

1-1976

Tax Forum: The Causes of the Accumulated Earnings Tax Penalty and How to Avoid It

Mable W. Kitchen

Follow this and additional works at: <https://egrove.olemiss.edu/wcpa>



Part of the [Accounting Commons](#), [Taxation Commons](#), and the [Women's Studies Commons](#)

Recommended Citation

Kitchen, Mable W. (1976) "Tax Forum: The Causes of the Accumulated Earnings Tax Penalty and How to Avoid It," *Woman C.P.A.*: Vol. 38 : Iss. 1 , Article 11.

Available at: <https://egrove.olemiss.edu/wcpa/vol38/iss1/11>

This Article is brought to you for free and open access by the Archival Digital Accounting Collection at eGrove. It has been accepted for inclusion in Woman C.P.A. by an authorized editor of eGrove. For more information, please contact egrove@olemiss.edu.



Tax Forum

THE CAUSES OF THE ACCUMULATED EARNINGS TAX PENALTY AND THE MEANS OF AVOIDING IT

Mable W. Kitchen, CPA
Price Waterhouse & Company
Cincinnati, Ohio

GUEST WRITER: This column was written by Wanda A. Wallace, M.P.A., CPA, of Fort Worth, Texas.

A corporation is subject to a penalty tax if it unreasonably accumulates earnings to avoid having them taxed to the shareholders as dividends. This accumulated earnings tax is in addition to the regular corporate tax of 48% and has a rate of 27½% on the first \$100,000 of accumulated taxable income and 38½% on any excess.

Given the present slump in the economy you probably think your company could not possibly have an accumulated earnings tax problem. You could be in for a surprise! Unknowingly, your company could have developed the problem stemming from (1) the decline in sales volume and the resulting decrease in the inventory level and the accounts receivable balances, (2) the tighter credit policy resulting from anticipation of increased business failures during the economic decline, and/or (3) the reduced level of corporate expenditures which were curtailed to conserve cash for what might be a long business slump. The effects of any or all of these steps may have put the company into a highly liquid cash position. Take a look at the company's balance sheet. Does it contain those "red flags" which indicate to the Internal Revenue Service (IRS) that the company may be unreasonably accumulating its earnings. First, take a look at the retained earnings balance; does it exceed the exempt level (in 1975 — \$150,000)? If so, does the balance sheet also show any of the following: (1) a very large cash balance, (2) an unreasonably

high current ratio, (3) an unrelated investment for example, marketable securities or vacant land, (4) substantial loans to major stockholders, particularly if no rendered services exist, and/or (5) a record of minimal dividend payments coupled with closely-held stock? If the answer to any of these is in the affirmative, your company has a problem. The existence of these factors creates the presumption that it has unreasonably accumulated income for the purpose of avoiding tax on the shareholders. As a result the company would be subject to the accumulated earnings tax penalty unless by a preponderance of evidence it can prove the contrary.

The accumulated earnings tax has plagued closely-held corporations particularly due to the shareholders' ability to control the dividend policy. However, the IRS says there is no legal impediment to applying the accumulated earnings tax to a publicly-held corporation.¹ In a recent case, *Golconda Mining Corp.*, it was determined that the levy did not apply to a publicly-held corporation;² however, the IRS has announced that it will not follow the decision. So, although it has been largely an important lever utilized by the IRS against closely-held corporations, the accumulated earnings tax may become an important consideration for publicly-held companies as well.

Historical Development

A look at history indicates that under the 1939 Internal Revenue Code, the IRS paid special attention to corporations that had not distributed at least 70% of their earnings as taxable dividends.³ (The 70% test does not apply under the 1954 code.)⁴ In any event the 70% figure was purely arbitrary and only a small fraction of corporations distributing less were actually assessed. On the other hand there

were no absolute assurances that a corporation distributing more would escape the tax. One court decision included the statement that "Hard, fast rules are not enough; clear preponderance of evidence is needed."⁵ The key to avoidance of the assessment is the substantiation of the "reasonable business needs" for accumulation of earnings, both past and present.⁶

The Application of Sections 531 to 537

The accumulated earnings tax is governed by Sections 531 to 537 of the Internal Revenue Code of 1954, the Income Tax Regulations related thereto, and case law on the subject. The application of Sections 531 to 537 is extremely difficult due to the ambiguity surrounding what constitutes a "fact" which will establish that the accumulation of earnings is to meet the reasonable needs of the business.

