Supreme Court of the United States

In the Matter of:

Docket No. 17

United States of America,

Petitioner,

vs.

The Donruss Company,

Respondent.

Duplication or copying of this transcript by photographic, electrostatic or other facsimile means is prohibited under the order form agreement.

Place Washington, D. C.

Date October 22, 1968

and Oct. 23

(see p. 24)

ALDERSON REPORTING COMPANY, INC.

300 Seventh Street, S. W.

Washington, D. C.

NA 8-2345

C O N T E N T S

****

IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1968

United States of America, Petitioner,	:	
vs.	:	No. 17
The Donruss Company, Respondent.	:	

Washington, D. C.
Tuesday, October 22, 1968

The above-entitled matter came on for argument at 2 p.m.

BEFORE:

EARL WARREN, Chief Justice
HUGO L. BLACK, Associate Justice
WILLIAM O. DOUGLAS, Associate Justice
JOHN M. HARLAN, Associate Justice
WILLIAM J. BRENNAN, JR., Associate Justice
POTTER STEWART, Associate Justice
BYRON R. WHITE, Associate Justice
ABE FORTAS, Associate Justice
THURGOOD MARSHALL, Associate Justice

APPEARANCES:

MITCHELL ROGOVIN
Assistant Attorney General
Department of Justice
Washington, D. C.
Attorney for the Petitioner

RICHARD L. BRAUNSTEIN
1225 Connecticut Avenue, N.W.
Washington, D. C. 20036
Attorney for Respondent

P R O C E E D I N G S

MR. CHIEF JUSTICE WARREN: No. 17, The United States, Petitioner, vs. The Donruss Company.

THE CLERK: Counsel are present.

MR. CHIEF JUSTICE WARREN: Mr. Rogovin.

ORAL ARGUMENT OF MITCHELL ROGOVIN

ON BEHALF OF PETITIONER

MR. ROGOVIN: Mr. Chief Justice, may it please the Court:

This is an income tax case dealing with the construction of a portion of the accumulated corporate earnings tax. The purpose of this tax, the accumulated earnings tax has been part of our tax fabric since 1913, is to determine holders of a corporation from avoiding individual income tax by having the corporation accumulate earnings beyond the reasonable needs of the corporation.

The Government's petition for writ of certiorari to review the judgment of the Sixth Circuit in this case takes place because the Sixth Circuit's decision was in conflict with four other circuits, circuits that had supported the United States in its construction.

The surplus earnings tax deals with Sections 531 thru 537 of the Internal Revenue Code and they have three essential features. Section 532 (a) of the Code has the critical operative provision in the context of the accumulated earnings tax. This

is the provision that imposes the special tax on "every corporation formed or available for the purpose of avoiding the income tax with respect to its shareholders by permitting earnings and profits to accumulate instead of being divided or distributed."

This feature requires a particular showing of conduct and a particular showing of the state of mind. Questions of intent and state of mind, however, are difficult and since 1913 the statute has carried with it a rebuttal presumption regarding the prohibited purpose.

Section 533(a) of the Code carries this presumption. It provides that the fact that earnings and profits are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders unless the corporation by the preponderance of the evidence shall prove to the contrary.

Finally, since 1954 there has been a credit provision within the accumulated earnings tax and this is found at 535(c). The most significant of the two credits are the 535(c)(1) credit which, in essence, permits a credit notwithstanding the essence of the prescribed purpose, as to that portion of the accumulated earnings determined by the tryer of fact to be reasonable.

Although the ultimate issue is whether or not there is a prescribed purpose, whether or not it exists, even if it is found to exist, the credit under 535(c)(1) would wash out the tax at least as to that portion of the accumulation ---

Q Is this true even though you are not relying on the presumption? Let's assume there is some express proof of what the purpose was and that it was to avoid the income tax?

A Yes, sir.

Q As long as the accumulation is reasonable, there is no penalty for it?

A Yes, Justice White, what happened prior to 1954 was that if any portion of the total accumulation were determined to be unreasonable, then the tax would apply to the totality of the accumulation. The credit in '54 allowed the taxpayer to at least take out of the ambit of the tax that portion which was determined to be reasonable at all times, assuming that the avoidance purpose existed.

Q This in effect is just a law against unreasonable accumulation?

A With the requisite intent, the intent is built into the statute.

To summarize, the special tax will be imposed if the purpose of avoiding the shareholder tax is found to exist either because of the presumption in 533(a) or if it is found independently of it but subject to the credit for so much of the retained earnings as are reasonably needed for the business.

