depreciation reserves would have been inadequate to replace the depreciating facilities because costs had increased."\(^{28}\) This mistake is somewhat understandable because in this case the Court apparently felt the taxpayer had a need to fund the accumulating depreciation. However, there is a significant difference in that need as perceived in Steele's Mills and as perceived in Metal Office. In the former case the impression received was that the company had an ongoing relatively pressing need to replace old equipment. In the latter case the taxpayer expressed the need to fund accumulated depreciation in addition to needs including normal expansion and a new division. The Court's attitude in Metal Office was to accept all needs claimed, noting that "eventually" the taxpayer's plants would have to be replaced.

The mistakes are compounded in Battlestein Investment Co.\(^{29}\) The District Court in Battlestein relied on a passage from Smoot\(^{30}\) to support its reasoning. However, the passage on which the Court relied misinterprets the meaning of appropriation. The confusion is compounded by the fact that the Battlestein trial court fails

\(^{28}\)Ibid., p. 953.

\(^{29}\)23 AFTR 2d 69-784.

\(^{30}\)5 AFTR 2d 626. This passage will be analyzed in depth under the subsequent heading "The Nature of Appropriations."
to distinguish between "appropriations of surplus" and "depreciation allowances." It appears that the Court is assuming that these are identical items. Finally, total confusion reigns on this topic as the Court apparently misconstrues the nature of accumulated depreciation. The Court found that the taxpayer had definite and specific plans to replace certain fixtures. In a specific interpretation of the aforementioned passage in Smoot and a deduction thereon, the Court said:

The authorities hold that a taxpayer is not entitled to duplicate the depreciation allowance with accumulated earnings for the purpose of replacing assets . . . . Thus, the only justifiable accumulation in this instance would be the difference between the total amount of depreciation recoverable and the higher replacement cost . . . . Finally, assuming that the price of fixtures has risen, the $137,558 which the taxpayer had in working capital at the close of the 1962 fiscal year was certainly more than enough to cover the spread between original and replacement cost.\(^3^1\)

A logical inference from this statement is that the Court has fallen into the trap that accumulated depreciation is equal to cash.

The proper method for evaluating accumulated depreciation and its relation to the replacement of assets is covered in Revenue Ruling 67-64. Two cases\(^3^2\) have partially quoted that Revenue Ruling. The same

\(^{31}\) 23 AFTR 2d 69-784, 787.

paragraphs were quoted in both cases. The material quoted was:

Although the reserve for depreciation itself may be considered and given appropriate weight as a part of the facts and circumstances in considering the reasonable needs of the business, the concept that a noncash deduction for depreciation based on historic costs requires the setting aside for an indefinite period a cash fund adjusted for economic fluctuation in order to provide for total replacement of plant assets is not within the meaning of the term 'reasonable needs of the business.'

Accordingly, a corporation may not include a fund equal to its depreciation reserves escalated for the economic factor of increased replacement costs in justifying the reasonable needs of its business pursuant to section 537 of the Code. However, the reserve for depreciation itself may be considered and given appropriate weight as a part of the facts and circumstances in each case.33

In this writer's opinion the two cases show that the effectiveness of this Ruling has been severely restricted by granting that "the reserve for depreciation itself may be considered and given appropriate weight . . . ." Conceptually, there is no difference in the economic significance between the need to expend funds to expand the business and the need to expend funds to replace assets--both needs refer to the future. The original cost of assets currently held is irrelevant in making a decision to replace those assets. Therefore the accumulated depreciation upon those assets is irrelevant, too. The acknowledgement that "accumulated depreciation" is a mere valuation account is consistent with economic reality. Since there is no conceptual difference between

33Rev. Rul. 67-64, 1967-1 CB 150.
expansion and replacement, then the tax principles which apply to expansion should apply to replacement. The Revenue Ruling recognizes the substance of this view. In the paragraph immediately preceding the above quotation this position is stated as follows:

Section 537 of the Code provides that the term "reasonable needs of the business" includes the reasonably anticipated needs of the business. Section 1.537-1(b) of the Income Tax Regulations provides that in order for a corporation to justify an accumulation of earnings and profits for reasonably anticipated future needs, there must be an indication that the future needs of the business require such accumulation, and the corporation must have specific, definite, and feasible plans for the use of such accumulation. Where the future needs of the business are uncertain or vague, where the plans for the future use of an accumulation are not specific, definite, and feasible, or where execution of such a plan is postponed indefinitely, an accumulation cannot be justified on the grounds of reasonably anticipated needs of the business. These regulations express the legislative intent as stated in Senate Report 1622, 83d Congress, 2d Session, 69, and House report 1337, 83d Congress, 2d Session, A172-A173.

In the light of economic reality no weight should be given to accumulated depreciation. The failure of this Ruling to unequivocally express this proper view of accumulated depreciation may be expected to impede understanding of this important aspect in determining the reasonable needs of a business. As noted, two cases have already quoted the misleading passages, rather than the correct one.

The Nature of Working Capital

The courts have erred in assuming that retained

\(^{34}\text{Ibid.}\)
earnings and accumulated depreciation were directly related to liquid assets. That mistake cannot be made with working capital. Working capital is defined as the excess of current assets over current liabilities. It is composed of liquid assets. Since working capital is merely a matter of arithmetical computation, then its nature is determined by the nature of current assets and current liabilities. The most common errors involve the relationship between current assets and current liabilities. The courts have been inclined to express this relationship in "rules of thumb" without always making a careful analysis of the applicability of those rules based upon the current ratio, acid-test ratio, or one year's operating expenses.

The Tax Court reviewed a number of cases in John P. Scripps Newspapers35 for various applications and views of rules of thumb. The Tax Court particularly noted the use of the current ratio as an indication of reasonable accumulations. Also, the Court observed the use of a rule that accumulations to cover operating expenses for one year are reasonable. However, this rule has been qualified by a judicial awareness that different businesses have different requirements. Therefore, this rule "should not be given any greater weight than a

3544 TC 453 (1965).
rule of administrative convenience."  

The danger in relying upon this rule of thumb was the cause for reversal and remand in *McNally Pittsburg Manufacturing Corp. v. U.S.*  
The District Court submitted instructions to the jury that approved the annual figure for cost of goods sold as a part of the current operating needs for a year. Under this assumption no funds were available to pay dividends. The government showed a substantial amount of funds available to pay dividends by excluding the annual cost of goods sold from current operating needs. The case was remanded in part because of the potential effect of a possible credit under section 535 upon the decision. 

The advent of the general credit provision of section 535 has increased the necessity for a more accurate measurement of working capital needs than rules of thumb can provide. The rules of thumb are expedient, but they essentially represent a static analysis of the dynamic needs of business. Perhaps the first court to give adequate notice of this difference between the techniques of analysis and the nature of business was the Fourth Circuit

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37 15 AFTR 2d 484 (10 Cir. 1965), reversing 11 AFTR 1578 (DC, Kans. 1963).

in *Smoot Sand & Gravel Corp. v. Comm.* In that case the Court said:

Working capital needs of businesses vary, being dependent upon the nature of the business, its credit policies, the amounts of inventories and rate of turnover, the amount of accounts receivable and the collection rate thereof, the availability of credit to the business, and similar relevant factors.