Prominent factors in one case may become minor in another and slight shades of differences may serve to tip the scales one way or the other . . . What would be reasonable in one situation or for one business might be clearly unreasonable in another.⁷

As if to justify such ambiguity in respect of the meaning of "facts" supporting accumulations of earnings as reasonable, courts have pointed out that the standards for the assessment of the accumulated earnings tax compare with the indefinite standards which are common in law, such as "the prudent driving of a motor car or the diligence required in making a ship seaworthy."⁸ Obviously, the recognition that more than one area of ambiguity exists within the framework of law does little to rectify the problem of applying Sections 531 to 537 of the Internal Revenue Code. In the opinion of this writer, it is

possible to shed some light on what constitutes a "finding of fact" that earnings have been reasonably accumulated by coordinating legislation and court cases and recognizing accepted standards which can support the ultimate finding.

In terms of legislation, Regulations 1.537-1 through 1.537-3 are a considerable aid to the taxpayer in deciphering the meaning of the Code sections. The importance of accumulating earnings for use in a related business for bona fide business purposes is stressed. Regulation 1.537-2 provides examples of grounds which, when supported by facts, may indicate reasonableness of earnings' accumulations.

REASONABLENESS TESTS

Expanding and Replacing Plant and Equipment

The first purpose for accumulating earnings which is cited as a reasonable goal is that of expanding and replacing plant and equipment. Concreteness of future plans for replacement of equipment, modernization of plant, or maintenance of competitive position is important. It is no excuse to say that because a corporation is small and informally conducted, alleged future plans lack specificity.⁹ The specificity requirements were written into the Regulations by the Commissioner precisely because a loosely run corporation presents a high potential for post hoc, unsupported rationalization for the prohibited hoarding of profits.¹⁰

However, in another case, the fact that "there was little documentation of a taxpayer's plans for modernization in the corporate minutes and formal memoranda" had little bearing on a decision for the taxpayer, since the management had daily contact and a history of acting in an informal manner.¹¹ The judge in this case explained that the requirement of "specific, definite, and feasible" plans does not demand that the taxpayer produce meticulously drawn, formal blueprints for action.

The test is a practical one, namely that the contemplated expansion appears to have been 'a real consideration during the taxable year, and not simply an afterthought to justify challenged accumulations'.

The evidence cited in the case as supporting expansion plans were the efforts to acquire continuously and persistently from a point in time preceding the taxable years in issue. The record indicated that if the petitioner had been able to acquire the firm it would have to immediately provide funds for additional working capital for the acquiree and to modernize its equip-

ment. The stronger evidence cited in the case is the fact that in 1968 the petitioner bought \$1,000,000 worth of stock — the desired amount. In the words of the judge, "we cannot and will not ignore the ultimate fruition of petitioner's expansion plans — accomplished within a reasonable time after the years in question at a cost closely in line with the amount originally estimated. While not controlling, evidence of what petitioner in fact did in subsequent years certainly affects the weight to be given its declared intention during the years in issue." The money set aside for replacement of the plant and equipment was considered appropriate in light of the testimony of officers of the petitioner and the fact that the record shows actual replacement of plant and equipment beginning prior to the first year here in issue.

Despite the emphasis on actual activities carried out, the actual planned activities do not have to occur.¹² In one case the facts were that a palletizing program was needed by a corporation and this made a warehouse imperative.¹³ There was no architect's design; the imperative need for a new warehouse and the carrying out of the palletizing program was sufficient evidence. In fact, even though there was evidence to show knowledge of the taxpayer that trackage could not be had at its warehouse site, this did not show that there was no plan for meeting the imperative need which the district court found existed. It appears in this case that the existence of a need is enough to justify accumulation of earnings for expansion.

Similar to the above case, *Sorgel, William J. V. U. S. 29 AFTR 2d 72-1035*, held that it was reasonable to accumulate "\$700,000 for the plant expansion Clogged workshops indicate the reasonableness of an expansion program" and plans to build a 260 foot building existed. The judge further pointed out that "While no doubt *Sorgel* could have financed at least part of the expansion through debts, the decision not to, if possible, cannot be considered unreasonable."