The present case takes the form of a suit for a refund. At the trial the jury heard evidence that for the years '60 and '61, the respondent, a bubble gum manufacturer, had increased

the accumulated earnings in those years in suit from approximately $1,638,000 to $1,679,000. There was no record of any dividends ever being paid in the years insuit or any indication of dividends being paid since the inception of the corporation in '47.

The sole stockholder testified that the reasons for the accumulations were to purchase the stock of respondent's major distributor. There was also testimony that the accumulations were because of a fear of depression, possible fear of war and also a desire on the part of respondent to follow, by expansion, in the footsteps of the Wrigley Company.

In response to interrogatories, the jury found that (1) during the years in suit the respondent had accumulated its earnings beyond the reasonably anticipated needs of the business but that it had not retained its earnings for the purpose of avoiding the income tax on its sole shareholder.

The Government's appeal was based on the District Court's refusal to define the phrase "the purpose as it relates to the reason for retention of the earnings." The Court of Appeals reversed and remanded for new trial, holding that the jury might well have been led to believe that tax avoidance must be the sole purpose behind an accumulation.

This position that tax avoidance must be the sole purpose had not been asserted by either of the parties. The Sixth Circuit in reaching this decision rejected the Government's

request for a jury instruction, that tax avoidance need only be one of the purposes for the company's accumulation policy.

The Sixth Circuit went on to hold that the jury should be instructed that the accumulated earnings tax applies only if tax avoidance was the dominant, controlling or impelling motive. The Government seeks review in this Court, because we believe that this dominant purpose standard is erroneous; we believe that the proper view is the view that was requested at the District Court, that tax avoidance need only be one of the purposes of an accumulation for this special tax to come into play.

The basic purpose of Sections 541 thru 537 to discourage the use of the corporation as a repository for accumulations, which if distributed would have been taxed at progressive rates from the individual shareholders. Since corporations have a legal existence apart from that of the shareholders, the corporation could be interposed between the source of income and the receipt by the individual owner, thus allowing the beneficial owner to avoid income tax at the graduated rates.

This device has been recognized by the Congress since the inception of the modern income tax in 1913, Sections 531 thru 537 are a statutory effort to overcome the fact that we do not have integration between the income tax and the corporate tax. The purpose of the accumulated earnings tax is as this Court had concluded in Helvering vs. Stockyards, 318 U.S. 693 at page 679,

"To compel the company to distribute any profits not needed for the conduct of its business so that when so distributed, individual shareholders will become liable."

Underlying this statute is a legislative assumption that it becomes a misuse of a corporation if its profits are retained for the purpose of avoiding the stockholders' individual income tax. Judge Learned Hand in the United Business Court, 663 Fed. (2d) 754, at 756, said as to the accumulated earnings tax, "Companies may accumulate what profits they please so long as they do not defeat the fiscal policies of the United States. Their business does not include the manipulation of dividends to avoid taxes; by definition that has nothing to do with the normal management of their affairs."

The critical language is that in 542, "availed of for the purpose of avoiding the income tax." In no way does this language import qualification such as formulated by the Sixth Circuit that this tax avoidance must be the dominant purpose. "Availed of" simply means used to the extent tax avoidance induces or aids in inducing in the retention of accumulated earnings the corporation has been used or, in the statutory language, availed of for this prohibitive purpose.

The Government's position is derived from the plain statutory language that implies no further qualification and also from this Court's interpretation of that statutory language in the Stockyards Case. We though, as did Fourth Circuit, that

this issue had been laid to rest.

Now in the Stockyards Case, the First Circuit, the taxpayer argued that the accumulation policy of the corporation intended to satisfy the debts of a New Jersey subsidiary upon its contemplated liquidation in 1940 and that this plan had been inaugurated prior to the adoption of the 16th Amendment and consistently followed by the corporation thereafter, so that, argued the taxpayer, the corporation could not have been availed of for the prescribed purpose set out in the law and this was their position as a matter of law.

Now although the First Circuit reversed the Board of Tax Appeals, which had upheld the assertion of the accumulated tax, the First Circuit rejected the taxpayer's argument. The First Circuitin Chicago Stockyards, 129 Fed (2d) 937, at page 948, said, "It is clear that Section 104 would apply if in the totality of reason which induced the continuing of the accumulation, the forbidden motive of surtax avoidance played a substantial part."

The First Circuit thus rejected the concept of a dominant purpose theory. It was in this context that the case came to this Court. This Court stated at page 699, "A corporate practice adopted for the mere convenience or for 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, that is, the conclusion of the

Board of Tax Appeals that the accumulated earnings tax was to be imposed, 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.

Q What case was that?

A In the Stockyards Case, 318 U.S., at page 699.