A new approach for evaluating the working capital needs of the business was adopted by the Tax Court in a memorandum decision, *Bardahl Mfg. Corp.* The company's operating cycle was used to evaluate its need for working capital. In this regard the Court stated:

Manufacturing's operating cycle, consisting of the period of time required to convert cash into raw materials, raw materials into an inventory of marketable Bardahl products, the inventory into sales and accounts receivable, and the period required to collect the outstanding accounts, averaged approximately 4.2 months during the 4 years here in question.

Petitioner required working capital as of the end of each of the years in question at least in an amount sufficient to cover its reasonable anticipated costs of operation for a single operating cycle.

After the Tax Court adopted the operating cycle approach,

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39 50 AFTR 1612 (2 Cir. 1957).
three circuit courts\(^4\) and four district courts\(^4\) also adopted it. However, the operating cycle approach contains its own problems in evaluating working capital needs. Several are:

1. Should an average cycle, or a peak cycle, be used?
2. How should the peaks of various cycles be treated when they fall within different months?
3. How should the credit cycle be evaluated?
4. Should the decimal expression of the cycle be applied to all other expenses as well as to the cost of goods sold?

A discussion of these problems and others and a comparison of the differences between the cases in applying the operating cycle has been made by Joseph H. Trethewey.\(^4\) He has also developed a financial comparison of the various approaches based upon the same hypothetical data. In his example the working capital needs as shown by the different approaches range from $172,041 to $675,050.\(^4\)

When the possibility exists that the upper limit


\(^4\)Ibid., p. B-17, 18, and 19.
of working capital needs can be four times the size of the lower limit, then it is questionable that the operating cycle approach is superior to the old rules of thumb. The answer could be "yes" if the trial judge has a sufficient knowledge of accounting to permit him to properly weigh operating cycle presentations. Otherwise, the working capital needs would probably be decided by unknown considerations as in Schenuit Rubber Co. v. U.S. 47

Schenuit Rubber is an example of the type of dilemma that judges might face. The taxpayer called the resident partner of one of the "big eight" accounting firms as an expert witness. This expert used an operating cycle approach and found working capital requirements for the end of fiscal 1961 at $2,939,288 and for fiscal 1962 at $3,206,156. The government countered with a professor from a prestigious university's school of business. This expert criticized the operating cycle approach used by the taxpayer's witness for ignoring the cycle of current liabilities. The professor used a different operating cycle approach that showed working capital needs as $1,532,124 and $1,159,280 for 1961 and 1962, respectively. The difference in the experts' calculations is roughly $1,500,000 for 1961 and $2,000,000 for 1962.

The Court stated, "In making its analysis and

4722 AFTR 2d 5794.
findings the Court has been guided by the following principles . . . ."48 The principles set forth by the Court were merely other judicial observations to the effect that every case is different and must be evaluated with a good business judgment without relying wholly upon a cursory view of a company's accounts. Then, without explaining the analysis used in arriving at a decision, the Court said:

All factors considered, the Court finds that the amount of working capital taxpayer reasonably needed for current operations as of April 30, 1961 was $2,250,000. The similar needs as of April 30, 1962 were $2,000,000.49

The working capital needs as determined by the Court are approximately midway between the positions taken by the experts. Whether this decision was made in a comprehensive understanding of accounting concepts, or in an attempt to split the difference in a manner reminiscent of the wisdom of Solomon, cannot be ascertained.

A distinctive approach is presented in Electric Regulator Corp. v. Comm.50 by the Second Circuit. The Tax Court had rejected a claimed need for a working capital reserve in cash of $430,000. The Tax Court noticed that the cash balance at the end of the company's fiscal

48 Ibid., p. 5802.
49 Ibid., p. 5803.
50 14 AFTR 2d 5447.
year, October 31, 1957, was about $821,000, and that for fiscal years 1957 and 1958 the average monthly cash balances were $479,600 and $354,700, respectively. The Tax Court's evaluation was that "based on all the evidence, petitioner's anticipated working capital requirements could be amply cared for by its accumulations from prior years plus the cash-generating transactions of its going business." 51 The Second Circuit concluded that the cash available was not adequate to pay the dividend that the Tax Court held should have been paid. The attack upon the Tax Court's position on this issue was supported in two ways. First, the Second Circuit observed that the actual cash balance had fallen to $190,000 on April 30, 1958. Second, the Second Circuit calculated "net cash available" at $320,000 before deducting needs for cash in the coming year. Significantly, the "net cash available" was determined in this manner:

<table>
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<tr>
<th>Cash available, October 31, 1957, after payment of current liabilities</th>
<th>$231,000</th>
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<tbody>
<tr>
<td>Net income, fiscal 1958</td>
<td>$89,000</td>
</tr>
<tr>
<td>Net cash available</td>
<td>$320,000</td>
</tr>
</tbody>
</table>

The addition of "net income, fiscal 1958," determined by an accrual system of accounting, 53 in arriving at "net

52 14 AFTR 2d 5447, 5451.
53 40 TC 757.
cash available" represents a touch of irony. The irony is that shortly before this calculation the Second Circuit specifically pointed out that retained earnings does not necessarily represent liquid funds. 54

The First Circuit has correctly summed up the proper approach to be taken in evaluating working capital needs. The explanation in *Apollo Industries, Inc. v. Comm.* 55 is:

Business decisions are not made on the basis of information collected at arbitrary dates. They take into account the timing of needs and availability of resources. And so should judicial attempts to deal justly with these decisions. But to ascertain such needs and the resources available, we are required to go behind the simple balance sheet presentation of assets and liabilities. 56

The Court's idea of fulfilling this statement is an operating cycle approach similar to the one followed in *Barndahl Manufacturing*. Although operating cycle approaches consider the duration of time that assets will be in a noncash form, they do not consider the timing of needs and the availability of liquid assets. The calculation of available cash in *Electric Regulator* is subject to the same criticism. In regard to timing, the operating cycle approaches and the *Electric Regulator* approach can hardly be considered superior to the old rules of thumb.

5414 AFTR 2d 5447, 5450.
5517 AFTR 2d 518 (1 Cir. 1966).
56Ibid., pp. 521-22.
A belief in the operating cycle approach as a tool of management is not limited to the courts. For example, Stephen S. Ziegler has expressed concern that the precision desired from operating cycles for management purposes may be greater than the precision desired for section 531 cases. Consequently, he suggests some leeway before assessing the accumulated earnings tax against a corporation. The courts are aware of the need for some leeway to protect businesses from undue governmental interference. The Second Circuit has expressed its awareness of the need in this fashion:

Although Section 102 should be rigorously applied to make it impossible for individuals to abuse the corporate form for the purpose of lowering their individual tax rates, the Commissioner may not use Section 102 as a device to enable him to look over the shoulder of the corporate manager and assess a penalty any time the Commissioner believes that a corporation has not been generous in its dividend policy or has temporarily invested its surplus in a manner not entirely acceptable to the Commissioner.

