ACCUMULATED EARNINGS TAX WILL HIT TAXPAYERS, DESPITE LACK OF LIQUIDITY OR CONTROL

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BACKGROUND

Even absent a distribution, shareholders of U.S. corporations may, under certain circumstances, be subject to a second layer of tax: the so-called accumulated earnings tax. This rarely-imposed penalty under U.S. tax law could become increasingly important if the tax rate disparity between corporate and individual income tax rates increases under the tax reform proposals put forth by President Trump and the House Republicans.[1] Recently issued I.R.S. guidance sheds some light on the application and potential impact of this rule.

In their endeavors to expand into the U.S. market, non-U.S. individuals and non-U.S. entities have various options to structure their investments. For reasons ranging from privacy concerns to substantial U.S. tax filing and reporting obligations, foreign taxpayers may prefer investing through a U.S. corporation, rather than through a U.S. partnership or a U.S. limited liability company ("L.L.C."). Generally, liquidity is not an issue, since often the investments are expected to grow over time -— with few, if any, distributions to the foreign shareholders.

A typical investment scenario could be as follows: A foreign national plans to move to the U.S. in the future and wishes to start investing in the U.S. with immediate effect. For privacy reasons, the foreign national chooses to invest via a U.S. corporation. The foreign national is a resident of a high-tax country that has a territorial system and no equivalent to the U.S. controlled foreign corporation regime or the passive foreign investment company regime. As a result, the foreign national may only be subject to home country taxation on income actually distributed by the U.S. corporation. The foreign national wishes for the corporation to only invest in passive-income generating assets, and absent any need for cash distributions from the U.S. entity, all income will remain in the U.S. corporation until the foreign national moves to the U.S.

Absent any distributions, the foreign national believes that the U.S. corporation will pay Federal, state, and local U.S. corporate income tax on the earnings, with no additional layer of shareholder tax. However, the accumulated earnings tax has been designed to prevent just this type of corporate accumulation.

While the accumulated earnings tax is not often mentioned in the news, a Chief Counsel Advice (the "C.A.A.") on the topic was issued by the I.R.S. on December 30, 2016. It is of interest to U.S. corporations claiming not to be liable to the accumulated earnings tax because of a lack of liquidity or control to make shareholder distributions.

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1 See "Trump and the Republican-Led Congress Seek Overhaul of International Tax Rules," *Insights* 1 (2017).

ACCUMULATED EARNINGS TAX REGIME

Rules and Computation of Tax

The accumulated earnings tax is a 20% surcharge on the taxable income.[2] It applies to corporations formed for or availed of the purpose of avoiding shareholder taxes by permitting corporate earnings to accumulate rather than be distributed.[3] Personal holding companies, tax-exempt corporations, and passive foreign investment companies are not subject to the accumulated earnings tax.[4]

The accumulated earnings tax is not based on a measure of liquid assets but rather on taxable income less statutory adjustments.[5] One of the adjustments comprises distributions to shareholders or deemed distributions to shareholders under the rules applicable to consent dividends.[6] However, adjustments for undistributed partnership income are not encompassed by these rules. The earnings calculation is further reduced by amounts retained to cover the reasonable needs of the business (the "accumulated earnings credit").[7]

Purpose: Preventing Accumulations Beyond Reasonable Needs

The accumulated earnings tax was enacted to prevent a corporation from retaining earnings beyond its reasonable needs, instead of distributing earnings to shareholders. Intent to avoid tax need not be the sole reason for the accumulation; it suffices that it be one of the reasons.[8]

Evidentiary rules include a rebuttable presumption that a corporation that has accumulated earnings beyond its reasonable needs has retained those earnings for the purpose of tax avoidance.[9] Generally, the burden of establishing that a corporation's accumulation of earnings exceeds its reasonable needs lies with the I.R.S.

A corporation's status as a holding or investment company is *prima facie* evidence of the purpose to avoid income tax with respect to shareholders.[10] For this purpose, a holding company is a corporation having practically no activities except holding property and collecting income therefrom or investing therein.[11] If the activities

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2 Code §531.

3 Code §532(a). As a result, if none of the shareholders would be subject to U.S. individual income tax on distributions from the corporation, the accumulated earnings tax does not apply (P.L.R. 9422028).

4 Code §532(b).

5 Code §535(b).

6 Code §§535(a), 565.

7 Generally decreased by the amount of net capital gains in excess of taxes on those gains (Code §§535(a), 535(c)(1)). When the corporation is a mere holding or investment company, the accumulated earnings credit is limited to the amount (if any) by which $250,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year (Code §535(c)(3)).

8 *Cataphote Corp. of Miss. v. U.S.*, 535 F2d 1225, 37 AFTR 2d 76-1433.

9 Code §533; Treas. Reg. §1.533-1(a)(1).

10 Code §533.

11 Treas. Reg. §1.533-1(c).

substantially consist of buying and selling stock, securities, real estate, or other investment property such that the income is derived not only from the investment yield but also from profits subject to market fluctuations, the corporation is an investment company.[12]

For most other corporations, whether a purpose to avoid income tax exists will depend on the facts and circumstances of each case.[13] Case law and regulations provi*de facto*rs that are indicative of a tax avoidance purpose.[14]

IRRELEVANCE OF LIQUIDITIES OR CONTROL – C.C.A. 201653017

In C.C.A. 201653017, the I.R.S. held that a corporation was liable for the accumulated earnings tax, despite a lack of liquid assets and control over partnership investments.

