

Now I Am a C Corp: What About the Accumulated Earnings Tax?

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In this article, Stigile provides background on the accumulated earnings tax and explains the steps corporate taxpayers may be able to take if the government begins to more actively audit and litigate the accumulation of profits.

The Tax Cuts and Jobs Act reduced the corporate tax rate from 35 percent to 21 percent, providing an additional significant incentive to conduct business through a corporation. Shareholders may be tempted to keep additional earnings in the corporation, rather than declare a dividend or pay compensation subject to an additional layer of tax at the individual level. The accumulated earnings tax (AET) and other code provisions discussed below may now play a bigger role in curbing excessive accumulation of profits and some types of passive income in corporations without the payment of dividends. There are several steps taxpayers may take to prepare should the government begin more actively auditing and litigating these issues.

Accumulated Earnings Tax

The AET is a 20 percent tax for each tax year on accumulated taxable income of corporations.¹ While the AET hasn't been widely imposed or litigated in recent years, it still applies to all

¹Section 531.

corporations — with limited exceptions² — formed or used to avoid the individual income tax by permitting earnings and profits to accumulate instead of being distributed.³

The computation of accumulated taxable income is generally taxable income, less federal taxes, charitable deductions without regard to limitations, capital losses, dividends paid, and an accumulated earnings credit.⁴ The code provides for a minimum accumulated earnings credit of \$250,000 per year, but an expanded credit is available to the extent the E&P for the tax year are retained for the reasonable needs of the business.⁵ The limited cases and guidance on the AET largely focus on what constitutes reasonable business needs.

The determination of whether accumulated E&P have been accumulated for reasonable business needs depends on the facts and circumstances of each taxpayer.⁶ The regulations⁷ and case law provide examples of circumstances in which the accumulation of profits would ordinarily serve reasonable business needs, including:

1. Bona fide expansion of a business or replacement of a plant.
2. Acquisition of a business enterprise through purchasing stock or assets.
3. Providing for bona fide indebtedness created in connection with the trade or business to be retired.

²The AET doesn't apply to personal holding companies, some exempt corporations, and passive foreign investment companies. Section 532(b).

³Section 532(a); Internal Revenue Manual section 4.10.13.2.3.

⁴Section 535(a) and (b).

⁵Section 535(c).

⁶Section 537; reg. section 1.537-2(a).

⁷Reg. section 1.537-2(b).

4. Providing necessary working capital for the business. In addressing working capital, courts have evaluated capital needed to cover the reasonably anticipated costs of an operating cycle. An operating cycle may be annual, or it may be shorter if, for instance, inventory turnover is more frequent.⁸ The Internal Revenue Manual provides that a “normal” operating cycle is the period required to convert cash into raw materials, raw materials into inventory of finished goods, finished goods inventory into sales and accounts receivable, and accounts receivable into cash.⁹
5. Providing for investments or loans to suppliers or customers as necessary to maintain the corporation’s business.
6. Providing for payment of reasonably anticipated product liability losses.

The IRM¹⁰ provides other business needs that may reasonably justify accumulations of earnings:

1. cash needs to meet competition;
2. reserves for business risks and contingencies, for example, self-insurance against casualties, potential liability from litigation, and unsettled business conditions;
3. setting aside financing for the employer’s pension or profit-sharing plans;
4. potential loss of a principal customer; or
5. redemption of stock held by minority stockholders or distributions in redemption of stock to pay “death taxes,” although examiners are encouraged to investigate situations in which redemptions primarily benefited stockholders, as opposed to serving a corporate purpose.

The regulations set forth activities that may suggest improper purposes for accumulating earnings in a corporation.¹¹ They highlight problematic loans, including those that provide personal benefits to shareholders, relatives, or

friends, or are made to corporations in a different business controlled by the same shareholders. Investments in properties or securities unrelated to the business of the taxpayer may also lead to additional scrutiny.

The IRS revised the AET section of the IRM in 2015 and provided guidance on shifting the burden of proof on AET issues in 2017.¹² The IRS also issued a legal memorandum¹³ in 2016 concluding that a corporation may be subject to the AET irrespective of its lack of liquidity and lack of control over the partnerships in which it invests, particularly when no valid business purpose is present for a holding company. Accordingly, even before the TCJA provided for the lower corporate tax rate, the IRS had already reinvigorated its interest in the AET.

Documentation of Reasonable Business Needs

During the examination, the IRS may issue open-ended information document requests to address the taxpayer’s business purposes for accumulated earnings. Those inquiries can focus on the specific factors above, such as dividend history, expansion plans, anticipated extraordinary expenses, or the reason for related-party loans. Taxpayers should be prepared to establish, with documents, how the business plan was developed and implemented. If the company didn’t deploy funds as initially planned, that should be documented as well.