Ziegler's plea for a margin of freedom for taxpayers in this area of taxation is commendable, but his faith in the precision of the operating cycle is misplaced.

Astute management practices call for budgets for effective planning and control. Budgets are particularly


applicable when a matter as crucial as timing is involved. However, two caveats are necessary with respect to evaluating working capital needs through a budgeting approach for tax purposes. Since management is able to control the timing of needs to a degree, a judge must determine whether good business judgment, or good tax judgment, is responsible for the timing in a given case. On the other hand, a judge must not be misled by the hindsight that liquid assets were not used for working capital as budgeted. The solution to both of these potential problems is an adequate margin for error in which management can operate. Thus, if a reasonable leeway is provided for managements, then the taxpayer should not feel pressed to manipulate the timing to protect reasonable accumulations from the tax. However, if a court determines that timing has been manipulated in order to shield accumulations, then the amount of leeway should be appropriately reduced. Yet, a reduction should not be made to the extent that the tax would be applicable to accumulations represented in transactions that would occur.

The Nature of an Appropriation of Retained Earnings

The preceding topics have shown the misunderstanding

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of earnings, depreciation, and working capital. As a special classification of retained earnings, an appropriation may be misinterpreted in the same ways that earnings have been misconstrued. Thus, the basic pitfall in understanding the concept of "appropriation" is that it necessarily has a direct relationship to cash or other liquid assets. This error was apparently made by the district court in *World Publishing Co. v. United States*. 60

The taxpayer decided to build an addition on an adjacent lot. A new press and related equipment were needed for the planned building. The Court noted the corporation's practice of "paying for such improvements out of its earnings" 61 and that the company "had begun accumulating a fund for that purpose." 62 Also, the Court noted that in December of 1939 " . . . a resolution to set aside a fund for the purpose was passed." 63 In regard to a similar director's meeting in December of 1941 the Court said:

Accordingly, a resolution was passed to withhold dividends and to set aside $150,000 for the purchasing of the press and accessory equipment, and $100,000 for the press building, bringing the earmarked accumulations for expansion to $500,000. 64

Whether these references are to a fund of cash, to an appropriation of retained earnings, or to both cannot be

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60 35 AFTR 1671 (DC, Okla.; 1947).
ascertained. Unfortunately, the actual resolution was not quoted. However, in a footnote given for this latter meeting, several paragraphs of the minutes of the meeting were quoted. The quotation relates the comments of the president. Therein the president seems to urge an appropriation of retained earnings of $500,000 while he appears to suggest, less strongly, that in connection with the appropriation the problem of conserving cash be considered. Subsequent statements of the Court are particularly enlightening.65

The book value of stocks, bonds, and cash less liabilities at December 31, 1941, was about $427,000. The market value of the same was not available. However, on the same date for 1942 and 1943 the comparable figures given were market values of approximately $496,000 and $646,000, respectively. The Court's conclusion was that these amounts were convincing that adequate assets were available for the planned expansion. Immediately, this view was followed by a citation of the retained earnings balances for the three years in the approximate amounts of $563,000, $643,000, and $740,000, respectively. Then the Court emphasized that the beginning balance of retained earnings for 1942 was greater than the cost estimate of the improvements at the end of 1942.66

65 Ibid. 66 Ibid., p. 1677.
by the Court provides a basis for the inference that it has erred by assuming that earnings represent liquid assets. Finally, the Court's misunderstanding seems clear as it relates funds in the treasury to profits and accumulations of earnings in this fashion:

The determination of the question in the instant case depends chiefly upon the sufficiency of the funds for the expansion plan in the corporate treasury before adding the profits of 1942 and 1943, and the immediancy of the need for any funds, or more specifically, for the 1942 and 1943 additions to the accumulations.67

Thus a logical extension of this improper construction seems to be that an appropriation of retained earnings automatically provides a fund of liquid assets.

This case was affirmed68 upon appeal to the Tenth Circuit. Significantly, Judge Phillips dissented. He properly compared liquid assets, net of the dividends that the Commissioner claimed should have been paid, to the estimated cost of expansion. Those assets were inadequate for the expansion, leaving nothing for working capital needs at the end of 1942. Increases in costs offset the earnings for 1943. Judge Phillips observed the strong reliance given to the comparison of retained earnings to the cost estimates and stated his conviction that the District Court had thereby erred. Also, he disagreed with

67Ibid., p. 1679.
6837 AFTR 150 (10 Cir. 1948).
the trial court's reliance on the indefiniteness of the time for implementation of the proposed improvements. Arguably, the District Court used this last point only to buttress its findings on the adequacy of accumulations.

The two appeals taken to the Fourth Circuit in Smoot Sand & Gravel Corp. v. Comm. are notable for their sagacious treatment of accounting principles and concepts. However, even these excellent opinions contain a misinterpretation of accounting. In the earlier discussion of depreciation, reference was made to a misinterpretation by the Court in Smoot. That statement is as follows:

Replacement of assets which are fully depreciated or depleted requires available cash but does not require a second appropriation of surplus. It is only when rehabilitation plans involve replacement of old equipment with equipment costing more than the original, or when additional equipment is required, that appropriation of surplus is justified.

The sentences apparently represent an unclear appreciation of the nature of an appropriation as it relates to depreciation and replacement of assets. This point is relatively insignificant in this case as the Court properly concentrated upon a comparison of liquid assets to needs in evaluating the reasonableness of accumulations. Yet, as explained in the preceding topic on depreciation, this

69 Ibid., pp. 154-57.

70 50 AFTR 1612 (4 Cir. 1957); 5 AFTR 2d 626 (4 Cir. 1960).

71 5 AFTR 2d 626, 633.
point of misunderstanding became the basis for further misconstruction.

An Accounting Rationale

Since earnings cannot be directly traced to specific assets, then assumptions must be formulated in order to relate earnings to specific assets. In Smoot the Fourth Circuit took the position that earnings could be accumulated to the degree that they were translated into assets related to the business. This case also presented the view that liquid assets greater than reasonably foreseeable business needs strongly indicate an improper accumulation of earnings.\(^2\) Of course, the assumption implied in this view is that earnings should be matched first with excess liquid assets.

The taxpayer sought to overcome this assumption by substituting a contrary assumption in the appeal of Battlestein Investment Co. v. U.S.\(^3\) The taxpayer's assumption was also based upon the Smoot language that earnings could be accumulated without limitation to the degree the earnings were translated into assets needed for the business. The taxpayer's assumption is that accumulated earnings should be matched against the cost of depreciable assets, first, as if paid for out of assets provided by the profit

\(^2\) Ibid., p. 630.

