
1966

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Recommended Citation

Joseph D. Sullivan, *Interplay of Section 531 with Other Sections of the Code*, 17 W. Rsrv. L. Rev. 709 (1966)

Available at: <https://scholarlycommons.law.case.edu/caselrev/vol17/iss3/10>

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II

Interplay of Section 531 With Other Sections of the Code

Joseph D. Sullivan

THERE ARE SEVERAL exceptions to, and limitations upon, the application of the accumulated earnings tax provisions of the Internal Revenue Code. This article will attempt to analyze these exceptions and limitations.

I. SCOPE OF THE ACCUMULATED EARNINGS PROVISIONS

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There are three types of domestic corporations to which the accumulated earnings tax provisions are inapplicable. This tax cannot be imposed upon a personal holding company,¹ a tax-exempt corporation,² or a Subchapter S corporation which has elected not to be subject to federal corporate income tax.³

In addition, this tax cannot be imposed upon a foreign, personal holding company;⁴ however, it is applicable to a foreign corporation, whether resident or nonresident, with respect to any income derived from sources within the United States if, under the treasury regulations, any of the shareholders of the foreign corporation are subject to income tax on the distributions of the corporation.⁵

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A lesser-known fact is that the gross income of a foreign corporation from United States sources is subject to the tax without the benefit of any deductions or credits for the reasonable needs of the business if the corporation does not file a United States income tax return.⁶ In view of this, it would behoove a foreign corporation to

¹ INT. REV. CODE OF 1954, § 532(b) (1) [hereinafter cited as CODE §].

² CODE § 532(b).

³ CODE § 1372(b) (1).

⁴ CODE § 532(b) (2).

⁵ Treas. Reg. § 1.532-1(c) (1959) [hereinafter cited as Reg. §].

⁶ CODE § 882 (c) (1); Reg. § 1.535-1(b) (1959).

file a United States income tax return if it has any income from sources within the United States.

II. POSSIBILITY OF GAINING ADDITIONAL 100,000 DOLLAR MINIMUM ACCUMULATED EARNINGS CREDITS

Every corporation ordinarily may accumulate at least 100,000 dollars in earnings without fear of incurring the accumulated earnings tax.⁷ However, there are several limitations on this rule.

A. One Hundred Per Cent Dividends-Received Deduction

The Revenue Act of 1964 amended the Internal Revenue Code to provide that corporations which are members of an "affiliated group" may elect to deduct from their accumulated earnings an amount equal to one hundred per cent of the dividends received from other members of the group.⁸ A by-product of this election is that an affiliated group of corporations making this election has the right to only one 100,000 dollar minimum accumulated earnings credit rather than to one such credit for each member of the group.⁹ Therefore, if multiple 100,000 dollar minimum accumulated earnings credits are desired by an affiliated group of corporations, only eighty-five per cent of the dividends received from other members of the group may be deducted.

B. Organization of an Additional Corporation

It is not always possible to obtain the benefit of an additional 100,000 dollar minimum accumulated earnings credit by organizing or activating an additional controlled corporation and transferring property, other than money, to it. The Commissioner may disallow an additional credit unless the controlled transferee corporation can establish that securing the additional credit was not a major purpose of the transfer.¹⁰ The major purpose test, as outlined in section 1551, may be avoided if the transaction is arranged so that the transferee corporation is not "controlled" by the transferor.¹¹

⁷ CODE § 535.

⁸ CODE § 243(a).

⁹ CODE § 243(b)(3).

¹⁰ CODE § 1551.

¹¹ See Hamovit & Schlesinger, *New Treatment of Multiple Corporations*, 16 W. RES. L. REV. 317 (1965).

However, such an arrangement may raise an additional problem — under the regulations, an investment which results in ownership of less than eighty per cent of a subsidiary might, in some cases, be considered to be an investment which is unrelated to the business of the parent corporation.¹²

Even if section 1551 is circumvented, an additional minimum credit could be disallowed under section 269, if the principal purpose for obtaining control of a new corporation or transferring property to another corporation in a tax free transaction, is the avoidance of tax by securing the benefit of an additional credit. However, it is doubtful if section 269 would be an effective bar to securing an additional minimum accumulated earnings credit except in obvious cases of tax avoidance.

III. ABSENCE OF PROVISIONS FOR DEFICIENCY DIVIDENDS

If the Commissioner establishes that a corporation was a personal holding company in a past year, the disastrous personal holding company tax can nevertheless be avoided by the payment of deficiency dividends to the shareholders subsequent to such a determination.¹³ However, no such "escape hatch" is available to a corporation which has unreasonably accumulated its earnings. Therefore, any action necessary to reduce or eliminate the possibility of the imposition of the accumulated earnings tax must be taken during the tax year or, in the case of dividends, within two and one-half months after the close of the tax year.

¹² Reg. § 1.537-3(b) (1959).

¹³ CODE § 547.