C Corporation Accumulated Earnings Tax

Cross References
• CCA 201653017, December 30, 2016

A distribution from a C corporation to a shareholder is taxable as a dividend if the distribution comes from the earnings and profits of the corporation. Since dividend distributions are not deductible by the C corporation, many consider this a form of double taxation. The C corporation pays tax on its earnings and profits when they are earned, and then the shareholder pays tax on those same profits when they are later distributed as dividends. Earnings and profits that have yet to be distributed as dividends are called accumulated earnings.

To prevent C corporations from accumulating excessive earnings and profits in an attempt to avoid double tax, a C corporation may be subject to an accumulated earnings tax. The accumulated earnings tax may apply during an IRS audit if it is determined that the corporation accumulated its earnings beyond the reasonable needs of the business, and the purpose for accumulating its earnings is determined to be tax avoidance. The accumulated earnings tax is 20% of the excess accumulated earnings.

C corporations may accumulate earnings up to $250,000 without being subject to the accumulated earnings tax ($150,000 for service type corporations in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting). Once earnings and profits are accumulated beyond the $250,000/$150,000 thresholds, they are subject to the accumulated earnings tax, unless there is a reasonable need for accumulating profits. Reasonable needs can include:
• To provide for expansion of the business.
• To acquire a business enterprise through purchase of stock or assets.
• To provide necessary working capital, such as for procurement of inventories.
• To provide for investments or loans to suppliers or customers if necessary to maintain the business of the corporation.
• To provide for the payment of reasonably anticipated product liability losses.

Example
Fred owns a grocery store. His business is incorporated as a C corporation. Fred’s average cost of inventory that he must carry on hand at any given time is $2 million. Fred can finance the cost of his inventory on hand by accumulating $2 million of earnings and profits.
Lack of liquidity. A recent Chief Counsel Advice memorandum illustrates that a lack of liquidity is not a reasonable need for accumulating earnings and profits. The C corporation was primarily organized as a holding company for several partnerships. The partnerships each determined how much of their earnings to distribute to partners and how much to accumulate. Partnership profits then flowed through to the C corporation to be taxed on the C corporation return.

The taxpayer argued that it is not liable for the accumulated earnings tax because it does not have control over distributions from the partnerships in which it invests. The taxpayer’s taxable income is derived solely from partnerships from which the taxpayer cannot control distributions. Thus, the taxpayer does not have liquid capital from which to distribute earnings to its shareholders and, therefore, should not be subject to the accumulated earnings tax.

The CCA memorandum said that the Internal Revenue Code computes the accumulated earnings tax based on accumulated taxable income. With respect to a mere holding company for which reasonable needs of a business are not relevant, it is not concerned with the liquid assets of the corporation. IRC section 535 uses taxable income as a starting point for defining accumulated taxable income, and none of the adjustments to taxable income include the undistributed income of partnerships.

The CCA memorandum also pointed to the consent dividend procedures provided by IRC section 565. Under the consent dividend procedures, a corporation is treated as if it made a dividend distribution to its shareholders even though it may lack the ability to actually do so. This procedure allows the corporation to avoid the accumulated earnings tax. The amount of the consent dividend is considered as if it were distributed in money by the corporation to the shareholder on the last day of the year, and then as if it were contributed back to the corporation as a capital contribution by the shareholder on that same day. Because the taxpayer permitted its earnings and profits to accumulate, and because consent dividends could have been used by the taxpayer and shareholder, the taxpayer remained subject to the accumulated earnings tax in spite of its lack of liquidity and lack of control over the partnerships in which it invests.