\(^3\) 27 AFTR 2d 71-713 (5 Cir. 1971).
element of operations. The Court correctly recognized an implicit premise in the taxpayer's position that a corporation has the right to retain liquid assets equal to the accumulated depreciation. Perhaps the following part of the taxpayer's brief will enable one to understand the dilemma of a Court having a limited knowledge of accounting:

With respect to the year January 31, 1962, which dollars paid the $50,000 debt principal, the earnings of $44,927 or the depreciation cash flow of $46,477? Obviously if earnings were used to pay this debt, the earnings have been reasonably used and Taxpayer cannot be penalized under Section 531.

We submit that as a matter of law the principal of debt incurred to purchase plant and equipment assets must be viewed as having been paid first by the dollars produced by earnings, not depreciation cash flow as the court below assumed.

The Fifth Circuit did not accept the taxpayer's arguments, and the taxpayer lost upon the appeal.

Under the going concern concept all depreciable assets must be replaced ultimately. Thus the idea of accumulating liquid assets equal to the accumulated depreciation in order to provide for the future replacement of depreciable assets has some appeal. However, many depreciable assets have a useful life of several decades. If a business grows, assets will be needed for expansion. Given that assets provided by recovery of depreciation charges and by earnings are each sufficient to support a

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74 Ibid., p. 71-715.
75 Ibid., p. 71-716 (see footnote 4).
company's expansion, the source of the dollars used is irrelevant considering the business as an entity. Therefore the only significance of the above question posed to the Fifth Circuit results from tax considerations. If the remaining useful life of a given asset extends beyond the reasonably foreseeable needs of the business, then assets representing a recovery of the investment in that asset through depreciation charges should be assumed to be those used for expansion. The rationale is that all taxpayers should not be expected to subsidize the expansion of a particular taxpayer's business while that taxpayer withdraws his investment from active duty in his business under the pretense of awaiting the occurrence of an event that is at best a mere possibility. This rationale is supported by an awareness that an asset having a long life is often not specifically replaced at the end of its life because it has been replaced gradually by the expansion that occurred. Consequently, the position taken by the courts to match accumulated earnings to the excess of liquid assets over the reasonably foreseeable needs of the business is sound.

SUMMARY

The nature of earnings, the nature of depreciation, and the nature of an appropriation of retained earnings have all been misunderstood by the courts in varying degrees. The most pervasive misunderstanding of these
concepts has been the relationship of each to cash or liquid assets. The cases presented in this chapter have shown that one aspect of a concept may be understood while another aspect of the same concept is misconstrued.

The nature of working capital has also been confusing to some courts. The basic misinterpretation of this concept has been a failure to appreciate the difference between a static measurement of working capital at a moment of time and the dynamic changes in working capital during a period of time. A suggestion was presented for a better analysis of working capital needs.

The approach by some courts to evaluating the reasonableness of accumulations by comparing liquid assets to reasonably foreseeable business needs was examined. A contrary approach was presented. Finally, a rationale to support the judicial approach on this issue was presented. The rationale is that all taxpayers should not be expected to subsidize the expansion of a particular taxpayer's business while that taxpayer withdraws his investment from active duty in his business under the pretense of awaiting the occurrence of an event that is at best a mere possibility.
CHAPTER V

AN INVESTIGATION OF FINAL DETERMINATIONS
CLASSIFIED BY JURISDICTIONS

The preceding three chapters have shown the great difference in factors that often arise in accumulated earnings tax cases. In addition to these broad factors there are numerous smaller factors, such as loans to stockholders and redemptions of stock, that might be present in varying degrees in any given case. Consequently, a specific case is a composite of elements taken from an infinite number of possibilities. Therefore, care must be exercised in drawing conclusions or making suggestions based upon the decisions in the accumulated earnings tax cases. This chapter presents four tables in which the final determinations are classified in different ways in order to obtain several views of the decisions.

FINAL DETERMINATIONS IN THE TRIAL COURTS

Chapter II presented a sketch of the legislative history involving the accumulated earnings tax. Several changes were noted which could have had some discernible effect in the administration of the tax. The tax rate went from 25 percent in the 1921 Act to 50 percent in the 1924 Act. The 50 percent rate was in effect until it was
reduced to graduated rates of 25 and 35 percent in the
1934 Act. A 100 percent increase in this tax rate is an
indication of a substantial increase in the harshness of
the tax with a possible increase in the reluctance of
judges to impose the tax. Of course the harshness of the
tax is interdependent with the personal income tax rates
and the point in the graduation of personal tax rates of
the stockholders of a corporation. Too much significance,
therefore, must not be placed upon the change in the
accumulated earnings tax rates. Another potentially
significant change was the change from the "prima facie
evidence of purpose" provision to the "evidence determina-
tive of purpose" provision in the 1938 Act. However, it
is questionable whether or not the human mind can apply
the difference in these two rules with any reliable degree
of precision, even if a significant difference is per-
ceived. Finally, the relatively extensive changes incor-
porated into the 1954 Code offered the greatest potential
for change in the administration of the tax.

Table 2 presents the final determinations of
accumulated earnings tax incidents classified by trial
court jurisdictions and revenue acts. The various revenue
acts have been grouped for classification in a manner com-
patible with the preceding discussion of potentially
significant changes. The trial court jurisdictions are
subdivided in Table 2. The Board of Tax Appeals and Tax
Court incidents are separated into those resulting from
memorandum decisions and those resulting from full court decisions. The district court incidents are separated into those resulting from jury trials and those resulting from nonjury trials. The number of incidents arising out of the Court of Claims is too insignificant to consider.

Table 2 shows that prior to the Revenue Act of 1938 the 54 incidents are almost evenly divided between the taxpayer and the government at 25 and 29, respectively. However, the 54 incidents are quite unevenly divided between the trial courts. Only five of these incidents arose in the district courts, and only one of the five was a jury trial. A comparison of the incidents arising under the column headed 1939-'38 to the earlier incidents reveals several interesting results. One result is an increase in the rate of incidents. The total number in the 1939-'38 group is 121 with 67 for the taxpayer and 54 for the government. The number arising from Board of Tax Appeals and Tax Court decisions remained rather evenly divided between the taxpayer and the government at 54 and 51, respectively. The most noticeable change seems to be the increase in the district court incidents. Perhaps significantly, the distribution of the final determinations is disproportionate between the taxpayer and the government at 13 and 3, respectively. The 13 incidents in favor of the taxpayer include the 5 incidents rendered by juries.

