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VIII

Planning To Avoid the Section 531 Tax

Joseph D. Sullivan

IN MANY SITUATIONS appropriate planning may avoid, or at least defer, the imposition of the tax on accumulated earnings. Some important planning should begin even prior to incorporation, and planning thereafter should be continuous.

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The several suggestions that follow are considered under five general topics: (1) organization and reorganization of the business; (2) use and amount of retained earnings; (3) making the record; (4) change in capital structure or ownership; and (5) dividends. This discussion is designed to provide a check list of planning possibilities with respect to the accumulated earnings tax. It is not exhaustive, and several of the suggestions are of limited practical application. However, timely utilization of one or more of these planning suggestions in the proper circumstances could very possibly help to delay or even avoid the imposition of the tax.

I. ORGANIZATION AND REORGANIZATION OF THE BUSINESS

A. Incorporation With Substantial Debt

The obvious advantage of financing a new business venture by issuing substantial debt securities to outsiders is that cash later generated from earnings can be utilized to pay the debts of the corporation. If this method of financing is not utilized it will be necessary for the corporation to find another use for the cash in order to avoid or defer the imposition of the penalty tax. Unfortunately, it is not always possible to maximize the advantage gained by incorporating with a large debt and relatively little capital if this requires that the corporation borrow from its shareholders. The determination of the amount of the corporation's initial shareholder debt must

take into consideration the views of the Internal Revenue Service and the courts with respect to so-called "thin incorporation."[1] However, the use of initial debt financing as an accumulated earnings tax planning tool has some utility.

B. *Operation of Business in Unincorporated Form*

There are many situations in which it may not be necessary to incorporate even a large or potentially large business venture. Consideration should be given to the operation of the business as a sole proprietorship or partnership.

C. *Subchapter S Election*

The accumulated earnings tax does not apply to a corporation which has elected to be taxed under Subchapter S of the Internal Revenue Code.[2]

D. *Additional Minimum Accumulated Earnings Credit*

A corporation can accumulate up to 100,000 dollars in earnings with impunity from the accumulated earnings tax penalty because of the 100,000 dollar minimum accumulated earnings credit granted in the Code.[3] Thus, an additional 100,000 dollar credit may be obtained with each new corporation owned. However, there are statutory limitations upon the availability of additional credits.[4]

E. *Creation of Personal Holding or Investment Company*

Often tax practitioners are confronted with the desire of a principal shareholder to initiate a program which would make it possible for some of his employees to obtain a stock interest in his corporation. Such an ownership interest would give the employees a keener interest in the success of the company and create a market for the interest of the principal shareholder in the event of his death or retirement.

In order to make it possible for these employees to purchase

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[1] See, *e.g.*, Benjamin, *Thin Corporations — Whose "Substance Over Form?"*, 34 TUL. L. REV. 1 (1959); Garver, *Tax Factors Affecting Debt-Equity Financing for a New Small Corporation*, 17 W. RES. L. REV. 773 (1966); Weis, *Successfully Incorporating Thin*, 51 ILL. B. J. 898 (1963).

[2] INT. REV. CODE OF 1954, § 1372(b)(1) [hereinafter cited as CODE §].

[3] CODE § 535(c)(2).

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

stock, it is usually necessary to reorganize the business in some manner in order to reduce the value of the common stock of the company. This reduction in value is additionally advisable from the viewpoint of the principal shareholder, who may desire to protect his interests to the greatest extent possible; in most cases, he intends eventually to transfer the management of his company to one or more of its employees.

These objectives can be accomplished by the transfer of assets of the corporation to a new, partially-owned subsidiary in a section 351 transaction in exchange for stock and as much in debt securities as possible. Subsequently, the employees would purchase part of the stock of the new operating company — preferably at least twenty per cent of the common stock in order to help the new company obtain a 100,000 dollar minimum accumulated earnings credit.[5] If no more than five individuals own more than fifty per cent of the stock of the parent company, an incidental benefit of this plan is that the parent company would then become a personal holding company or an investment company neither of which is subject to the accumulated earnings tax.[6]

If all of the assets of the old corporation are not transferred to the new operating company, some caution should be exercised when contemplating this type of reorganization since the Commissioner may take the position that the assets not transferred to the new company were not needed in the parent corporation's business. In such a case, it may be advisable to defer the transfer until such time as the corporation has minimized its accumulated taxable income for those tax years which will not be barred from examination by the statute of limitations.