To prepare for each of the inquiries above, business decisions should be documented in regular corporate minutes, during management’s budgeting process, or with other contemporaneous documentation. The representative may need to explain in detail the nature of the business and the specific reasons accumulated earnings are needed. To the extent significant funds are set aside, for instance, to construct or acquire a new building, the company’s budgeting documents and any

⁸ See *Magic Mart Inc. v. Commissioner*, 51 T.C. 775 (1969).

⁹ IRM section 4.10.13.2.5.

¹⁰ *Id.* at section 4.10.13.2.4.2.

¹¹ Reg. section 1.537-2(b).

¹² IRM section 4.8.8.2. Under section 534(b), the burden of proof is on the IRS unless a notification is sent to the taxpayer before a notice of deficiency is issued. If the taxpayer then responds with a statement about reasonable business needs, the burden can be shifted back to the IRS as to the grounds in the statement. See reg. section 1.534-2(a)(2).

¹³ ILM 201653017; see James M. Plecnik and Ling Ju, “The Accumulated Earnings Tax: Recent Developments and History,” 127 *J. of Tax’n* 75 (Aug. 2017).

internal communications (including emails) concerning the new building should be retained so they are available to demonstrate why management set aside the earnings.

If the tax year under audit is the first or second year of a long-term plan, the revenue agent may question whether the funds will be used. Naturally, profits must be accumulated over time to accomplish a long-term plan, but the representative will need to establish that the accumulated amounts are reasonable in the particular tax period at issue within the context of the broader business plan.

While courts are reluctant to substitute their business judgment for that of corporate management, an examination involving AET will certainly seem like an evaluation of management's business judgment. The focus at the examination level should be establishing the valid business reasons behind management's budget, the company's cash needs, and possibly the company's story and vision for the future.

Personal Holding Companies

In evaluating whether a company is subject to the AET, revenue agents are encouraged to analyze and set forth the basis for concluding that a corporation doesn't qualify as a personal holding company (PHC). Those inquiries are part of a broader determination of whether a company is a mere holding or investment company that was formed or used to shelter its shareholders from income taxes.¹⁴ The PHC tax is a penalty tax that serves a similar purpose to the AET by discouraging excessive accumulation of passive income.¹⁵ A PHC tax of 20 percent is imposed for each tax year on the undistributed PHC income of every PHC.¹⁶

In contrast with the AET, which is initially determined by the IRS during an examination and isn't assessed before the issuance of a notice of deficiency, the PHC regime requires taxpayers to objectively apply the regime and self-report any PHC tax on the corporate tax return on a Schedule PH. A corporation is a PHC if both it has

significant passive earnings (at least 60 percent), and most of the value of the outstanding stock is owned by five or fewer individuals at any time during the last half of each tax year.¹⁷ To the extent PHC income is distributed to shareholders, the PHC tax is inapplicable.

Compensation Issues for the AET, PHC Regimes

Revenue agents may challenge whether compensation paid by corporations is reasonable, and they may identify that issue if they perceive an abuse of the corporate form. The IRC permits a deduction for salaries or other compensation, but only when the compensation is reasonable and the services are actually rendered.¹⁸ Deductibility issues arise if compensation is excessive or if a shareholder doesn't establish that services were performed. Compensation amounts may not exceed what is reasonable under all the circumstances and what would ordinarily be paid under similar circumstances.¹⁹

In reviewing that issue, the courts apply a facts and circumstances test, including the employee's qualifications and role in the company, hours worked, duties performed, and overall contribution.²⁰ Courts also consider the character and condition of the company, compensation amounts provided by similar companies for similar roles, and the compensation history for other employees of the same company.²¹

Under the PHC regime, the IRS's disallowance of excessive compensation may affect whether the taxpayer has undistributed PHC income. For instance, the IRS may argue that a shareholder's compensation was excessive, nondeductible, and in substance a disguised dividend. As set forth above, a dividend could ordinarily reduce undistributed PHC income, but in this instance, the shareholder's "dividend" may be viewed as a preferential dividend that is ineligible for the dividends paid deduction, resulting in PHC tax.

¹⁷ Section 542(a)(1) and (2).

¹⁸ Section 162(a)(1); *Gamble Construction Co. v. Commissioner*, T.C. Memo. 1978-404.

¹⁹ Reg. section 1.162-7.

²⁰ *Automotive Investment Development Inc. v. Commissioner*, T.C. Memo. 1993-298.

²¹ *Id.*

¹⁴ IRM section 4.10.13.2.3(4).

¹⁵ IRM section 4.10.13.2.3(3).

¹⁶ Section 541.

Under the AET regime, a failure to distribute dividends or pay adequate compensation is a factor in determining whether a company accumulated earnings to avoid the payment of an individual-level tax. Accordingly, a history of reasonable compensation amounts for shareholders based on their services performed removes an argument that they improperly accumulated earnings.

Conclusion

The IRS's recent attention to the AET in the IRM, combined with the TCJA's favorable corporate tax rate, may create the perfect storm for increased examinations of AET issues. Corporate taxpayers and their representatives should assess their reasonable business needs for accumulated earnings and plan and document their needs in anticipation of an examination involving those issues. ■

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