These results may be compared with the results under the 1954 classification. Because of the important
### Table 2

**Final Determinations of Accumulated Earnings Tax Incidents**

Classified by Trial Court Jurisdictions & Revenue Acts

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<thead>
<tr>
<th>Incidents Determined in Favor of Taxpayer (T) &amp; Government (G)</th>
<th>Arising Under Revenue Acts for the Years:</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Trial Court</strong></td>
<td><strong>1954</strong></td>
</tr>
<tr>
<td>-----------------</td>
<td>--------</td>
</tr>
<tr>
<td>Full BTA(^4) &amp; TC(^5) Incidents</td>
<td>T</td>
</tr>
<tr>
<td>10</td>
<td>9</td>
</tr>
<tr>
<td>Memo. BTA &amp; TC Incidents</td>
<td>27</td>
</tr>
<tr>
<td>Sub-total</td>
<td>37</td>
</tr>
<tr>
<td><strong>District Courts:</strong></td>
<td></td>
</tr>
<tr>
<td>Nonjury Incidents</td>
<td>19</td>
</tr>
<tr>
<td>Jury Incidents</td>
<td>14</td>
</tr>
<tr>
<td>Subtotal</td>
<td>33</td>
</tr>
<tr>
<td><strong>Total Incidents</strong></td>
<td>70</td>
</tr>
</tbody>
</table>

\(^1\) As defined in CHAPTER I. Court of Claims incidents omitted due to the insignificance of the number thereof.

\(^2\) In a very few incidents the time period involved years covered by Revenue Acts in adjoining columns. Such incidents are classified in the column representing the older applicable Revenue Act.

\(^3\) S denotes cases in which the decision was split between the taxpayer and government due to the section 535(c) credit.

\(^4\) Board of Tax Appeals.

\(^5\) Tax Court.
departure from previous statutes of the general credit provision of section 535(c), a heading in addition to those provided for the taxpayer and government is provided. The additional heading represents decisions which were split between the taxpayer and the government by the application of section 535(c). The total incidents under the 1954 classification are 122. This number includes only six decisions classified as "split." The remaining 116 incidents show 70 in favor of the taxpayer and 46 in favor of the government. In contrast to the 1939-'38 column, the 1954 column might represent the beginning of a trend in favor of the taxpayer in Tax Court cases. The 1954 column reveals 37 incidents for the taxpayer and 23 for the government arising from the Tax Court. The incidents arising out of memorandum decisions account for almost all of this difference as the incidents arising from a full review are 10 for the taxpayer and 9 for the government. The district court incidents are similarly divided with 33 in favor of the taxpayer and 23 in favor of the government. All of this difference arises out of the jury trials as the nonjury incidents are evenly divided at 19 each for the parties.

The indication of a possible bias in favor of taxpayers in jury trials is strengthened by a continuation of the trend shown in the 1939-'38 column. Whether or not the bias is real, the change in the dispersion of incidents between trial court jurisdictions is some
indication that taxpayers believe that it exists. This suggestion is made as a logical inference from the observation that the total incidents for the 1954 column and the 1939-’38 column are almost the same at 122 and 121, respectively, while the proportion of district court incidents increased with an attendant decline in the proportion of Tax Court incidents.

FINAL DETERMINATIONS IN THE APPELLATE COURTS

Since appeals from the Tax Court and the district courts go to the United States Circuit Courts of Appeals, an examination of the results of the appeals from all of the incidents provides an additional basis for evaluating the incidents. Table 3 separately presents the appeals taken by the taxpayer and the government from the Board of Tax Appeals and Tax Court incidents to various Circuit Courts of Appeals. This table reveals a total of 72 appeals, with 69 taken by the taxpayer and 3 taken by the government. This division of the appeals is in striking contrast to the relatively even division of incidents between the taxpayer and the government as shown by Table 2. The taxpayer was able to obtain a reversal 15 out of 69 times, for a rate of 21.7 percent. The government did not win any of its three appeals.

In Table 4 the appeals taken upon the district court incidents are presented. The total number of appeals taken is 21. Of this number, 15 were taken by the
TABLE 3

The Number of Incidents Appealed\(^1\) and Reversals\(^2\) Obtained by the Taxpayers and the Government in Accumulated Earnings Tax Cases Originally Before the Board of Tax Appeals\(^3\) and the Tax Court\(^3\) Since the Passage of the Revenue Act of 1921

<table>
<thead>
<tr>
<th>The United States Circuit Courts of Appeals</th>
<th>1st</th>
<th>2nd</th>
<th>3rd</th>
<th>4th</th>
<th>5th</th>
<th>6th</th>
<th>7th</th>
<th>8th</th>
<th>9th</th>
<th>10th</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Appeals by Taxpayers</td>
<td>8</td>
<td>20</td>
<td>5</td>
<td>4</td>
<td>9</td>
<td>3</td>
<td>3</td>
<td>8</td>
<td>6</td>
<td>3</td>
<td>69</td>
</tr>
<tr>
<td>Reversals Obtained</td>
<td>4</td>
<td>4</td>
<td>2</td>
<td>2</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>15</td>
</tr>
<tr>
<td>Percentage Reversed</td>
<td>50.0%</td>
<td>20.0%</td>
<td>40.0%</td>
<td>50.0%</td>
<td>11.1%</td>
<td>33.3%</td>
<td>0%</td>
<td>0%</td>
<td>16.7%</td>
<td>0%</td>
<td>21.7%</td>
</tr>
<tr>
<td>Number of Appeals by the Government</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>Reversals Obtained</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Percentage Reversed</td>
<td>-</td>
<td>0%</td>
<td>-</td>
<td>-</td>
<td>0%</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>0%</td>
<td>-</td>
<td>0%</td>
</tr>
</tbody>
</table>

\(^1\)Cases dismissed by agreement of the parties have been omitted.

\(^2\)Cases classified as reversed include those vacated and remanded as well as those reversed outright.

\(^3\)Memorandum decisions are included.
taxpayer and 6 taken by the government. The taxpayer obtained three reversals for a rate of 20 percent. This rate is quite close to the 21.7 percent reversal rate for taxpayers shown in Table 3. However, the appeals by the government indicate some significant differences, although the absolute numbers are small. In contrast to the results presented in Table 3, Table 4 shows that the number of government appeals doubled for a total of six, while the total number of appeals decreased to 30 percent of the total appeals presented in Table 3. This increase in appeals by the government may be interpreted as indicating a bias in favor of taxpayers in the district courts. When one considers that four reversals were obtained upon the six appeals taken by the government, the suggested bias becomes more credible. Table 5 is a compilation of Table 3 and Table 4, and it is presented to give an overview of the appeals.

