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# The Accumulated Earnings Tax: Back from the Grave?

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The accumulated earnings tax (AET) is imposed by Internal Revenue Code (IRC) section 531, on C corporations "formed or availed of" for the purpose of avoiding the imposition of income tax on their shareholders, by permitting earnings and profits to be accumulated instead of being distributed. As a practical matter, the tax is collected only when asserted by the Internal Revenue Service on examination, rather than through self-assessment by taxpayers, and even then is not frequently encountered on audit in the experience of the authors. This may be in part because of the obvious economic desirability of distributions, particularly at the relatively low rates applicable since 2001, and in part because of the availability of pass-through entities such as partnerships and S corporations not subject to the AET. Accordingly, conducting business through a C corporation and retaining earnings at the corporate level beyond the needs of the business seems unlikely to be a compelling tax avoidance strategy.

Nonetheless the AET remains part of the Internal Revenue Code, and developments over the past decade including increases in the highest rate of federal tax imposed with respect to qualified dividend income (from 15% to 20%) and the 3.8% tax on "net investment income," may cause further consideration to be given to deferral of distributions. Perhaps coincidentally, the IRS Chief Counsel recently issued a memorandum concluding that the AET may apply to a corporation that lacks ready access to cash or other liquid assets for distribution. The structure of the AET and Chief Counsel Advice 201653017 (December 30, 2016) are discussed below.

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**Overview of AET**

The AET is imposed on the "accumulated taxable income" of corporations formed or used "for the purpose of avoiding the income tax with respect to its shareholders" by having the earnings accumulate by the corporation. (Corporations not subject to the AET include a "personal holding company" (potentially subject to a different penalty tax); a corporation exempt from tax under IRC section 501; a "passive foreign investment company"; and an S corporation.) The application of the AET is determined without regard to the number of shareholders—so that it may apply even to corporations with widely held, publicly traded stock (IRC section 532(c)).

The AET is imposed in addition to the regular corporate income tax. The tax rate is 20% of "accumulated taxable income," defined as taxable income with adjustments, including the subtraction of federal and foreign income taxes.

A corporation may be allowed an "accumulated earnings credit," in the nature of a deduction in computing accumulated taxable income, to the extent it can establish that its earnings and profits for the year at issue were retained for the reasonable needs of the business. A corporation that is a mere "holding or investment company," however, is entitled to a credit of not more than $250,000, and its credit is zero if its accumulated earnings and profits as of the close of the preceding year already exceed $250,000.

IRC section 537 and regulations thereunder describe the determination of the "reasonable needs of the business" that are taken into account in determining the extent of earnings that may be retained without triggering the tax. These include needs to fund an expansion of the business or new equipment, to make a business acquisition, to fund the retirement of debt related to the business, for working capital, or to fund a reserve for reasonably anticipated product liability losses, as well as to fund the redemption of stock from a decedent to the extent necessary to pay estate taxes. If the corporation provides a statement of grounds for its retention of earnings and profits, the burden of proof may shift to the government with respect to whether the accumulated earnings exceeded the reasonable needs of the business, as taken into account under the AET.

The fact that a corporation is a mere investment or holding company, however, is prima facie evidence of the purpose of avoiding income tax on its shareholders. The "reasonable needs of the

business" concept is not generally relevant to the application of the AET to investment or holding companies, but such corporations may nonetheless be able to avoid the tax if they can otherwise establish that they were not formed or used to avoid income tax with respect to shareholders (see Reg. section 1.533-1(a)).

**CCA 201653017**

The context described in the CCA (simplifying slightly) involved the contribution by an individual of his entire interest in each of various partnerships (and limited liability companies treated as partnerships for tax purposes) to a corporation in exchange for all of its stock in an exchange under IRC section 351. Most of the income of the partnerships consisted of fund management fees and "offshore incentive fees" associated with a hedge fund advisory business in which the individual participated as the manager of one department. (Control of the partnerships was in the hands of another individual, "Founder.")

The corporation also reported other income passed through from the partnerships, including dividends, interest, capital gains, and gains from foreign currency transactions. The corporation had no wage expense or other material expenses. The individual received a salary from one of the partnerships.

The partnership agreements permitted the partnerships to limit distributions to amounts sufficient to pay the partners' income taxes. Accordingly the corporation received only distributions sufficient to pay its tax liabilities, and did not pay dividends or other distributions to its individual sole shareholder. The partnerships were apparently profitable such that the corporation reported retained earnings and profits in various years.

The only purposes disclosed by the corporation to the IRS for the incorporation of the individual's interest in the partnerships were to avoid potential tax by various jurisdictions, such as the state where the managing partnership was located and the country where the shareholder resided. The memorandum also notes that the directors' minutes for the years at issue did not contain any plans or information regarding the reasons for accumulation of earnings.

The memorandum's analysis begins with the assertion that the corporation was a mere holding or investment company, and that, in light of that fact and the retention of earnings, there was at least prima facie evidence that the corporation was formed or used to avoid tax on shareholders.

The corporation asserted that the AET could not apply because it had no liquid assets, nor did it or its shareholder control the extent of partnership distributions. The memorandum concludes, however, that the statute does not authorize the exclusion of undistributed income from partnerships in determining a corporation's accumulated taxable income for purposes of the tax, and that the other circumstances referenced by the corporation did not affect the conclusion that the corporation was subject to the AET.

The memorandum refers to an earlier IRS technical advice memorandum (TAM 9124001, February 15, 1991) as concluding that the lack of liquid assets does not prevent the imposition of the AET, at least where the corporation had the opportunity to avoid the AET by declaring "consent dividends." Under IRC section 565, if shareholders so agree, specified amounts are deemed distributed to the consenting shareholders, and then deemed recontributed to the corporation. This results in the same tax consequences as a dividend—and reduces or eliminates accumulated taxable income subject to the AET—without any need for corporate liquidity to fund an actual distribution (though the shareholders will be taxed on the distributions deemed received).

It was noted in the 1991 TAM that the shareholder and his spouse controlled the partnership and the two corporations involved. The individual owning the corporation addressed in the 2016 memorandum did not control the partnerships in which the corporation owned interests; but the 2016 memorandum concludes that the corporation remains subject to the AET because it "permitted its earnings and profits to accumulate"—apparently by not "declaring" consent dividends.

**Observations**

If, as the memorandum asserts, "earnings and profits" for purposes of the AET are an economic concept based on taxable income with adjustments, and not limited to earnings that are realized and available as liquid assets or through the disposition of investment property, there is some logic to its conclusion. The circumstance that the corporation was formed with knowledge that the partnerships would not make distributions beyond those needed to fund the payment of taxes by its partners may also have made the IRS comfortable with the conclusion that it was appropriate to apply the AET, notwithstanding the corporation's lack of control or liquidity.

The conclusion in the memorandum is not the only possible interpretation of the statute, however, and it would not be surprising if this position is tested in the courts. It does seem clear, however, that the IRS is prepared to assess AET even in situations where the corporation has no liquid investments or cash to distribute, and corporations should plan accordingly, including (in non-investment company contexts) periodic assessment of the reasonable needs of the business as grounds for retention of earnings.

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