Q Mr. Rogovin, I suppose it is true that most companies now and for many years, most very large companies, have paid out only a small fraction of their earnings as dividends?

A I believe that is correct, sir.

Q Does the Bureau proceed on the assumption that some of the largest companies are totally without purpose of a tax avoidance for their stockholders in that process of accumulation? Take any one of them you like as an illustration, any of the largest companies. Pick any one that you like and tell me does the Bureau assume that the rule you advocate here would or would not compel you to go after them?

A It is a two-part test. The objective part of the test has not been considered in your hypothetical and that is, are the accumulations unreasonable, are the funds retained for the purpose of avoiding the surtax on individuals?

Q I understand that part of it. I understand that problem, I think, but some of them are mighty big.

A I believe the track record of the Revenue Service in

this regard tends to indicate that they are looking at the small closely held corporations.

Q That is exactly it, that is what bothers me. As I understand it, this statutory provision has been used almost exclusively with respect to the small closely held corporations and my question to you is whether the standard for which you contend would have an impact upon that, whether it is the Bureau's view that if this standard is correct in view of the problem presented by the large corporations.

A The concern of the Congress in passing the accumulated earnings tax was the concern that the stockholders could so manipulate the corporation and thereby require or cause the corporation to retain earnings, earnings that would not be passed on to the stockholders.

Q I don't think you are contending that should be a condition precedent to the Bureau's ability to invoke this section, are you?

A That is a presumption that the Congress indulged in assuming that this close relationship between stockholder and corporation could cause this result and there would be no objective evidence to demonstrate tax avoidance, so the presumption was built into the statute.

Q Are you telling this Court that the Bureau construes this statute or these sections on unreasonable accumulations, as applicable only to the small closely held corporations?

A No, theoretically it could be applicable to a large listed corporation if the listed corporations, Justice Fortas, had the liquid assets and the accumulated cash in an unreasonable posture for its needs.

Q Has it ever been applied to any company other than the small closely held company?

A I believe it has been applied in one case, TRICO, to 1500 stockholders.

Q That is the largest?

A That is about the largest, yes, sir.

Q I know the origins of these provisions way back in Section 102, I think, were the Christian Corporation, and those closely held companies. But certainly the wording in the statute is much broader and certainly the rule for which you are now contending would literally open up the question of a large corporation, those that are held generally, isn't that right?

A Technically it would open it up, technically we are construing it as it has always been construed. To respond to your question, however, I feel the question of the nature of the accumulation would differ substantially with the large corporation.

Q What you are saying is the large corporation might or it might not be able to show some intended or prospective need for the accumulation great enough or imminent enough to justify their holding onto it without the accumulation being characterized

as unreasonable?

A I believe the pressures of large listed corporations and stockholder pressures are such that large amounts of liquid assets not being applied to the purposes of the corporation would generate better management, if not dividends.

Q I wonder if Congress wanted this applied mainly to small closely held corporations if it would not have said so in the act. Certainly this would go to large companies as well as small companies when Congress was using the general language it used?

Why won't it make the distinction in the language rather than have you make it in the administration of the statute?

A I have no answer to the question.

Q Put it this way, if Congress wrote the statute, generally what authority is there in the Internal Revenue Bureau to interpret it in this manner just as against these small corporations are closely held?

A It is because the concern of the Congress was in the retention for the benefit of shareholders and in the large corporations, listed corporations with hundreds of thousands of shareholders that potential just doesn't exist with any degree of frequency.

It does exist and that is what Congress is concerned about in the main and has been expressed this concern throughout the reenactments of the statute since 1913. But there has been

no indication that the statute would not apply to a large corporation if the factual pattern so existed. I don't think the Revenue Service is binding itself that it would not go audit a corporation and raise this issue if it exists, but the facts just don't support it in large corporations.

Q Your ability to make it stick would depend on your ability to prove that the accumulation was unreasonable?

A That is right.

Q Why in this particular case, for example, isn't the suggestion that the accumualted on this -- were thinking of going out to market and buying stock of a company that owned a substantial block and buy some stock of a related company?

A Of a distributor, yes.

Q And they had never done it, as I remember the facts of this case; nevertheless they said, "We are thinking about getting bigger by a stock acquisition." Why doesn't that put them in the category of a big company rather than a small company for the purposes of the application, so to speak, of the statute?

A This was a solely owned corporation, wholly owned by one individual. The testimony was given as to why the accumulations were being retained and the jury evidently didn't feel satisfied, because they found for the Government, they found that there were unreasonable accumulations.