F. *Organization of Foreign Subsidiary*

The accumulated earnings tax does not apply to the income of a foreign subsidiary corporation from sources outside of the United States whether the parent corporation is a United States resident or not.[7] Therefore, a corporation which has an accumulated earnings tax problem and substantial foreign sales might alleviate its tax problem by organizing a foreign subsidiary as a vehicle for sales abroad.

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[5] *Ibid.*

[6] CODE § 532(b).

[7] Treas. Reg. § 1.535-1(b) (1959) [hereinafter cited as Reg. §].

G. *Liquidation*

Another method by which a corporation can remedy its tax problem in the future is through a liquidation. This might not be an advisable course of action if the corporation has substantial intangible assets such as good will and if its business will be continued in noncorporate form. In such cases, the Commissioner might try to impose a tax on the former shareholders based upon the value of the intangibles transferred. Furthermore, after liquidation the business cannot be reincorporated or operated in a manner which would cause it to be treated as an association, taxable as a corporation. If either of these procedures is attempted, the liquidation distributions might be considered to be dividends to the extent of the earnings and profits of the corporation. However, there may be situations where a liquidation is in order.

II. USE AND AMOUNT OF RETAINED EARNINGS

A. *Investment in Stock of Another Corporation*

Investments in properties or securities which are unrelated to the business activities of the taxpayer-corporation are indicative of an unreasonable accumulation of earnings.[8] However, the business of a corporation encompasses any line of activity which it may undertake.[9] Under the regulations, the business of a subsidiary *will* be considered to be the business of the parent corporation if the parent owns at least eighty per cent of the subsidiary's voting stock; the business of a less than eighty per cent owned corporation *could* be considered the business of the parent corporation depending on the particular circumstances of the case.[10] The regulations do not state what circumstances would indicate that the business of the subsidiary is the business of the parent in this case. It would appear that the existence of a partially-owned subsidiary operating in the same or in a related business would be enough, especially if there are sound reasons for the parent's failure to control the subsidiary. However, the regulations take the very restrictive view that the subsidiary must be a "mere instrumentality" of the parent in order for its business to be considered that of the parent.[11]

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[8] Reg. § 1.537-2(c)(4) (1959).
[9] Reg. § 1.537-3(a) (1959).
[10] Reg. § 1.537-3(b) (1959).
[11] *Ibid.*

The subsidiary must be engaged in the active conduct of a business in order for its business to be considered that of its parent. The business of a subsidiary personal holding company, investment company, or a corporation not engaged in the active conduct of a trade or business will not be considered the business of the parent corporation.[12]

B. *Investments in or Loans to Suppliers and Customers*

Investments in or loans to suppliers and customers are reasonable needs of the business "if necessary in order to maintain the business of the corporation."[13]

C. *Creation of Reserve for Self-Insured "Key Man" Protection to the Corporation*

It is generally recognized that one of the essential ingredients of a corporation's continuing financial success is its management. The life insurance industry has enjoyed outstanding success in selling to corporations protection against the loss of key employees. A successful corporation can, and probably should, protect itself against the untimely loss of one or more key individuals. This could be accomplished by the purchase of commercial insurance policies. However, if a corporation has a substantial cash balance, the same result may be accomplished by recognizing the corporation's risk of loss and reserving the cash considered necessary to "self insure" the corporation from the loss. The creation of such a reserve has been judicially recognized as a reasonable business need.[14]

Furthermore, if a reserve for a self-insured key man program is proper, it follows that the reserve could be funded with corporate securities rather than with cash or low yield government securities. This should be true even though such an investment might otherwise be considered to be unrelated to the business activities of the corporation. In a recent case[15] the company had funded a fixed liability program with preferred stock of another corporation. It was held that when a noncurrent liability is funded, the assets used to fund the liability did not constitute current assets. The Commissioner agreed with this conclusion in his brief.

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[12] *Ibid.*

[13] Reg. § 1.537-2(b)(5) (1959).

[14] Bradford-Robinson Printing Co. v. United States, 58-1 U.S. Tax Cas. 67631 (D. Colo. 1957).

[15] John P. Scripps Newspapers, 44 T.C. 453 (1965).