Based on the above decisions it appears that while concrete construction plans are helpful, the simple proof of an existing need to expand is sufficient to prove reasonableness of funds accumulated for expansion. Of course, the amount set aside for expansion purposes must be a "reasonable" size, as well. If the expansion plans are actually carried out prior to a court case involving allegations that accumulations were unreasonable in prior years, they provide excellent proof of good intentions of a taxpayer.

Working Capital Needs and Current Ratio

A less subjective factor in establishing "reasonableness" is that of providing a working capital need and showing a reasonable current ratio. The Bardahl formula — a mathematical determination of working capital requirements of industrial corporations — has been accepted in the Supreme Court as a good rule of thumb in justifying retention of earnings for operations. This involves the calculation of current expenses over an "operating cycle." The operating cycle is the time it takes to buy raw materials, convert them into goods, sell the goods, and collect the proceeds. The total of operating expenses during a cycle (in a peak period) is equal to a working capital requirement considered "reasonable."¹⁴ Likewise, the Tax Court has consistently held that the accumulation of funds to meet operation expenses for at least one year is reasonable.¹⁵ All working capital calculations must be adjusted for the uniqueness of the company involved, its experience with receivables, its peak periods of operations, and its subsequent historical needs for working capital. A rule of thumb of the courts in terms of current ratio is that approximately 2.5 to 1 is an "indication that the accumulation of earnings and profits is not unreasonable."¹⁶

Other Support Taken From Court Cases

Valid reasons for accumulations have included the following:

The desire to expand a business or a plant without the dilution of the present owners' interest and without borrowing

The desire to acquire a new business, especially if that business is directly related to the existing business of the accumulating corporation

The desire to increase inventories

The desire to retire outstanding debt

The need to provide loans to suppliers or customers

The desire to fund pension plans

The desire to substitute a self-insurance plan reserve for commercial coverage.¹⁷

While each of the above reasons are acceptable, they should be adequately documented in the corporate records if they are to be recognized as facts by the courts.

Perhaps most importantly, a firm that is denied reasonableness of accumulations should take heart at the District Court's

(Continued on page 33)

Theory and Practice

(Continued from page 31)

financial difficulty by purchasing a loan or a property at an amount in excess of market value, forgiving an indebtedness, reducing the advisory fees, providing required compensating balances or making outright cash payments. In these situations, full disclosure of the nature of the relationship between the REIT and its advisor and the nature and amount of the transactions between them should be made. Appropriate accounting in the present framework of generally accepted accounting principles requires adjustment of any assets (or liabilities) transferred between the REIT and the advisor to current market value as of the date of the transaction and recognition, as income or as a reduction of advisory fees, of the operating support effectively obtained. When material, the effect of such transactions should be reported separately in the statement of operations.

This Statement is applicable to all REITS whether qualified under Sections 856-858 of Internal Revenue Code or not. Other companies engaged in the business of investing in real estate or making loans related to real estate are beyond the scope of this Statement; however, the conclusions in the Statement may also be appropriate for these companies.

Auditing implications of this Statement are being considered by the Auditing Standards Executive Committee of the AICPA. In forming a judgment regarding the adequacy of the allowance for loan losses, the auditor is presented with at least two significant problems. These are using the work of non-accounting specialists and availability of evidential matter to estimate net realizable value of properties. Estimated selling price and estimated costs to complete construction are among the factors to be considered in the determination of net realizable value. The work of an appraiser or engineer may be needed for some of these estimates. If construction has not been completed or if it is anticipated that a purchaser may be difficult to locate, estimation of net realizable value at a point in the future may be necessary. The auditor may need to evaluate "estimates of future economic events" and the reasonableness of assumptions used in making such "estimates". If the auditor is unable to obtain satisfaction as to the reliability of appraisals, assumptions and projections used in the determination of the carrying value of real estate and any related allowance for loan losses, it may be necessary to appropriately qualify or disclaim an opinion.

Tax Forum

(Continued from page 30)

statement that the "Failure of a taxpayer corporation to prove that its entire accumulation was for the needs of the business does not necessarily mean that no part of the accumulation was reasonable." The tax will only be assessed on that portion which is unreasonable.

