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THE NEW EMPHASIS ON SECTION 531: A SURVEY OF THE PENALTY TAX ON UNDISTRIBUTED EARNINGS

An area of increasing importance to tax lawyers in recent years has been the penalty tax imposed on improper accumulations of earnings. Demonstrative of the renewed interest of the Internal Revenue Service in this matter is the increase in the number of tax audits which have resulted in the assertion of the penalty tax and the corresponding increase in judicial decisions involving penalty tax questions. Especially vulnerable to the penalty tax are those corporate enterprises the majority of whose shares are not widely held by the public and which have large surpluses, high ratios of current assets to current liabilities, or a large degree of liquidity. From a planning viewpoint, steps can be taken to minimize, and perhaps even to eliminate, exposure to the penalty tax. Moreover, from a defensive viewpoint, procedures may be undertaken to avoid the assertion of the tax or, once the penalty tax has been imposed, to bring the issue to a successful conclusion. The following articles examine some of these steps by reviewing the more important statutory provisions pertaining to the penalty tax on undistributed earnings. These articles will cover the relationship of the section 531 penalty tax to other provisions of the Internal Revenue Code and will analyze the various requirements which must be met before the penalty can be imposed. Some of these requirements will be examined in depth, with particular emphasis upon the more recent statutory changes and judicial developments. — Harlan Pomeroy.

I

The Statutory Pattern

Harlan Pomeroy

THE PENALTY TAX on improper accumulations of earnings had its origin in 1913.[1] From 1913 through 1920, the added tax or penalty was imposed upon the shareholders, rather than upon the corporation, on the theory that if the corporation were improperly accumulating its earnings instead of properly distributing them by way of larger dividends, the statute would treat as done that which ought to have been done.

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Beginning in 1921 and continuing to the present time, the statutory sanction has been against the corporation rather than its shareholders.[2] The penalty now is thus a direct inducement to the corporation, rather than to its shareholders, not to accumulate, but to pay out, its earnings.

I. Purpose of the Penalty Tax

The general purpose of the penalty tax is to make it more costly and hence less attractive for a corporation to shelter its earnings at fixed and relatively lower corporate tax rates thereby saving its shareholders the graduated and higher individual tax on distributed earnings. In the absence of the threat of the penalty tax, a group of shareholders could, by design, build up the net worth of a controlled corporation through the accretions of undistributed corporate earnings and subsequently liquidate the corporation or sell their stock with the resulting capital gain. It is also possible that the shareholders might contribute their stock to charity or die while holding the stock. In either case, no additional income tax would be imposed upon the tax-sheltered increase in net worth reflected in the appreciation of the value of the stock. To counteract these possibilities, the Internal Revenue Service exacts a penalty tax under section 531 of the Internal Revenue Code of 1954 in any case in which a corporation accumulates its earnings to one or more of these ends.

II. The Penalty Tax Provisions

The Internal Revenue Code[3] imposes the penalty tax on an annual basis upon certain corporations. The tax base, or the income upon which the penalty tax is applied, is the corporation's "accumulated taxable income."[4] Generally, this is the corporation's yearly taxable income less such nondeductible items as income taxes and dividends. The Code also specifies other technical adjustments, such as the accumulated earnings credit, which was added in 1954 and now makes it possible, upon a proper showing of facts, to shelter a portion of the corporation's income in a particular year from the application of the penalty tax.[5]

[1] Revenue Act of 1913, ch. 16, 38 Stat. 166.

[2] Revenue Act of 1921, ch. 136 § 220, 42 Stat. 247.

[3] INT. REV. CODE OF 1954, §§ 531-37 [hereinafter cited as CODE §].

[4] CODE § 535. The technical details of the computation of accumulated taxable income are beyond the scope of this series of articles. See Treas. Reg. §§ 1.535-1 to -3 (1959) [hereinafter cited as Reg. §].

[5] CODE § 535(c); Reg. § 1.535-3 (1959). Simply stated, the accumulated earnings credit is the amount of current earnings and profits shown to have been retained for reasonable business needs. For a situation where the credit was used to mitigate what, under the 1939 Code, would have been an all or nothing result in terms of im-

The rate of the penalty tax is twenty-seven and one-half per cent on the first 100,000 dollars of accumulated taxable income each year. In addition, when the corporation's accumulated taxable income exceeds 100,000 dollars for the particular year, the rate is increased to thirty-eight and one-half per cent on the balance.[6] Generally, a corporation can accumulate up to 100,000 dollars of earnings and profits over the years before the penalty tax can be imposed.[7] Thus, with certain exceptions,[8] until a corporation has an earned surplus of 100,000 dollars, it need not be concerned that the penalty tax will be imposed. However, beginning with the first year in which its year-end earned surplus exceeds 100,000 dollars, the corporation should be prepared to meet the challenge of the penalty tax provisions.