D. *Profit Sharing and Pension Plans*

A corporation having an imminent accumulated earnings tax problem and not possessing a profit sharing or pension plan may improve its status through the use of such a plan or plans even if, as a part of the program, substantial contributions have to be made for the benefit of nonshareholders. Perhaps a nonqualified plan would be more suitable under the circumstances, since such a plan could be designed to favor shareholders. The company could not deduct contributions to a nonqualified plan, but the reserves under the plan could be funded with securities of other corporations or other property.[16]

E. *Reliance on Rules of Thumb*

It is important not to rely on discarded rules of thumb when ascertaining the possibilities with respect to the imposition of the accumulated earnings tax. The tax may still be imposed if seventy per cent of the corporation's current earnings are paid out as dividends. An earlier rule to the contrary has been discarded by the Internal Revenue Service. The corporation's accumulated cash may still be excessive even if the amount of cash remaining after the deduction of other reasonable business needs of the corporation does not exceed the annual expenses of the corporation. A corporation will be allowed to accumulate sufficient working capital to conduct its business properly, but an accumulation equal to one year's expenses could be unnecessary. This may still be a rule of administrative convenience and might be given some recognition by a court,[17] but the rule is not controlling.

III. MAKING THE RECORD

A. *Documentation of Reasons for Accumulation*

Since the accumulated taxable income for a year is reduced by the amount of earnings retained for the reasonable needs of the business of the corporation, it is essential that a corporation be able to demonstrate properly the actual reason or reasons why its earnings have been allowed to accumulate. A logical place to demonstrate these reasons is at meetings of the Board of Directors during which dividend action is considered and discussed. The minutes of these meet-

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[16] *Ibid.*

[17] *Ibid.*

ings should reflect the basis for the retention of earnings. However, these minutes should not go to the extreme of being fanciful in order to impress an examining revenue agent. If there is no definite plan or program for the use of the earnings retained, it would be inadvisable to set forth reasons which are unlikely to materialize, since the unrealistic nature of such reasons will ultimately come to light. This type of record building may gain the corporation a short deferral of the penalty tax, but the claimed reasons may eventually be detrimental to the taxpayer.

The business judgment of those who decide to retain earnings can also be documented by office memoranda and letters indicating actual and potential problems. Industrial and other publications are another source of material which might illustrate the many problems that beset the company. This type of material should be circulated, initialed when read, and appropriately filed.

Another means of demonstrating the reasoning behind a decision to accumulate is to offer evidence of reliance on advice from the corporation's public accounting firm, business and engineering consultant, and other advisors. These parties may be of the opinion that a corporation's apparently excessive accumulation of cash is only temporary in nature or is the result of a short-sighted approach to the future well-being of the company. For example, rapidly developing technological advances may be about to engulf the company in a sea of additional costs for such things as computerization. Another possibility is that the advances of the company's competitors may require large expenditures for research and development. There may be adverse market trends, greater competition, and inflation in costs. It might also be helpful to review past occurrences in order to forecast the future. These and many other problems and expected developments can be documented through letters and reports. Reliance on expert advice in the formulation of dividend policy should be sufficient to avoid the imposition of the tax, even if the experts are later proven to be wrong, since the reason for the accumulation would have been the well-being of the company rather than the avoidance of surtax on the shareholders.

B. Preparation of Financial Statements

In order to avoid the contention that the penalty tax should be imposed, it would be advisable to keep a written record of the corporation's actual and contingent non-book liabilities. Some of these liabilities could even be footnoted in financial statements.

For example, vacation pay — which an accrual-basis taxpayer accounts for on the cash basis — and contingent liabilities, such as warranty and patent infringement liabilities, could be quickly brought to the attention of an examining agent in this fashion.

C. *Choice of Fiscal Year*

A corporation does not necessarily have to demonstrate that all of its year-end cash is needed in the business if it has one or more lower interim cash balances. However, if possible, a fiscal year which ends when the cash balance of the corporation is at its lowest annual level should be chosen in order to present a more favorable impression. A fiscal year can be changed with the consent of the Commissioner.[18]

D. *Payment of Large Salaries*

The payment of large salaries to shareholder-employees can be of considerable help if a corporation is concerned with the reasonableness of its accumulation of earnings. Large salaries not only reduce the accumulated earnings for the year but also are indicative of a lack of intent to avoid the surtax on the shareholders.[19] Of course, in order to be deductible, the salaries have to be kept within reasonable limits.

