PENALTY TAXES ON CORPORATE ACCUMULATIONS

INTRODUCTION AND STUDY OBJECTIVES

The accumulated earnings tax and the personal holding company tax are penalty taxes designed to prevent taxpayers from using the corporation for tax avoidance. Both taxes are imposed on unwarranted accumulations of income that would have been taxable to the individual if it had been distributed. The purpose of the two penalty taxes is to compel distributions, thereby discouraging taxpayers from using the corporation for tax avoidance purposes.

In studying the rules of corporate accumulations, the student should have these objectives:

1. To learn the rules related to the assessment of the accumulated earnings penalty tax.
2. To learn the rules related to the imposition of the personal holding company penalty tax.
3. To understand when the rules of both penalty taxes will be applied.
4. To become familiar with various methods that are available to the taxpayer to avoid assessment of the penalty.

STUDY HIGHLIGHTS

ACCUMULATED EARNINGS TAX

1. The accumulated earnings tax is a penalty tax designed to discourage the excessive accumulation of earnings by a corporation. The tax aims at forcing the corporation to distribute its earnings to the shareholders, who then in turn pay taxes on dividend income. Whether income is being accumulated for the forbidden purpose of avoiding taxes requires a determination of the taxpayer’s intent.

2. The accumulated earnings tax is calculated as follows:

\[
\text{Accumulated taxable income} = \text{Taxable income} + \text{The dividends-received deduction} + \text{The net operating loss deduction} + \text{Capital loss carryovers included in taxable income} - \text{Federal income taxes (excluding penalty taxes)} - \text{Charitable contributions in excess of the 10\% limitation} - \text{Net capital losses incurred during the year} - \text{Net LTCG over Net STCL (net of taxes)}
\]

\[
= \text{Accumulated taxable income} - \text{Accumulated earnings credit} - \text{Dividends-paid deductions} = \text{Accumulated taxable income} \times 15 = \text{Accumulated earnings penalty tax}
\]

For tax years beginning after 2002 (as extended each year) the penalty tax is 15%.

6-1
Example. J corporation, a nonservice company, has the following transactions during the year.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income</td>
<td>$450,000</td>
</tr>
<tr>
<td>Tax liability</td>
<td>150,375</td>
</tr>
<tr>
<td>Excess charitable contributions</td>
<td>33,000</td>
</tr>
<tr>
<td>Short-term capital loss</td>
<td>(60,000)</td>
</tr>
<tr>
<td>Dividends received</td>
<td>150,000</td>
</tr>
<tr>
<td>Dividends paid</td>
<td>60,000</td>
</tr>
<tr>
<td>Accumulated earnings from prior years</td>
<td>220,000</td>
</tr>
</tbody>
</table>

Assuming no reasonable business needs to justify additional accumulations, the § 531 penalty tax is calculated as follows:

\[
\begin{align*}
\text{Taxable income} & \quad 450,000 \\
\text{Plus:} & \\
80\% \text{ Dividends-received deduction} & \quad 120,000 \\
\hline
\text{Total} & \quad 570,000 \\
\text{Less:} & \\
\text{Tax liability} & \quad (150,375) \\
\text{Excess charitable contribution} & \quad (33,000) \\
\text{Net short-term capital loss} & \quad (60,000) \\
\text{Dividends paid} & \quad (60,000) \\
\text{Remaining accumulated earnings credit} & \quad (30,000) \\
\text{($250,000 - $220,000)} & \\
\text{Accumulated Taxable Income} & \quad 236,625 \\
\end{align*}
\]

The penalty tax for the year would be \((236,625 \times 15\%) = 35,494\).

3. The accumulated earnings credit is a reduction in arriving at accumulated taxable income. The amount of the credit is the greater of:
   - $250,000 minus the accumulated earnings and profits at the end of the prior year, or
   - The current earnings and profits retained for the reasonable needs of the business minus net LTCG over set STCL (net of taxes).

4. The accumulated earnings credit is reduced to $150,000 for corporations primarily engaged in the business of providing professional services (e.g., accountants, attorneys, engineers, etc.).

5. The dividends-paid deduction comprises the following dividends:
   - Dividends paid during the taxable year not previously used.
   - Dividends paid within 2.5 months after the close of the taxable year.
   - Consent dividends.
   - Liquidating dividends.
6. Consent dividends are not actually paid to the shareholders; nonetheless, the shareholders must include them in computing their taxable income as if they had received an actual distribution. A consent dividend will increase the basis of the shareholder’s stock.