The facts presented to the I.R.S. involved a U.S. individual shareholder (the "Shareholder") who invested in eight different partnerships (the "Partnership Interests"), along with other taxpayers. The Shareholder then contributed the Partnership Interests to a newly formed corporation (the "Taxpayer"). The Taxpayer had no other holdings and no other income other than the flow-through partnership income. The I.R.S. noted that no valid business purpose appeared to exist for the contribution.

One partnership served as the manager for all other partnerships and was itself managed by a board of six directors that had the power to vote on partnership matters. As a result, the Taxpayer had no control over partnership distributions.

During the years at issue, the Taxpayer's sole activity was holding and maintaining the Partnership Interests. The Taxpayer (i) had no operating expenses or employees and (iii) made no distributions to shareholders.

The Taxpayer included its distributive share of partnership income in its taxable income. In accordance with the provisions of the various partnership agreements, the Taxpayer only received partnership distributions up to an amount sufficient to cover its Federal and state tax liabilities. The remainder of its distributive share was retained by the various partnerships. The Taxpayer reported retained earnings for the years at issue but made no distributions out of those earnings.

Taxpayer argued that because it had no control over partnership distributions, it did not have enough cash to distribute to the Shareholder.

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12 *Id.*

13 Treas. Reg. §1.533-1(a)(2).

14 The factors are dealings between the corporation and its shareholders, such as personal loans to the shareholders or expenditures by the corporation for the personal benefit of its shareholders (Treas. Reg. §1.533-1(a)(2)(i); see also, *e.g.*, *Herzog Miniature Lamp Works, Inc. v. Commr.,* 481 F.2d 857 (2d Cir. 1973)); investment of undistributed earnings in assets having no reasonable connection with the business of the corporation (Treas. Reg. §1.533-1(a)(2)(ii)); the dividend history of the corporation (Treas. Reg. §1.533-1(a)(2)(iii); see also, *e.g.*, *Doug-Long, Inc. v. Commr.*, 72 T.C. 158 (1979)); and whether shareholder-employees are under-compensated (Herzog, 481 F.2d 857).

The I.R.S. rejected the Taxpayer's argument on the following grounds:

- Because the Taxpayer is a mere holding or investment company, the I.R.S. determined that there was *prima facie* evidence that the Taxpayer was formed to permit its shareholders to avoid tax pursuant to the accumulated earnings tax rules.
- The law does not base the accumulated earnings tax on available cash. Rather, its starting point is taxable income, less certain statutory adjustments. The undistributed income of partnerships owned by the corporation is not among these adjustments.
- To prevent the assertion of the accumulated earnings tax, the Taxpayer could have followed the consent dividend procedure set forth under the Code.[15]

"The Taxpayer remains subject to the accumulated earnings tax. The Taxpayer's lack of liquidity or control in the partnerships is irrelevant."

According to the I.R.S., the consent dividend procedure was enacted to address situations such as in the case in issue (*i.e.*, where a corporation that accumulated earnings beyond its reasonable needs lacks the liquidity to make distributions). Under the consent dividend procedure, a shareholder can agree to include in income a portion of a corpration's earnings without actually receiving cash. The included amount will be treated as having been distributed by the corporation to the shareholder and then contributed by the shareholder to the corporation's capital.

The I.R.S. refers to Private Letter Ruling 9124001 (the "P.L.R." or the "Ruling"), which dealt with a similar case except that the corporation's (*i.e.*, the taxpayer's) controlling shareholder controlled both the taxpayer and the partnership that retained all earnings. Notwithstanding the controlling shareholder's control of the partnership and, hence, the ability to resolve on a distribution, the ruling rejected the liquidity argument.

According to the P.L.R., by implementing consent dividend procedures Congress intended to remove obstacles to the distribution of taxable dividends from corporations to their shareholders. Consequently, the corporations would not have been subject to the accumulated earnings tax if, in conjunction with the shareholders, the entities had used the available consent dividend procedure. The P.L.R. concludes that the corporations' earnings and profits that are attributable to their distributive shares of the partnership income must be taken into account in determining whether the accumulated earnings tax should be imposed.

Citing the ruling, the C.C.A. stated that because the Taxpayer allowed its earnings and profits to accumulate – and because consent dividends could have been used by the Taxpayer and its sole and controlling Shareholder – the Taxpayer remains subject to the accumulated earnings tax. The Taxpayer's lack of liquidity or control in the partnerships is irrelevant.

CONCLUSION

The C.C.A. does not fundamentally change the accumulated earnings tax landscape. However, it is a good reminder that the tax has its place in tax planning. In view of a possible increase in the disparity between corporate and individual income tax rates, the accumulated earnings tax may gain significance in coming months.

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[15] Code §565.

With a suggested reduction of the corporate income tax to a rate of 15% or 20%, respectively, under the Trump and House Republican tax reform plans, corporations may be inclined to accumulate earnings in order to benefit from the rate arbitrage. Taxpayers should be aware that the I.R.S. enforces Congressional intent and does so by making certain that corporate distributions are made – whether actually or through otherwise available mechanisms, such as the consent dividend procedure.

Based on the reasoning of the C.A.A., it appears that those taxpayers that have no accumulated taxable income and no earnings and profits can continue to fall outside the accumulated earnings tax provision.