E. *Completion of Plans After Audit*

There is no reason to be hesitant about completing corporate plans after the commencement of an audit in the belief that completion would be tantamount to an admission against interest. At least one court[20] has given substantial weight to the fact that certain plans were completed even though the completion was accomplished after audit.

IV. CHANGE IN CAPITAL STRUCTURE OR OWNERSHIP

A. *Dividend in Preferred Stock*

A tax-free dividend of preferred stock, paid to holders of common stock, may be helpful in avoiding the penalty tax. The preferred stock could be given to lower-bracket relatives, such as children or

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[18] CODE § 442.

[19] Bremerton Sun Publishing Co., 44 T.C. 566 (1965).

[20] John P. Scripps Newspapers, 44 T.C. 453 (1965).

other dependents, either as an outright gift or pursuant to a short-term trust. The preferred stock dividend income would presumably be taxed in a lower bracket than the grantor's. The preferred stock might be retained by a common shareholder who is about to retire and wishes to transfer his now less valuable common shares to his children, thereby eliminating future growth in his estate. Alternatively, the preferred stock might be given to a charity which ultimately could have the stock redeemed by the corporation and thereby reduce or eliminate the corporation's excess liquid assets.

B. *Common Stock Dividends*

The payment of common stock dividends could conceivably be helpful, since proper accounting principles require the transfer of an amount equal to the value of the stock from earned surplus to the capital stock account upon the payment of such dividends. This transfer would probably not reduce the amount of the accumulated earnings for federal income tax purposes,[21] but the future balance sheets of the corporation would reflect the reduced retained earnings. Of course, the transfer would be apparent upon an examination of the earned surplus account and the capital account.

C. *"Going Public"*

If the members of the Board of Directors of a corporation do not own a large part of the shares of a corporation, it would be difficult, if not impossible, to prove that the dividend policy of the corporation was motivated by the desire to gain tax advantages for shareholders. There are no regulations and only one known litigated case[22] involving publicly owned corporations; therefore, no clear rules are available with respect to the percentage of shares which must be sold to the public in order to insulate a corporation from the tax.

A disadvantage of "going public" is that members of the Board of Directors might be subjected to a shareholders' derivative suit if the corporation is found to have unreasonably accumulated its earnings for a year in which it was publicly owned.

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[21] *But see* Koch Co. v. Vinal, 228 F. Supp. 782 (D. Neb. 1964), *nonacq.*, Rev. Rul. 65-68, 1965 INT. REV. BULL. NO. 12, at 7.

[22] Trico Prods. Corp. v. McGowan, 67 F. Supp. 311 (W.D.N.Y.), *aff'd*, 169 F.2d 343 (2d Cir.), *cert. denied*, 335 U.S. 899 (1948); Trico Prods. Corp., 46 B.T.A. 346, *aff'd*, 137 F.2d 424 (2d Cir.), *cert. denied*, 320 U.S. 799 (1943).

V. DIVIDENDS

A. Amount of Dividends

If all other methods fail, an obvious way of eliminating accumulated earnings tax liability for a given year is to pay out all of the corporation's income as a dividend. However, it should be kept in mind that the payment of the accumulated earnings tax and the tax upon the residue at the time of liquidation at long term capital gain rates may result in a smaller tax than that imposed upon the dividend income of the shareholders. This would depend upon the interplay of the tax brackets of the shareholders with that of the corporation.

B. Timing of Dividends

The computation of the accumulated taxable income of a corporation for a taxable year requires the deduction of dividends paid after the fifteenth day of the third month of the fiscal year and prior to the sixteenth day of the third month after the close of the year. Therefore, some advantages can be obtained by proper timing of dividends. For example, if no penalty tax problem is apparent in the current year, but there exists the possibility of a problem occurring thereafter, the payment of dividends should be deferred. If the problem already exists, the payment of dividends should be accelerated without a change in the year in which they must be returned by the shareholders.

VI. CONCLUSION

This brief analysis of the vast array of methods available for avoiding the imposition of the section 531 penalty tax offers impressive support for the theory that careful and conscientious planning will result in unlimited financial benefit to a corporation. The utilization of one or more of the methods discussed herein should be a mandatory part of the planning scheme of any corporation.