We are talking about accumulations that come about because of loans to relatives, accumulations that come about

because of large portfolios of stock that have no relationship to the corporation, these are not normally the sizes that you find with a large sized corporation.

Q When was this law passed?

A 1913.

Q Is the issue here really whether the Government proved the purpose or only one of several purposes?

A Those are the burdens, but it is the taxpayer's burden.

Q It seems to me that if the taxpayer can prove that there was a reasonable purpose, he certainly doesn't pay any tax, does he?

A The structure of the tax would reach that result.

Q So even if there was also the purpose of avoiding taxes, he would still win?

A As long as the accumulation were reasonable, he would still win, that is correct.

Q All he has to prove is he does avoid additional taxes just by proving one other purpose beside avoiding taxes?

A After those accumulations, you may have a million dollar accumulation and the taxpayer may have 15 or 20 purposes, as subscribed to the accumulation, and then the tryer of the fact would determine whether, for example, moneys that were set aside for a fear of a depression, a reserve of a setup of that nature was a reasonable type of reserve.

The Court may say no, it is unreasonable.

Q They may decide it is unreasonable, but what they are really deciding is there is no other purpose than avoiding taxes.

A The Court could find that the accumulation were reasonable and concurrently throughout all of this there was a tax motive. But as to those portions determined not to be reasonable---

Q Then there isn't any other reason for it?

A It is simply that the tryer of fact determined that was not a reasonable accumulation.

Q They showed $200,000. The reasonable needs of the business are $100,000.

A There would be a $100,000 need.

Q And the tax would be assessed against the other $100,000?

A Yes.

Q Suppose you had a case where, in fact, you accumulation is again $100,000, but you know the only purpose of the accumulation would be tax avoidance. Yet they also introduce evidence that they have a business need and $100,000 is reasonable. Again the $100,000, there would be no tax on that?

A That is correct.

Q And there would be no tax?

A That's right. And what the Sixth Court has done in this case, they are saying if a corporation with an admitted tax avoidance purpose, if this corporation could avoid the penalty if the tryer of fact was persuaded that at least equal weight was to be given to the nontax reasons, as described by the

corporation.

We believe this an erroneous statement of the statute. If a corporation has a variety of motives for the accumulation, it does not matter which motive predominates, Congress provided for the elimination of the tax through the credit to the extent that there are demonstrable business needs to justify the accumulation and what the Sixth Circuit Court is doing is putting into the statute an extremely heavy burden.

Q I don't understand how that comes down to anything except the hypotheticalities I suggested, that establish insofar as the accumulation is related to the reasonable needs of the business there is no tax and any excess is taxed, is that right?

A No, there has to be a finding under the 532 finding there that the purpose of the accumulation was to avoid the tax on the shareholder level.

Q But the presumption is not rebutted?

A That is correct.

Q If all you establish is insofar as dollars are related to the reasonable needs of the business, period, then you pay a tax on the extra?

Q May I ask you did the single stockholder make any effort to prove that in the production of bubble gum he needed any more than $1 million to carry on the business?

A There was no evidence of that. The $1.6 million was an accumulation.

Q Did he make a showing he wanted to enlarge the bubble gum business?

A There was some indication that they wanted to follow in the footsteps of the Wrigley Company, but there were no definite plans as what he was going to do with these funds.

Q As I recall it, the Roosevelt Adminstration at one time thought this law was not enough to prevent tax evasion and attempted to get laws which would coerce.

Q It not only attempted to, but put into effect many, many laws.

A The Congress has uniformly reenacted this statute and this statute has the effect, the policy is to put a pressure on the corporation to divulge, to distribute dividends where they have no other use for the accumulated earnings to the extent that there is another purpose or a business purpose.

Q There was during the Roosevelt Administration an income tax law which went further.

A In 1938 the Senate Finance Committee had an opportunity to strengthen the presumption in this statute and the Finance Committee described the changes that took place as "This is page 17 of the brief, requiring the taxpayer by a clear presentation of the evidence to prove the absence of any purpose to avoid surtaxes upon shareholders after it has been determined that the earnings and profits have been unreasonably accumulated."

We believe that the decision of the Sixth Circuit is

erroneous, that this decision of this Court in the Stockyards Case is controlling.

Q Now the Stockyards Case was a case in which the Board of Tax Appeals found, first of all, that the corporation and then the Board of Tax Appeals further found that the sole purpose of the retention of earnings was to avoid taxes. The issue in this case, which finally got here, was whether or not a corporation originally formed for another purpose could later be availed of for retention of earnings for the prohibited purpose. That was the basic issue here.

And finally there was a question of accepting the fact-finding of the BTA.