The idea of judicial bias is somewhat repugnant to ideals of justice. However, a deliberate bias is not suggested. Instead, the suggested bias is believed to be a subconscious one that is expressed in the attitude of a judge,¹ or jury member, as he views any given issue. For example, the different interpretations of the sub-

Table 4

The Number of Incidents Appealed\(^1\) and Reversals\(^2\) Obtained by Taxpayers and the Government in Accumulated Earnings Tax Cases Originally Before the District Courts Since the Passage of the Revenue Act of 1921

<table>
<thead>
<tr>
<th></th>
<th>1st</th>
<th>2nd</th>
<th>3rd</th>
<th>4th</th>
<th>5th</th>
<th>6th</th>
<th>7th</th>
<th>8th</th>
<th>9th</th>
<th>10th</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Number of Appeals by Taxpayers</strong></td>
<td>0</td>
<td>2</td>
<td>0</td>
<td>2</td>
<td>4</td>
<td>2</td>
<td>1</td>
<td>1</td>
<td>2</td>
<td>1</td>
<td>15</td>
</tr>
<tr>
<td><strong>Reversals Obtained</strong></td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>2</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>3</td>
</tr>
<tr>
<td><strong>Percentage Reversed</strong></td>
<td>0%</td>
<td>-</td>
<td>0%</td>
<td>50.0%</td>
<td>50.0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>20%</td>
</tr>
</tbody>
</table>

|                  | 0   | 1   | 0   | 0   | 0   | 2   | 0   | 0   | 0   | 0    | 3     | 6     |
| **Number of Appeals by the Government** |     |     |     |     |     |     |     |     |     |      |       |       |
| **Reversals Obtained**            | 0   | 0   | 0   | 0   | 0   | 1   | 0   | 0   | 0   | 3    | 4     |
| **Percentage Reversed**           | 0%  | -   | -   | -   | -   | 50.0% | -   | -   | -   | 100.0% | 66.7% |

\(^1\)Cases dismissed by agreement of the parties have been omitted.

\(^2\)Cases classified as reversed include those vacated and remanded as well as those reversed outright.
Table 5

The Number of Incidents Appealed\(^1\) and Reversals\(^2\) Obtained by Taxpayers and the Government in Accumulated Earnings Tax Cases Since the Passage of the Revenue Act of 1921

<table>
<thead>
<tr>
<th>The United States Circuit Courts of Appeals</th>
<th>1st</th>
<th>2nd</th>
<th>3rd</th>
<th>4th</th>
<th>5th</th>
<th>6th</th>
<th>7th</th>
<th>8th</th>
<th>9th</th>
<th>10th</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Appeals by Taxpayers</td>
<td>8</td>
<td>22</td>
<td>5</td>
<td>6</td>
<td>13</td>
<td>5</td>
<td>4</td>
<td>9</td>
<td>8</td>
<td>4</td>
<td>84</td>
</tr>
<tr>
<td>Reversals Obtained</td>
<td>4</td>
<td>4</td>
<td>2</td>
<td>2</td>
<td>3</td>
<td>2</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>18</td>
</tr>
<tr>
<td>Percentage Reversed</td>
<td>50.0%</td>
<td>18.2%</td>
<td>40.0%</td>
<td>33.3%</td>
<td>23.1%</td>
<td>40.0%</td>
<td>0%</td>
<td>0%</td>
<td>12.5%</td>
<td>0%</td>
<td>21.4%</td>
</tr>
</tbody>
</table>

| Number of Appeals by the Government      | 0   | 2   | 0   | 0   | 0   | 1   | 2   | 0   | 0   | 1   | 3     | 9     |
| Reversals Obtained                      | 0   | 0   | 0   | 0   | 0   | 1   | 0   | 0   | 0   | 0   | 3     | 4     |
| Percentage Reversed                     | -   | 0%  | -   | -   | 0%  | 50.0% | -   | -   | 0%  | 100.0% | 44.4% |

\(^1\)Cases dismissed by agreement of the parties have been omitted.

\(^2\)Cases classified as reversed include those vacated and remanded as well as those reversed outright.
stantive rules of law presented in CHAPTER II are believed to be the result of judicial attitudes which are based upon subconscious values of the individual judges. The effect of a probable bias must be considered in an evaluation of equity.

SUMMARY

This chapter has presented four tables in order to draw conclusions and inferences from the final determinations in the accumulated earnings tax cases. Table 2 showed that the number of accumulated earnings tax incidents began to increase with the Revenue Act of 1938. The results of jury trials indicated a probable bias in favor of taxpayers. An examination of the appeals taken, as presented in the subsequent tables, tends to support the suggestion of bias. Furthermore, the reversals obtained tend to corroborate the bias suggested.
CHAPTER VI

SUMMARY AND CONCLUSIONS

This chapter contains a summary and conclusions based upon the results of this study. The conclusions contain an objective and subjective evaluation of equity as revealed in the cases investigated. In addition to an evaluation of equity as it has existed, an evaluation of the future prospects of equity is presented. Finally, recommendations are made in the light of past proposals and related criticisms and the results of this study.

SUMMARY

This study was introduced with a presentation of various aspects of the problem, definitions of some terms limited to this study, a review of the relevant literature, and a statement of the methodology to be used in this study. CHAPTER II presented a brief legislative history of the accumulated earnings tax and the judicial development of two substantive rules of law. CHAPTER III examined the development of a procedural rule of law, the burden of proof under section 534, and its relationship to section 535. CHAPTER IV presented some applications of accounting concepts in determining the reasonable needs of the business. CHAPTER V investigated the final determinations as clas-
sified in different ways. Each of these chapters is summarized in the following discussion.

Introduction to the Study

The primary purpose of this study was to make an evaluation of equity in the judicial administration of the accumulated earnings tax cases. Specific objectives were to examine these cases in order to determine the characteristics of conflicting decisions, to determine the judicial basis for such decisions, to evaluate equity in those cases, and to evaluate future prospects for equity. Proposals for tax reform are constantly being presented. This study should contribute some evidence in weighing proposals for judicial reform in the federal tax area. The study was limited to three broad topics involving two substantive rules of law, a procedural rule of law, and applications of accounting concepts. In addition, an investigation of the final determinations was presented.

Three terms were specifically defined for this study. They are: equity, reasonable classification, and incident.

The review of the literature began with a presentation of the Traynor and Surrey proposals for judicial reform. They made three significant suggestions which were as follows:

(1) To transfer the original jurisdiction of the District Courts and the Court of Claims to the Board of Tax Appeals, thus giving the Board exclusive original jurisdiction in all income, estate, and gift tax cases;
(2) To decentralize the Board of Tax Appeals; and

(3) To create a single Court of Tax Appeals and limit appeals to this Court with appeal from the Court of Tax Appeals by certiorari to the Supreme Court.

The views of various critics of these proposals were given. However, six years after the Traynor and Surrey proposal, Professor Griswold revived the controversy. Griswold limited his efforts to supporting a single Court of Tax Appeals although he suggested refinements to the related proposal by Traynor and Surrey. Professor Griswold was concerned about the long time period during which the conflicting decisions remained unsettled. Critics of Griswold's proposal concentrated their attention upon the aspect of time, rather than the fact of conflict. Madeline Remmlein conducted a study of conflict cases in order to evaluate the time period in which a conflict might go unresolved. Remmlein interpreted the data to indicate a fallacy in the charge that conflicting circuit court decisions delayed settlement of tax controversies. A second study