7. *Reasonable business needs* is not defined in the code. The Regulations state that reasonable business needs include
   - Capital for bona fide expansion of the business.
   - Provisions for the retirement of bona fide indebtedness.
   - Reserves for pending litigation.
   - Investments or loans to suppliers.
   - Provisions for working capital needs.

8. The courts have developed an operating-cycle approach to determine the working capital needs of a business. This approach, known as the *Bardahl* formula, permits an accumulation equal to the cost of operating a business for a single operating cycle. See *Example 6* in the textbook for an excellent illustration.

9. Because the accumulations tax is assessed upon the shareholder’s intent, the need for the penalty is based upon a subjective assessment. The burden of proof is generally placed upon the taxpayer; however, the burden can be shifted to the IRS. To shift the burden, the corporation must respond within 60 days after a notice is received from the IRS requesting information as to the reasonableness of the corporation’s accumulation of earnings.

PERSONAL HOLDING COMPANY

10. The personal holding company tax is aimed at so-called incorporated pocketbooks and incorporated talent. These are corporations established to receive and hold investment income or compensation of its shareholders in order to shield that income from the higher individual tax rates that would apply had the income been received by the shareholders.

11. Certain companies are exempt from the personal holding company penalty tax. These include banks, savings and loan associations, most finance companies, and life insurance and surety companies.

12. A personal holding company is any corporation that meets both of the following tests:
   a. Ownership: At any time during the last half of the taxable year more than 50 percent of its outstanding stock is owned, directly or indirectly, by up to five individuals.
   b. Passive income: At least 60 percent of the corporation’s adjusted ordinary gross income (AOGI) consists of personal holding company income (PHCI).

13. The attribution rules of § 544 are used in determining the stock ownership test.

14. AOGI is calculated as follows:

\[
\text{AOGI} = \frac{\text{Gross income}}{C0} - \frac{\text{Capital gains}}{C0} - \frac{\text{§ 1231 gains}}{C0} - \frac{\text{Deductions related to rental and royalty income}}{C0} = \text{Adjusted ordinary gross income (AOGI)}
\]
15. PHCI is essentially passive income such as dividends, interest, rents, and royalties. However, in some cases, amounts received under personal service contracts or as compensation for the use of corporate property by shareholders are also included in PHCI. See Chapter 6, Exhibit 8 in the textbook for a more thorough description.

16. Rental income is normally classified as PHCI. However, if two specific tests are met, adjusted rents (gross rents minus directly related expenses) are excluded from the PHCI category. The test for exclusion requires that both of the following be met:

a. 50 percent or more of the corporation’s AOGI is adjusted income from rents.
b. Dividends paid during the year equal or exceed nonrent PHCI minus 10 percent of OGI.

Example. N Corporation has gross income for the year of $40,000, which includes $30,000 in rental income, $8,000 in dividends, and a $2,000 long-term capital gain. Expenses related to the rental income are $20,000 and the company paid dividends of $5,000. AOGI must be calculated first:

\[
\begin{align*}
\text{Gross income} & \quad \$40,000 \\
\text{Capital gain} & \quad (2,000) \\
\text{OGI} & \quad \$38,000 \\
\text{Rental expenses} & \quad (20,000) \\
\text{AOGI} & \quad \$18,000
\end{align*}
\]

Next adjusted income for rents must be 50 percent or more of AOGI:

\[
\begin{align*}
\text{Rental income} & \quad \$30,000 \\
\text{Rental expenses} & \quad (20,000) \\
\text{Adjusted income from rents} & \quad \$10,000
\end{align*}
\]

\[
50\% \text{ of AOGI} (\$18,000) \quad 9,000 \quad \text{TEST I satisfied}
\]

Next dividends paid must exceed nonrent PHC minus 10 percent of OGI:

\[
\begin{align*}
\text{Nonrent PHC income} & \quad \$8,000 \\
10\% \text{ of OGI} & \quad (3,800) \\
\text{Excess} & \quad \$4,200 \\
\text{Dividends paid} & \quad \$5,000
\end{align*}
\]

Since both tests are satisfied, the company is allowed to exclude rental income (net of expenses) in determining the amount of passive income for the year. Accordingly, PHCI amounts to $8,000 (dividends only).

17. Additional tests exist to exclude adjusted income from mineral oil and gas royalties as well as compensation for the use of property by a shareholder.
18. Prior to the Tax Reform Act of 1986, the personal holding company penalty tax was 50 percent of undistributed personal holding company income (UPHCI). The Tax Reform Act reduced the rate to 39.6 percent. Currently, the rate is (for years beginning after 2002) 15 percent of UPHCI.