A As to the language of this Court with respect to inducement or aids in inducing, the purpose of the question, this was the language that the Court inserted. The First Circuit referred to avoidance playing a substantial part.

Q The administrative body, the fact-finding body had found that it was the sole purpose of Mr. Prince's corporation, had it not?

A It had, yes, sir.

Thank you.

MR. CHIEF JUSTICE WARREN: Mr. Braunstein.

ORAL ARGUMENT OF RICHARD L. BRAUNSTEIN

ON BEHALF OF RESPONDENT

MR. BRAUNSTEIN: May it please the Court:

On the issue before this Court is the construction of a statute that has been on the books for many, many years, since 1913. The statute as enacted at that time provided that a corporation formed or fraudulently an accumulation for the purpose of preventing tax on the shareholders would trigger a penalty tax on the shareholder at that time.

There was a rebuttal presumption then as there is now that is earnings were permitted to accumulate beyond the reasonable needs of the business, that this was prima facie evidence for the purpose to escape the tax. The statute has been amended throughout the years. The word "fraudulently" was excised. The tax is now imposed on the corporation rather than the shareholders and instead of a prima facie evidence or a rebuttal presumption, we have a virtual determinant of an assumption that once a corporation accumulates its earnings beyond its reasonable needs, that unless the taxpayer comes forward and determinatively shows otherwise, that the penalty applies.

Q May I ask you if it shows why they struck out the word "fraudulently"?

A I think there was the question on the common law it was very difficult to establish fraud and that was the reason that was struck out. The reason the tax was then imposed on the

shareholder, it was first imposed on the shareholders and then it was not. Perhaps there was a constitutional question involved. I think the purpose going into this statute that reading the early indications, that there were a lot of holding company cases involved here.

At the time the statute was enacted there was no corporation tax, taxpayers were permitted to deal with their corporation in sizes which would lead to tax avoidance, and what happened, many taxpayers who had stocks and securities and were receiving income on that were able to put it in a corporate shell and really insulate themselves from any taxes.

In addition, a taxpayer was permitted to sell stock which he had purchased to his corporation. If he realized a loss on that, he could take it. I think if this case came up in 1913 we would make a very strong argument that the purpose required was the sole purpose and that the Court used the word "fraudulently" because it was talking about a situation where the corporation was used in a fraudulent manner.

I think had this case come up, we could say that the case, the statute only applied if there was absolutely no reason, no valid reason that the sole purpose for the shareholder forming this corporation had to be tax avoidance.

Q Did you say "valid reason"?

A That the sole purpose for the corporation, there was no business reason, that before the penalty was to apply, the

Court would have to find that the sole and only purpose of forming the corporation was ---

Q But to succeed, don't you have to say that even if the taxpayer may succeed, even though he can't prove that the accumulation is reasonable in terms of business need?

A I think basically coming down through our test and what the Sixth Circuit is really saying is that once it is shown that the accumulation is beyond the objective useful needs of the business, and that phrase has tremendous significance. That has been determined as fixed, definite, certain plans, almost balance sheet liabilities and written commitments, once the taxpayer has accumulated beyond that, and the fact that he says, "Well, my purpose is really I would like to expand, I would like to acquire, but I just can't go out and buy a newspaper or a radio station or a cement plant. It is just impossible."

The position of the Government today is that you are out of the ballgame. The reason they say that is, they say what is the purpose test? How do we determine that?

It is very simple. They say if the shareholder is subject to taxable income, he is in a tax bracket, he has no operating loss carryovers, and he has been advised that a distribution would result in taxable income, that is all you have to show, because then it follows that accumulated results in an avoidance of the tax, which is true.

Q And the avoidance is the purpose?

Q This isn't really a case about whether you need one or several purposes?

A It isn't. I think the Government concedes he might have 100 purposes and that you might be talking about tax avoidance or the tax purpose might be incidental, remote. He would not really care about it, but the tax applies. That is the Government's position. They say if it is one out of 100 reasons the tax applies.

Basically if you take that approach ---

Q The Government says that its position is that it is up to the taxpayer to prove the complete absence of any tax avoidance purpose and your point is that is impossible to do?

A It is impossible. The only two situations I can think of is if you have a net operating loss carryover where you can show the distribution will not result in income, or in the other situation where someone is just completely and honestly ignorant and had not been advised. But it just doesn't happen. But I think the whole point of the Government's position, it is really not asking for a construction of the statute, you can forget about available for a purpose.

What the Government's position is, in effect, saying that if you accumulate beyond fixed, definite and reasonable needs, forget about it if you are closely held corporations. We think that at least the small businessman should have the opportunity to try to rebut this presumption.