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by Remmlein for a time period contiguous to the time period of her first study supported the prior study, but it did indicate a possible trend toward a greater total elapsed time until settlement of a case. In spite of the Remmlein studies, Judge Walter Pope concluded that the weakness at the circuit level, noted by Traynor and Griswold, was still in existence. Judge Pope believed that the strongest objections were based upon the process for appointing judges to a Court of Tax Appeals, and he set forth a plan which he hoped would avoid the objections he perceived. Professor Lowndes reviewed all of the federal income, estate, and gift tax cases going to the Supreme Court since ratification of the Sixteenth Amendment through the 1959 term. He classified these cases into the three categories of criminal cases, constitutional cases, and construction cases. Lowndes concluded that the Supreme Court should retain jurisdiction of cases in the first two categories. However, cases involving the construction of statutes, which is a preponderance of the cases, should be within the jurisdiction of a Court of Tax Appeals. Finally, Professor Del Cotto conducted a


study similar to those made by Remmlein. Del Cotto's study followed the first Remmlein study by 16 years. He found that the time required to settle conflict cases had increased since Remmlein's study. Professor Del Cotto believed that the time period in which tax questions remained in doubt was far too long.7

The basic methodology of the studies reviewed was an analysis of conflicting cases from the Supreme Court down to the circuit courts. In contrast to this methodology, the present study examined cases at the trial court level for conflicting decisions on each one of three broad topics previously set forth. Analysis of these conflicts proceeded from the trial court up to the Supreme Court in applicable cases. This analytical approach provides some insight for the existence of conflicts that have not reached the appellate level. Such conflicts would go undetected by the approaches taken in the other studies. An objective comparison of important conflicting issues permits judicial attitudes to be ascertained for an evaluation of equity.

Two Substantive Rules of Law

The basic statutory provision for the accumulated earnings tax throughout its existence is that it will be levied against a corporation if that corporation has been

formed or availed of for the purpose of avoiding income
taxes upon its stockholders. The term "purpose" has
been interpreted in several different ways during a period
of almost four decades. In the order of decreasing
favorableness to the taxpayer, the interpretations are:

1. The "sole" or "express" purpose test,
2. The "primary" or "dominant" purpose test,
3. The "one of the determining purposes" test, and
4. The "a," "any," or "one of the purposes" test, compatible with the "complete absence of purpose"
test.

The Supreme Court settled the conflict among these inter­pretations in favor of the fourth construction in Donruss
in 1969.

Another substantive rule of law governs the rela­tion­ship of the reasonable needs of the business to the
purpose. The fact that earnings had been accumulated be­yond the reasonable needs of the business was "prima
facie" evidence of the prohibited purpose prior to the
Revenue Act of 1938. Beginning with the 1938 Act the
same fact became "determinative" of the prohibited pur­pose. Under either of these provisions the relationship
between the reasonable needs of the business and the pur­pose is subject to interpretations that yield eight
possible paths to a final determination in an accumulated
earnings tax case. In CHAPTER II these paths were presented
in Table 1.
Section 534 and Section 535

Section 534 provides for a shift in the burden of proof from the taxpayer to the Commissioner under certain conditions. Early critics charged that the Tax Court's treatment of this section had frustrated the intent of Congress. The Second Circuit duly noted the Congressional intent for adopting the provision and the Tax Court's failure to determine the section 534 issue in Gsell. This Court of Appeals admonished the Tax Court of the necessity for making a determination of the section 534 issue, especially in close cases. A second round of criticism developed as writers became aware of the potential impact of the general credit provision of section 535(c) upon section 534. Critics suggested that the burden of proof should extend to section 535 so that the Commissioner would have the burden of proving the extent of the reasonableness of accumulations in appropriate cases.

The cases since Gsell reveal a trend in determining the burden of persuasion element of the burden of proof. The burden of producing evidence has received relatively less attention. Arguably, the cases appealed since Gsell provide a suggestion that further development has been impeded by the preoccupation of the courts in determining boundaries for the reasonable needs of the business and the proper application of accounting concepts.
An analysis of the comments of the critics and the opinions of the courts led to a restricted theory that regardless of the Tax Court's treatment of a section 534 issue, the final result of an appellate decision will be unaffected. However, this theory does not negate the need for the Tax Court to determine the section 534 issue. Finally, a proposal was tendered to accommodate the various factions. The proposal calls for a full interplay between sections 534 and 535. The essential features require that an adequate section 534 statement include a dollar amount for estimated needs, that such a statement will shift both elements of the burden of proof to the Commissioner, and that the burden of producing evidence will shift back to the taxpayer upon the Commissioner's presentation of evidence disproving the amount of the need claimed in the section 534 statement.

Applications of Accounting Concepts

The accumulated earnings tax cases were examined for the judicial treatment of basic accounting concepts. The nature of earnings, the nature of depreciation, and the nature of an appropriation of retained earnings have all been misunderstood in varying degrees. The most pervasive misunderstanding of these three concepts has been the relationship of each to cash or liquid assets. The cases presented revealed that one aspect of a particular concept may be understood, while another aspect of the same concept is misconstrued. The nature of working capital has also
been confusing to some courts. The basic misinterpretation of this concept has been a failure to appreciate the difference between a static measurement of working capital at a moment of time and the dynamic changes in working capital during a period of time. A suggestion was made for a better analysis of working capital needs. The courts' approach to evaluating the reasonableness of accumulations by comparing liquid assets to reasonably foreseeable business needs was examined. Although a contrary approach was presented, a rationale to support the judicial approach on this issue was presented.

**An Investigation of Final Determinations**

The final determinations in the accumulated earnings tax cases have been classified in different ways in order to obtain several views of the decisions. Table 2 showed that the number of accumulated earnings tax incidents began to increase with the Revenue Act of 1938. The results of jury trials indicated a probable bias in favor of taxpayers. An examination of the appeals taken, as presented in the subsequent tables, tends to support the suggestion of bias. Furthermore the reversals obtained tend to corroborate the bias suggested.

**CONCLUSIONS**

**Evaluation of Past Equity**

An objective evaluation of equity requires that the constraints imposed by the definitions of equity and
reasonable classification be satisfied. These constraints can seldom be satisfied in a comparison of different cases. However, the constraints may be satisfied by isolating identical issues in cases which would not otherwise be comparable. An evaluation of equity must proceed by deduction from an objective comparison of the judicial treatment of identical issues. As one step to this end the development of two substantive rules of law was examined.

During a period of almost four decades, four distinctly different interpretations of the prohibited purpose were used by the courts. The application of the accumulated earnings tax is predicated upon the existence of the proscribed purpose. Thus the interpretation of purpose is the most important issue to be determined. With four different interpretations of purpose in use, inequitable treatment of taxpayers is a highly probable result. Inequitable results do not necessarily follow from the existence of different constructions of statutory provisions because other factors can be such that the same result would occur regardless of the interpretation utilized. For example, if the facts of a case were to be such that the express purpose test would result in a decision for the Commissioner, the one of the purposes test would be in favor of the Commissioner, too. Therefore, the existence of equity in these cases has been partially a matter of chance.