The penalty tax may be asserted only against those corporations "formed or availed of" for the purpose of avoiding the income taxes of their shareholders or of the shareholders of any other corporation.[9] Moreover, this prohibited purpose must be manifested in a certain, specified way before the penalty tax can be imposed. The corporation must have permitted its earnings and profits to accumulate instead of being divided or distributed.[10] Thus, the *subjective intention* of avoiding the shareholders' income taxes must exist concurrently with the *objective fact* of permitting the earnings to accumulate instead of being distributed. In a sense, the penalty tax, like the fraud penalty, is "a direct tax on the state of mind."[11]

If the earnings and profits are permitted to accumulate beyond the reasonable needs of the business, there is a statutory presumption of a purpose to avoid the shareholders' income taxes.[12] While this presumption is rebuttable, it nevertheless narrows the issue so that the typical section 531 penalty case is concerned with whether the need for capital asserted by the corporation is in fact a reasonable need of the business.

To reduce the possibility of unfairness, or perhaps to narrow the issues, the 1954 Code added a new provision whereby the

position of the penalty, see Ted Bates & Co., P-H 1965 TAX CT. REP. & MEM. DEC. (34 P-H Tax Ct. Mem.) ¶ 65251 (Sept. 17, 1965).

[6] CODE § 531.

[7] CODE § 535(c)(2).

[8] See Sullivan, *Interplay of Section 531 with Other Sections of the Code*, 17 W. RES. L. REV. 709 (1966).

[9] CODE § 532(a).

[10] *Ibid.*

[11] Helvering v. National Grocery Co., 304 U.S. 282, 289 (1938).

[12] CODE § 533(a).

burden of proof in cases before the Tax Court may be shifted from the corporation to the Commissioner on the issue of whether the accumulation was beyond the reasonable needs of the business.[13] However, the burden of proof on the broader question of whether the corporation has sought to avoid its shareholders' income taxes remains with the corporation. This fact, together with the insignificance of who has the burden of proof after evidence has been presented, raises a question as to the reason for congressional tampering with the established rules pertaining to burden of proof.[14]

The above analysis raises the question of whether the penalty tax can be imposed (1) where the accumulation of earnings is unreasonable but there is no purpose to avoid the shareholders' income taxes[15] or (2) where there has been no unreasonable accumulation of earnings but there is a purpose to avoid the shareholders' income taxes.[16]

As a practical matter, the directors of each corporation exposed to the penalty tax must annually ask themselves whether the earnings should be paid out as a larger dividend or whether the earnings are needed in the business. The Commissioner of Internal Revenue may well be a silent director who later will claim that if he had attended the directors' meeting, he would have voted to pay a substantially larger dividend. Thus, the directors' business reasons for accumulating the earnings may eventually be subjected to scrutiny by the Service. In order to avoid the penalty, the corporation must prove that its needs are "directly connected with the needs of the corporation itself and must be for bona fide business purposes."[17]

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[13] CODE § 534; Reg. §§ 1.534-1 to -2 (1959). *Compare* CODE § 534(a) (1), *with* CODE § 534(a) (2). For the importance of specifying business needs in terms of dollars, if the burden is to be shifted, see Ted Bates & Co., P-H 1965 TAX CT. REP. & MEM. DEC. (34 P-H Tax Ct. Mem.) ¶ 65251 (Sept. 17, 1965).

[14] Since the Tax Court will not rule in advance as to which party has the burden of proof, the parties must await at least until the outcome of the particular litigation before they learn which party unknowingly carried this burden all along. Thus, the statutory mechanism for shifting the burden of proof as to one of the fact issues generally involved in a § 531 case, appears to be little more than a confusing nullity. See, *e.g.*, Commissioner v. Young Motor Co., 316 F.2d 267 (1st Cir. 1963); Ted Bates & Co., P-H 1965 TAX CT. REP. & MEM. DEC. (34 P-H Tax Ct. Mem.) ¶ 65251 (Sept. 17, 1965).

[15] The answer would appear to be no. Reg. § 1.533-1(a) (2) (1959). See Sullivan, *Prohibited Purpose for Accumulation of Earnings*, 17 W. RES. L. REV. 712-13 (1966).

[16] The answer, theoretically at least, is yes. Reg. § 1.533-1 (a) (2) (1959). However, the accumulated earnings credit, based upon a showing of reasonable business needs, may prevent assertion of the penalty in this situation. See Sullivan, *supra* note 15, at 714.

[17] Reg. § 1.537-1(a) (1959).

The test is whether the past and current accumulation of earnings "exceeds the amount that a prudent businessman would consider appropriate for the present business purposes and for the reasonably anticipated future needs of the business."[18] An additional point, which is sometimes overlooked, is that it may be cheaper for the particular corporation and shareholders involved to expose the corporation to the substantial risk that the penalty tax will be incurred, rather than to pay out earnings which may be taxed to the shareholders at such high individual tax rates as to make retention of the earnings by the corporation, even with the added penalty tax burden, the less costly alternative.[19]

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[18] *Ibid.*

[19] See Kidder, *Accumulating Surplus for Business Needs*, 17 W. RES. L. REV. 724 (1966).