There are two general considerations by the court that might prove worthwhile to keep in mind: (1) The courts have recognized a corporation's right to grow and within reasonable limits to protect itself and its shareholders,¹⁸ and (2) The business judgment of those entrusted with the management of a successful growing enterprise is not to be ignored.¹⁹

Conclusions

Reasonableness of the accumulation of earnings can be established by using one of the methods set forth above such as the Bardahl formula, the "reasonable current ratio", the need for the funds for expansion, etc. In any event there are two things which should definitely be done to enable a corporation to avoid the accumulated earnings tax penalty:

- (1) the corporation should keep up-to-date records of why earnings are retained and
- (2) if the corporation lists any intangible factors such as fear of a depression, available supporting data, such as an economist's report, should be filed with the list. The more tangible the items, such as plant expansion, the more concrete the evidence should be, e.g. as near to the blueprint stage as possible.²⁰

The accumulated earnings credit for \$150,000 (\$100,000 for years before 1975)²¹ exists because the lawmakers and courts recognize the need for a firm to retain ample earnings for operations and for expansion; this credit may be adjusted if reasonableness of needs for retaining more earnings can be established.

Notes

¹Standard Federal Tax Reports; Taxes on Parade, Commerce Clearing House, Inc., vol. 62, no. 18, April 2, 1975, p. 2.

²Standard Federal Tax Reports; Taxes on Parade, Commerce Clearing House, Inc., vol. 61, no. 56, December 10, 1974, p. 2.

³TD 4914, 1939-2 CB 108, as amended by TD 5398, 1944 CB 194.

⁴TD 6378, 1959-1 CB 680, amending TD 4914 above.

⁵Latchis Theatres of Keene, Inc. et. al. v. Comm., 7 AFTR 2d 380.

⁶Standard Federal Tax Reports; Taxes on Parade, Commerce Clearing House, Inc., vol. 61, no. 9, January 29, 1975, p. 7.

⁷Prentice-Hall, volume 3, 1973, 21,327.

⁸Ibid.

⁹Bahan Textile Machinery Co., Inc. v. U. S., 29 AFTR 2d 72-418.

¹⁰Motor Fuel Carriers, Inc. v. U. S., 12 AFTR 2d 5554.

¹¹Walton Mill, Inc., P-H Memo TC 72,025.

¹²Sterling Distributors, Inc. v. U. S., 11 AFTR 2d 767.

¹³Ibid.

¹⁴Prentice-Hall, volume 3, 1973, 21,328.

¹⁵F. E. Watkins Motor Co. v. Comm., 31 TC 288, Note 7.

¹⁶Bremerton Sun Publishing Co., 44 TC 566.

¹⁷Federal Taxes and Management Decisions, by Ray M. Sommerfeld; Richard D. Irwin, Inc., Homewood, Illinois, 1974.

¹⁸Prentice-Hall, volume 3, 1973, 21,328

¹⁹F. E. Watkins, op. cit.

²⁰Prentice-Hall, volume 3, 1973, 21,301.

²¹Prentice-Hall 1976 Federal Tax Course, Prentice-Hall, Inc., Englewood Cliffs, New Jersey, 1975, p. 3126.

Personal Management

(Continued from page 23)

lated to the individual's goals and objectives such as:

- 1) the degree of financial independence desired,
- 2) the level of retirement income desired,
- 3) the investment level desired,
- 4) the standard of living level desired,
- 5) and how these goals and objectives fit into the individual's income tax picture.

According to Mr. Conway, once the above objectives have been set the individual can begin to assemble a financial plan.

The two methods discussed above are basically the same. The first step is to prepare a budget, which forces us to look ahead and to consider how the various classes of income and expense fit together. We all remember from our budgeting classes in school that the primary benefit of a budget is that it makes us put down in writing exactly what our plans are. It is very easy to underestimate expenses. Not until we actually start tallying up exactly what we spend for what can we accurately determine the total expenditures related to each expense category. The budgeting process also points out to us the many ways in which we can possibly cut expenditures.

Perhaps the most difficult aspect of the financial plan is the necessary self-discipline. Or, perhaps, it is just facing up to the fact that we do need a financial plan and then doing something about it.