The computation is illustrated as follows:

\[
\text{Taxable income} + \text{Dividends-received deduction} + \text{Net operating loss deduction (except prior year NOL allowed without a dividends-received deduction)} + \text{§ 162 plus § 167 deductions related to rent exceeding rental income} - \text{Federal income taxes (excluding penalty taxes)} - \text{Charitable contributions in excess of the 10\% limitation} - \text{Net LTCG over net STCL (net of taxes)} = \text{Adjusted taxable income} - \text{Dividends-paid deduction} = \text{Undistributed personal holding company income} \times \text{Applicable tax rate} = \text{Personal holding company penalty tax}
\]

19. The dividends-paid deduction for a personal holding company includes the following types of dividends:

- Those dividends paid during the taxable year.
- Dividends paid within 20 months after the close of the taxable year.
- Consent dividends.
- Carryover dividends.
- Deficiency dividends.
- Liquidating distributions.

20. Carryover dividends are the excess of dividends paid in the prior two years over the adjusted taxable income for those years.

21. A deficiency dividend is an actual dividend paid within 90 days of a determination that a personal holding company penalty liability exists. A deficiency dividend only reduces the amount of the penalty tax and will not eliminate the assessment of penalties and interest.

22. The IRS cannot assess both an accumulated earnings penalty tax as well as a personal holding company penalty tax in any one year.

23. Under § 6501(f), the personal holding company tax on a personal holding company (PHC) that did not file a PHC schedule with its income tax return may be assessed for up to six years after the income tax return was filed.
STUDY QUESTIONS

True or False

1. The tax law is designed to discourage the retention of earnings in a corporation beyond the normal business needs.

2. Tax avoidance needs to be the controlling reason for retaining earnings in the corporation before imposition of the accumulated earnings penalty tax.

3. The accumulated earnings tax is only imposed on that income which is in excess of the reasonable needs of the business.

4. A reserve to pay stock dividends would be considered a reasonable need of the business.

5. Accumulated taxable income equals taxable income, plus or minus certain adjustments, plus the dividends-paid deduction, minus the accumulated earnings credit.

6. The personal holding company penalty tax was imposed to discourage the sheltering of passive income in a personal holding company.

7. The personal holding company tax is added to the regular tax and equals 50 percent of the undistributed personal holding company income.

8. Adjusted ordinary gross income (AOGI) is gross income (GI) less capital gains.

9. An S corporation election will circumvent the application of the § 531 penalty tax.

10. The penalty taxes under § 531 are very objective, while the penalty taxes under § 541 are subjective.

11. A corporation can be subject to the accumulated earnings penalty as well as the personal holding company penalty if both violations occur.

Multiple Choice

1. The accumulated earnings tax imposed on corporations for improper accumulation of earnings in excess of reasonable needs does not apply to which of the following?

   a. Closely held corporations.
   b. Widely held corporations.
   c. Publicly held corporations.
   d. Personal holding companies.
   e. None of the above.

2. In determining whether a corporation is subject to the accumulated earnings tax, which of the following items is not a subtraction in arriving at accumulated taxable income?

   a. Federal income tax.
   b. Capital loss carryback.
   c. Dividends-paid deduction.
   d. Accumulated earnings credit.
   e. Excess charitable contributions over the 10 percent limit paid during the year.
3. What amount of accumulated earnings of a service corporation will be considered within the reasonable needs of a business without the corporation having to show a bona fide business reason for the accumulation?

   a. $150,000 or less.
   b. $200,000 or less.
   c. $250,000 or less.
   d. $300,000 or less.
   e. $350,000 or more.

4. Which of the following would not be considered reasonable needs of a business in determining the accumulated earnings tax?

   a. Specific plans to update factory machinery.
   b. Definite long-range commitment to purchase raw materials.
   c. A feasible long-range plan to expand factory productions.
   d. An amount, with certain limitations, necessary to redeem the corporation’s stock included in a deceased stockholder’s gross estate.
   e. Specific and feasible plan to declare a stock dividend to all shareholders.

5. D Corporation, which is not a holding company, derives its income from retail sales. D had accumulated earnings and profits at December 31, 2007, of $145,000. For the year ended December 31, 2008, it had earnings and profits of $115,000 and a dividends-paid deduction of $15,000. It has been determined that $20,000 of the accumulated earnings and profits for 2008 is required for the reasonable needs of the business. How much is the allowable accumulated earnings credit at December 31, 2008?

   a. $105,000.
   b. $125,000.
   c. $150,000.
   d. $250,000.
   e. None of the above.

6. Which of the following types of income is not considered personal holding company income?

   a. Dividends.
   b. Interest.
   c. Royalties.
   d. Annuities.
   e. Capital gains.