The Sixth Circuit Court isn't giving anything here. When you talk about it, the burden, it is a determinative burden which this taxpayer has to show that tax avoidance was not the dominant or impelling motive. He just can't sit up there and say that wasn't my motive. He's got to be fairly specific and concrete in what he is saying.

I think the thing that really disturbs us about this case is you are really preventing expansion of the smaller corporation. I just can't see how we could expand under the Government's interpretation.

I think things have changed where the substantial economic power is in the publicly held corporation. But a statute which was aimed at the power, the economic power, is now being applied against the little man and the persons that it was intended to cover initially are just not being covered at this particular time. I think basically our position here is that simple, that what the Government asks is not a construction of the statute. There is no construction; there is no statute.

We think the only real tenable and reasonable view is the position of the Sixth Circuit.

MR. CHIEF JUSTICE WARREN: We will adjourn.

(Whereupon, at 2:32 p.m. the Court adjourned, to reconvene the following day, Wednesday, October 23, 1968, at 10 a.m.)

The argument was resumed at 10:10 a.m., Wednesday Morning, October 23, 1968.

MR. CHIEF JUSTICE WARREN: Number 17, United States, Petitioner, versus the Donruss Company.

Mr. Braunstein?

ARGUMENT OF RICHARD L. BRAUNSTEIN, ESQ.

MR. BRAUNSTEIN: May it please the Court, I believe the impression was left yesterday that the taxpayer in this case accumulated a substantial amount of funds, with the sole purpose being the avoidance of tax, but that was not the decision of the court below.

The first inquiry is whether the accumulation exceeds the reasonable needs of the taxpayer's business. But this phrase has come to mean the fixed, definite and certain needs of the business, or of the obligations of the taxpayer. It is a test which the Government is trying to restrict as closely as possible.

Q Do we have that before us, or isn't the narrow issue before us the Government's request for an instruction and denial of that instruction, and then the action of the Court of Appeals in reversing further procedures pursuant to the standards it has laid down, all of this being with respect to the question of purpose or intent?

A That is correct. This issue is not before the Court, but I think it is pertinent in terms of the effect of

what the Government proposes to ask this Court to set as a test, because in circumstances like this, the jury found that the taxpayer did not have fixed and definite purposes, but they held that he did not have a tax avoidance purpose.

The taxpayer stated that he had plans for expansion. He intended to buy stock in a distributor.

The jury, we could infer, believed that this was the purpose motivating his conduct. So while it was not fixed, definite and certain, nevertheless it was a permissible purpose and the facts were that the taxpayer did purchase $380,000 worth of the distributor's stock, and the taxpayer did expand.

It was because of this expansion and purchase that the taxpayer is continuing to be successful. But the critical point is that it is the Government's position that in adopting the purpose test, you would then ask the taxpayer only two questions:

No. 1 - If the distribution was made to you, would it be taxable?

No. 2 - Were you aware that if the distribution was made to you it would be taxable?

If both of those answers were yes, then it is my understanding that regardless of the fact that the taxpayer's purpose, his dominant purpose, the whole purpose of the accumulation, was for expansion, to preserve and expand the business, that, nevertheless, the penalty would apply.

Q The Government would not agree with that characterization, would it?

A I haven't heard them deny that characterization.

Q It is not whether the effect on the distribution would be to subject the stockholder to the tax, but whether that was one of the motives in withholding the distribution.

A I don't regard that as what the Government is asking this Court to rule on. I think they say very clearly that if the avoidance is one of 100 purposes, regardless of its significance, then the tax applies.

Having determined what do you mean by avoidance of tax -- avoidance of tax is knowledge that a distribution results in taxable income, and the whole thrust of the Government's argument and our argument here is such a test really writes out the purpose test.

Q I guess it gets pretty obvious, but there is a difference between what we are struggling with, shading the difference between the words "purpose", "effect", and "motive".

A I think that is correct. It is basically our position that the Sixth Circuit correctly characterized the test in terms of the dominant motive.

I think one of the difficult things is the burden of proof that the taxpayer has, if you enunciate a test other than dominant or impelling test, whether it has any meaning, because once the court finds that an accumulation is beyond the

objective and reasonable needs of the business, the taxpayer is faced with a determinate presumption. He has to go forward and prove and bear a heavy burden that this was not the purpose.

He obviously cannot say "Well, that was not my purpose." I don't think that carries the burden. I think he is compelled to give specific and definite reasons as relates to his motivation.

As a practical matter, these cases are tried four or five years after the year in issue, and he cannot fabricate. I think the Government is concerned that these are subjective matters; that there is no objective way to determine or test the testimony of the taxpayer.