A most significant factor affecting the probability
of equity has been the relationship of the reasonable needs of the business to the purpose because the statutory provisions have provided that accumulations in excess of those needs were either prima facie evidence of the purpose, or were evidence determinative of the purpose. Previously, eight paths were presented to show the possible ways to reach a final decision assuming only one definition of purpose. Two of these paths treat the reasonableness of the accumulations as determinative of the final decision without consideration of the purpose. Thus six paths require a determination of purpose. Since four interpretations of purpose have existed, each of the six paths can be reproduced for each interpretation. Therefore, twenty-four paths involving purpose, plus two paths involving only the reasonableness of accumulations, gives a total of twenty-six possible paths. Considering this large number of possible paths to a final decision, the probability of equity for past years is quite low.

The operation of the burden of proof under section 534 presents a different aspect of the cases for evaluation because it involves a procedural rule of law. Inequity has resulted from the Tax Court's failure to make a determination of the section 534 issue in all appropriate cases. The magnitude of the inequity is substantially less than in the instance of the substantive rules of law discussed above. The reasons for the smaller magnitude of inequity under the section 534 issue are: (1) the
provisions of section 534 were incorporated into the law for the first time in the 1954 Code, (2) section 534 applies only to cases coming before the Tax Court, and (3) the Tax Court has been increasingly making section 534 determinations.

A determination of the reasonable needs of the business has required the application of such basic accounting concepts as earnings, depreciation, working capital, and appropriation of earnings. The dilemma presented to a judge attempting to determine the reasonableness of accumulations is as follows: Reasonable needs of the business must be satisfied out of the assets of a corporation, but accumulations are measured as equities which must also be satisfied out of the assets. The confusion over the accounting relationships has been apparent in the cases in which the courts have explained the application of accounting concepts. Of course in most cases accounting concepts have not been explained, and this writer had initially assumed that accounting concepts were properly applied in those cases. However, the misunderstanding of accounting evidenced by so many explanations of these concepts has eliminated the assumption of proper application by the courts. The judicial awareness of the need to assume a relationship between liquid assets and accumulated earnings in the 1960 Smoot case was a significant improvement. Overall the courts' treatment of accounting concepts is considered to be an
additional indication of a lack of equity, or at least further evidence that equity is a matter of chance in the accumulated earnings tax cases.

The investigation of final determinations enables the evaluation based upon a comparison of identical issues to be placed in perspective. Different interpretations of any given issue almost inevitably means that one interpretation will be favorable to one party while a different interpretation will be less favorable to that party. The different interpretations are believed to result from different judicial attitudes toward the government and the taxpayer. The increasing percentage of cases taken to the district courts by taxpayers indicates that taxpayers believe they will receive more favorable treatment in the district courts than in the Tax Court. The final determinations of incidents decided by jury trials seems to support this apparent difference in attitudes. The pattern of appeals suggests that both the Commissioner and taxpayers sense the difference in attitudes among the forums. The reversals obtained corroborate the suggestion of bias. Thus the conclusion is made that in the past equity has been mostly a matter of random chance, rather than the inexorable process of justice.

Evaluation of Future Equity

The prospects for future equity must be based upon the most recent developments. The developments will be considered in the topical order followed to this point.
The 1969 Supreme Court decision in *Donruss* finally eliminated all interpretations of purpose except for the "one of the purposes" test. However the relationship between purpose and the reasonable needs of the business has not been settled. Specifically, a whole new series of conflicting decisions involving the relationship of purpose to the general credit provision of section 535(c) is predicted. Additional conflicting interpretations on the interaction of section 534 with section 535 are expected. Furthermore, misinterpretations of accounting concepts are expected to continue. If section 535 increases in importance, which seems probable, the application of accounting concepts will play a more important role in determining equity in the accumulated earnings tax cases. The adoption of an assumption for relating liquid assets to retained earnings was an improvement, but the courts' poor ability to evaluate working capital needs through an operating cycle analysis is disheartening. Thus on the whole only a small improvement may be expected. However, statutory changes could completely alter this outlook at any time.

**Recommendations**

Equity in the judicial administration of the accumulated earnings tax cases is not the natural product of justice as it should be. No individual judge or court can be singled out as being responsible for the lack of
equity. The judicial system for federal tax cases must bear the blame. Several suggestions made by previous writers were presented in a review of the literature. Several of those views will be examined in the light of this study.

Most of the critical comments concerning the judicial system in tax cases have emphasized the length of time that uncertainty prevails until conflicts are settled. After the controversy over the Traynor and Surrey proposals subsided, the time and uncertainty arguments centered upon the need for a single court to hear all tax appeals. The analysis in CHAPTER III of the case development of section 534 since the Second Circuit's Gsell case is relevant to a determination of this need. The Tax Court decisions showed a substantial change in policy toward making section 534 determinations in about 50 percent of the cases examined. More importantly, the appeals taken disclosed that in all appeals taken to the Second Circuit the section 534 issue had been decided, but the appeals taken upon cases in which that issue had not been resolved went to other circuit courts. This disclosure is not startling, but it emphasizes the effect that a Court of Tax Appeals could have in reducing the time and uncertainty that attends conflicting decisions. This study also supports the position of Professor Lowndes that there is no reason to have the Supreme Court exercise jurisdiction in construction cases. So as noted earlier
the Supreme Court's decision in Donruss settled only the issue involving the construction of purpose while leaving the relationship of purpose to the reasonable needs of the business unresolved. Furthermore, this writer feels that the results achieved by the Supreme Court in National Grocery Co. and Chicago Stock Yards Co. were no better than could have been achieved by a Court of Tax Appeals. For example, in Chicago Stock Yards (1943) the Supreme Court passed an opportunity to adopt a construction of purpose only to face that task in Donruss (1969). Thus a single Court of Tax Appeals is recommended.

In addition to this recommendation, another recommendation initially made by Traynor and Surrey is hereby endorsed. The other recommendation is to grant the Tax Court exclusive original jurisdiction in all income, estate, and gift tax cases. Although a Court of Tax Appeals would substantially reduce the uncertainty in tax cases, this writer believes that there would still be too much leeway at the trial court level for judges to interpret tax law within the framework of their personal attitudes until precedents could be set by the Court of Tax Appeals. The operation of the Tax Court in which full court decisions are rendered, as well as memorandum decisions, provides a vehicle for the crystallization of judicial viewpoints that is missing under the present system. Furthermore, the need for specialists in tax matters is quite evident from the applications of
basic accounting concepts presented in CHAPTER IV. A program to appoint such specialists to all of the district courts is not feasible. Thus a single court for the trial of federal tax cases as well as a single court for tax appeals is recommended.
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Frank E. Watkins, Jr. was born in Cleveland, Tennessee, on June 8, 1941. His family moved to Knoxville, Tennessee, in 1946. He attended elementary schools in Knoxville and graduated from Fulton High School in 1959.

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EXAMINATION AND THESIS REPORT

Candidate: Frank Edwin Watkins, Jr.

Major Field: Accounting

Title of Thesis: An Evaluation of Equity in the Judicial Administration of the Accumulated Earnings Tax Cases

Approved:

Clarence L. Dean
Major Professor and Chairman

James E. Frankham
Dean of the Graduate School

EXAMINING COMMITTEE:

J. L. Cooper

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Date of Examination:

September 8, 1973