7. Which of the following rates is used to compute the personal holding company tax for 2008?

   a. 28 percent.
   b. 34 percent.
   c. 39.6 percent.
   d. 50 percent.
   e. 70 percent.
8. Which of the following are deemed reasonable business needs for the accumulated earnings credit?
   a. Loans to customers.
   b. Loans to shareholders.
   c. Loans to friends.
   d. Loans to family members.
   e. None of the above.

9. Which one of the following is not used as a method of avoiding double taxation?
   a. Multiple corporations.
   b. Excessive compensation for services to the corporation by shareholder.
   c. Issuance of debt in lieu of stock.
   d. Leasing of property to the corporation by shareholder.
   e. None of the above.

10. In calculating adjusted taxable income for accumulated earnings tax purposes, which one of the following is not subtracted from taxable income?
    a. Regular Federal income taxes for the year.
    b. Dividends-paid deduction.
    c. Charitable contributions in excess of allowable deduction.
    d. Net capital loss.
    e. Net capital gains.

11. B Corporation, a service company, operates on a calendar year and has paid no dividends for three years. What would its accumulated earnings credit be?
    Estimated reasonable needs for the current year $200,000
    Prior accumulations 100,000
    Net capital gain 15,000
    Taxes attributed to capital gain 5,100
    a. $85,000.
    b. $90,100.
    c. $100,000.
    d. $150,000.
    e. $250,000.

12. Which one of the following is not part of the dividends-paid deduction for accumulated earnings tax purposes?
    a. Dividends paid within 20 months after the close of the tax year (“throwback dividends”).
    b. Dividends paid during the year.
    c. Deficiency dividends.
    d. Consent dividends paid on the last day of the year.
    e. None of the above.
13. Section 533, Accumulated Earnings Tax, provides that a corporation is deemed to have been formed or availed of for the purpose of avoiding tax on shareholders if

   a. the corporation is a holding or an investment company.
   b. the corporation has accumulations in excess of the designated minimum credit.
   c. the corporation has invested in assets unrelated to the corporation’s business.
   d. the corporation has paid no dividends.
   e. the corporation has ten or fewer shareholders.

14. A Corporation has $400,000 of accumulated taxable income. Its accumulated earnings tax for 2008 is:

   a. $158,400.
   b. $124,000.
   c. $112,000.
   d. $60,000.
   e. Can’t be determined from the information provided.

**Fill In the Blanks**

1. The penalty tax associated with the unreasonable surplusing of earnings is the _______ _______ tax.

2. The § 531 penalty tax rate is _______ percent for 2008.

3. A consent dividend is an example of the _______ deduction.

4. The accumulated earnings penalty tax will not be assessed if the corporation has _______ needs.

5. The _______ formula was developed to help determine the working capital needs of the corporation.

6. The _______ tax is aimed at preventing incorporated “pocketbooks.”

7. The § 541 penalty tax rate is _______ percent for 2008.

8. Carryover dividends are the excess dividends paid in the prior _______ years over the adjusted taxable income for those years.

**Code Section Recognition**

For each of the following Code sections, try to match the response that most properly identifies the underlying provision.

1. § 531  a. imposition of personal holding company tax

2. § 535  b. imposition of accumulated earnings tax

3. § 541  c. definition of dividends-paid deduction

4. § 547  d. accumulated taxable income defined

5. § 561  e. deduction for deficiency dividends
SOLUTIONS TO STUDY QUESTIONS

True or False

1. True.

2. False. It is only one of the factors considered, although it is a major consideration.

3. True.

4. False. Dividends are not business-related.

5. False. Less the dividends-paid deduction.

6. True.

7. True.

8. False. The definition given describes ordinary gross income.


10. False. Section 531 is subjective and § 541 is objective.

11. False. Either penalty can apply, but not both.

Multiple Choice

1. d.

2. b.

3. a. The credit for service corporations is $150,000 versus $250,000 for nonservice corporations.

4. e.

5. a. ($250,000 – $145,000). $20,000 is smaller and therefore not considered.

6. e.

7. e.

8. a.

9. a.

10. b.
11. b. $(200,000 - 100,000 - 15,000 + 5,100) = 90,100.$

12. c.

13. a.

14. d. $(400,000 @ 15\%) = 60,000.$

Fill In the Blanks

1. Accumulated earnings.

2. 15.

3. Dividends-paid.

4. Reasonable business.

5. *Bardahl*.

6. Personal holding company.

7. 15.

8. Two.

Code Section Recognition

1. b.

2. d.

3. a.

4. e.

5. c.