But this is not true. He is talking about a situation of his intentions, of his plans, and we are viewing this four or five years after. What he says must be as susceptible to objective verification and reason.

It is our position that it is only through utilization of the dominant or impelling test that there is any meaning in the phrase "avoidance of the purpose"; that any other test just puts an impossible burden on the taxpayer. I think this is why we believe that the Government's position is very clear when they say one out of 100, that that is enough to carry the day. That is their position.

A But it is only their position against the background of the finding that the accumulation was, in terms of

their frame of reference, by objective standards, an unreasonable accumulation.

A I don't gather that from the record. I think the Government's position in a purpose, that if avoidance of the tax is a purpose --

Q Do you mean the jury wouldn't have to find that there was an unreasonable accumulation?

A I think the jury would have to find initially --

Q That is what I mean.

A Yes.

Q Before the taxpayer goes out the window in the Government's position, it has to be found that the accumulation was unreasonable.

A Unreasonable.

Q And once it is found to be unreasonable, objectively there is a no-reason in terms of the needs of the business to the extent that it is unreasonable.

A No, I don't think that is true. When you talk about the unreasonable needs of the business, that phrase has been determined as requiring fixed, definite and certain needs, something that is susceptible to a knowledge that this is going to require a liability. If we had a more liberal view of the unreasonable --

Q But you do concede it is necessary to find the accumulation was unreasonable, then what the taxpayer is claiming

as justification for this accumulation has been termed to be unreasonable, and he is giving an unreasonable reason for the accumulation.

It may be that as a matter of subjective thinking, he thought he needed this much money for that purpose. You say that that subjective attitude -- that there should be some room for that, some room for you to prove that in the case.

A I would think so, because one of the things that concerns or disturbs me is that in testing what is unreasonable, it is not a very broad test. It is rather limited. I think the whole thrust of our argument in terms of the unreasonable test --

Q What if it weren't, though?

A I think if it were not, you would have fewer cases going on the purpose test. I think what you are really getting here is the expansion problem, the taxpayer that intends to expand, desires to diversity, but under the unreasonable test cannot satisfy it because his plans have not matured to the state required by the statute.

Our position is, in view of the fact that this is what the unreasonable test is, to then adopt a purpose test precludes a taxpayer from expanding.

Q But if the court, if the judge or a jury, found the accumulation to be unreasonable by whatever applicable standards there were, your suggestion is, nevertheless, the

taxpayer should be allowed to not be taxed on the unreasonable accumulation because he had a good-faith view that his business needed this accumulation.

A Correct. I think what we are saying is whatever his motivation, he is not looking to avoid tax, but he honestly believes this.

Q Mr. Braunstein, the consideration that bothers me in this case, following your colloquy with Justice White, is that it is arguable that the standard adopted by the Court of Appeals, which you are defending here, is contrary, really, to what Congress expressed and provided. In a way, it undermines the specific language of section 533(a). 533(a) makes the test of intent to avoid stockholder tax a very minor consequence, as I read it.

It says once you find that the earnings of the corporation are permitted to accumulate beyond the reasonable needs of the business, that "that shall be determinative of the purpose to avoid the income tax with respect to shareholders unless the corporation, by the preponderance of the evidence, shall prove to the contrary."

Those are very rigid standards, but they are Congress' standards. Whether one thinks they are good, bad, or indifferent, there they are in the law.

A I agree with you. I think they are very difficult standards.

What we are saying is that in the Government's view, to adopt a purpose test really writes out any opportunity of the taxpayer to meet that standard.

Q Even if you assume that, if you go the other way and adopt a dominant purpose test, as the Court of Appeals did, it would seem to be extreme and to undermine what would seem to be the fairly obvious intention of the Congress.

A I view that really as a burden of proof aspect that Congress created, making it most difficult for the taxpayer once a determination has been made that the accumulation exceeds the "reasonable needs of the business," that a very difficult burden is placed on the taxpayer.

In turn, the taxpayer then is given one last opportunity, as I view it, to show that its conduct was not motivated by the avoidance of tax; that it was motivated by something else. If we adopt the "a purpose" test --

Q That would be the reasonable needs of the business, but as my brother White was pointing out, if you can show that this accumulation was needed for the reasonable needs of the business, you never get to that question.

A You never get to that; but, on the other hand, reasonable needs of the business have been construed by regulation, in the courts and in instruction, to be fixed, definite. There are many taxpayers, if they do want to go on an expansion program at the end of any particular year, it may be completely

fortuitous that they have advanced to this stage.

What we are saying is that if you accept the Government's interpretation, in effect you are just preventing a taxpayer whose legitimate purpose is the expansion and diversification of his business from pursuing that point of view.

Q The problem that I am putting to you is, very simply, whether your argument is properly addressed to this Court or to the Congress. And that gets down to the matter of unraveling what the Congress really intended; what the spiritual thrust of the legislation is.

A I think the spiritual thrust of the regulation is, going back historically, to get at corporations where the primary purpose was formation for matters not germane to the corporate function, but to tax avoidance. I think that really is the thrust.

What we are saying here is that this interpretation is not inconsistent with that thrust. What it does is permit the closely held corporation to compete with the public corporation.

In no way do I view the test enunciated by the Sixth Circuit as inconsistent with this basic purpose. I think the Second Circuit recognized the fact that this statute should not be construed inconsistent with the antitrust laws; that it recognize that the philosophy of Congress, I think, rather than being hindered by the interpretation of the Sixth Circuit, is

actually helped. I think it is consistent with permitting competition and permitting the closely held corporation to compete.

We are not arguing for a standard which permits tax avoidance. We are arguing for a standard which permits the closely held corporation to compete with the public company to diversify and expand. To that extent, I submit it is completely consistent with the Congressional purpose of this statute.

Q The Government's position is the "a purpose".

A That is correct. Their position, as I understand it, is that the statute applies if a purpose was the avoidance of tax. The way to test a purpose is that if the individual knows the distribution will result in taxable income, it is a purpose.

Q I thought it was a reference to subsection (a) of the statute.

A No. I am sorry.

Our position is that you are really writing out the statute. Under that interpretation, I might as well just have a statute that says that if there is an accumulation beyond the reasonable needs of the business, the tax applies, period, because if you accept that interpretation, the rest is just surplus. I can't see any need for it at all.

Q If you were the judge preparing a charge to the jury, how would you define it?

A Under the statute?

Q Yes.

A I think under the statute the judgewould have to say that to find it is reasonable you would have to find that the taxpayer had fixed and definite commitments; he had contracts which required the expenditure of these funds. The fact that a taxpayer intended, whether you believed he intended or not, to expand and to diversify, or was attempting to diversity, does not qualify under the reasonable accumulation test.

Q What does that have to do with your charge about being reasonable? That is what they have to determine -- whether it is reasonable without regard to the motive.

A That is correct. The motive would only be important on the avoidance of the purpose test. It is our position that the proper construction is that the motive resulting in a substantial penalty should be the motive controlling the actions of the taxpayer.

Q Didn't Congress intend to let somebody determine whether there was more than was reasonable?

A I think ultimately it is a jury or a court question. I think at first blush the revenue agent does come in and make a determination as to whether the accumulation was reasonable or unreasonable in terms of the defined standard.

Q Is it ordinary to turn over tax cases to juries to probe the minds, to find out how many of the dominant purposes are for one thing and how many are for another?

A I am not suggesting it is an easy test, but the court has done it in the Allen Trust Company of Georgia case, involving transfers, as the court did it in Duberstein, in terms of what is a gift when it is searched. I think in Duberstein the court refused to come up with an easy test, but said you have to search for the dominant, controlling and impelling motive.

We are asking the Court where this test presents no more of a difficulty than this Court addressed itself to in Duberstein and the Trust Company of George where it did accept the dominant and compelling test.

Q Suppose there was a $2,000 corporation that sold $2 million worth of goods and made $1-1/2 million profit? Would the motive of the man who saved that $1-1/2 million have anything to do with what the jury decided?

A I think it is required under the statute.

Q You do?

A Yes, I do.

Q Do you think the jury is instructed that the taxpayer loses only if there is an unreasonable accumulation, and the jury finds there is an unreasonable accumulation? Do you think as a matter of actual practice, in terms of whet her you are going to win or lose the case, the jury is going to say, "Well, there was an unreasonable accumulation here but, nevertheless, the taxpayer still wins because he just made a mistake."

How is your experience with a jury or judge going to be against that finding?

A I think our experience quite frankly, and most tax practitioners have focused everything in trying to convince the trier of the fact, is that it is unreasonable. But you then get into a very difficult question if the courts restrict what is reasonable and what is not; that you only have one last refuge. Whatreally concerns us --

Q I am just wonderig how significant this whole argument is. What is the finding going to be?

A We think it is substantial in terms of the closely held company.

Q And I think the Government thinks so, too. I guess what it means is that there probably will be more trials, more efforts, the necessity to make more settlements.

A We say it is a small price to pay for a competitor's assignees.

(Whereupon, the oral argument in the above-entitled matter was concluded.)