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LEGISLATION

CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS

Introduction

It has often been stated that taxes are here to stay. This statement is obviously true and it is just as true that people will always do their utmost to avoid the payment of those taxes. These simple statements and the acts that result therefrom have given rise to one of the most controversial tax laws ever enacted, *viz.*, the penalty surtax which is imposed upon corporations improperly accumulating surplus. The history of that tax commenced with the *Tariff Act of 1913*,¹ gained force through the *Revenue Act of 1934*² when it was first numbered as Section 102, reached its greatest effectiveness through the *Revenue Act of 1938*³ when the burden of proof was shifted to the corporation, and suffered its first major setback in the *Revenue Act of 1954*.⁴ This development of the law will be the foundation for this article with the main emphasis being supplied in regard to the changes brought forth by the *Revenue Act of 1954*.

Before discussing the provisions of these acts it is important to try to discover why such an act was adopted by the Congress of the United States. In order to do this we must view the tax rates that are in effect in regard to both the individual and the corporation. At present the corporation is taxed by means of a normal tax at thirty percent of the taxable income plus a surtax of twenty-two percent of the amount by which the taxable income exceeds \$25,000.⁵ The individual is taxed at a rate which varies between twenty percent of the taxable income and ninety-two percent of the taxable income.⁶ Thus, we see that there is a wide variance between the amounts taxable when the upper income brackets are reached. The result of this variance may be the attempt by the individual to lessen his tax burden by seeking the advantages of the corporate form of business. There are numerous advantages to such a plan as can be seen by the following:

- (1) The reinvested earnings of the corporation as earning assets are greater by the amount of the avoided personal tax to the shareholders.
- (2) Should the corporately reinvested capital later be realized by the stockholder as a long-term capital gain through corporate liquidation or sale of stock, then the Treasury loses and the stockholder gains by the difference in the effective rate of tax on the long-term capital gain as compared with the top rate of personal tax of ninety-two percent.

¹ Tariff Act of 1913, 38 Stat. 166-167.

² Revenue Act of 1934, 48 Stat. 702-703.

³ Revenue Act of 1938, 52 Stat. 483.

⁴ Revenue Act of 1954.

⁵ Section 11 (b) of the Internal Revenue Code of 1954. This section further provides that "in the case of a taxable year beginning after March, 31, 1955, the normal tax is equal to 25 percent of the taxable income."

⁶ Section 1 (a) of the Internal Revenue Code of 1954 provides the table of tax rates for an individual.

(3) Should the withheld amount of corporate earnings subsequently be lost by reverses in the business, no present or future personal tax is paid by the stockholder on the retained earnings.

(4) Should the reinvestment of the earnings by the corporation result in later dividend distributions therefrom in a year or years in which (a) the stockholder is in a lower income bracket by reason of reduced income from other sources, or (b) there is a congressional reduction in surtax rates, the shareholder will stand to gain.

(5) Should a stockholder in control of a corporation be in a position in which dividend distributions are not especially necessary or desirable, corporate earnings can be indefinitely reinvested, and at a shareholder's death, the corporate shares can be transferred to his heirs. The advantages of this would be in the partial revenue compensation by death tax, or gift if the property is transferred prior to death.

(6) Should the amount of retained earnings by the corporation not be invested in the business but be loaned instead to the controlling stockholder, no personal tax on the amount accrues, yet the stockholder has the current beneficial use of such funds.⁷

Since there were such advantages available to an individual through the retention of earnings in the corporation, many individuals attempted to use that device as a means of avoiding the tax.

Criteria in the Application of the Penalty Surtax

The basic provision in regard to the penalty surtax imposed upon corporations improperly accumulating surplus is found in Section 532 of the *Internal Revenue Code of 1954* wherein it is provided:

"(a) General Rule.—The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

"(b) Exceptions.—The accumulated earnings tax imposed by section 531 shall not apply to—

- (1) a personal holding company (as defined in section 542),
- (2) a foreign personal holding company (as defined in section 552), or
- (3) a corporation exempt from tax under subchapter F (section 501 and following)."

In viewing this provision it becomes obvious that there are two main factors in the determination of whether or not the additional surtax should be applied to the corporation, *viz.*, (1) the objective factor of the accumulations of earnings and profits and (2) the subjective factor of intent to avoid the imposition of the in-

⁷ Hall, James K., *The Taxation of Corporate Surplus Accumulations*, prepared for the Joint Committee on the Economic Report, U. S. Government Printing Office, Washington, D. C., 1952, pp. 5-7.

come tax upon its shareholders or the shareholders of any other corporation. The matter of proving these elements is extremely difficult, and therein lies the main problems in the administration and enforcement of these sections. In an effort to facilitate the administration of these provisions, Congress had enacted two main presumptions in the *Internal Revenue Code of 1939*. The *Revenue Act of 1954* has adopted one of these and has modified the other as will be seen in the following discussion.

Section 533 of the *Internal Revenue Code of 1954* deals with evidence of the purpose to avoid income tax. That section provides:

“(a) Unreasonable Accumulation Determinative of Purpose.—For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders unless the corporation by the preponderance of the evidence shall prove to the contrary.

“(b) Holding or Investment Company.—The fact that the corporation is a mere holding or investment company shall be prima facie evidence of the purpose to avoid the income tax with respect to shareholders.”

The provision just cited is substantially the same as the provision found in Section 102 (c) of the *Internal Revenue Code of 1939*. It is of note that the section stresses “reasonable needs of business”. One of the major problems involved in the application of the penalty surtax on improper accumulations of surplus by the corporations has been the determination of the “reasonable needs”. The difficulty arises in part from the fact that there can be no standard method of measurement thus causing each corporation to be individually considered according to facts which are peculiar to that particular corporation.

In regard to this problem of what are the “reasonable needs of business” we find the following in the regulations of the Bureau of Internal Revenue:⁸

“An accumulation of earnings or profits (including the undistributed earnings or profits of prior years) is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case. It is not intended, however, to prevent accumulations of surplus for the reasonable needs of business if the purpose is not to prevent the imposition of the surtax. No attempt is here made to enumerate all the ways in which earnings or profits of a corporation may be accumulated for the reasonable needs of business. Undistributed income is properly accumulated if retained for working capital needed by the business; or if invested in additions to the plant reasonably required by business; or if in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation. The nature of the investment of the earnings or profits is immaterial if they are not in fact needed in the business. Among other things, the nature of the business, the financial condition of the corporation at the close of the taxable year, and the use of the undistributed

⁸ Regulation 118, § 102-3(a).

earnings or profits will be considered in determining the reasonableness of the accumulations.”

The policy of the Bureau of Internal Revenue was firmly entrenched with the issuance of *T.D.* 4914. This decision was in the form of instructions to the Bureau's personnel and directed them to particularly look out for five classes of items. Where any of these five existed, the corporation was to be subjected to close scrutiny. The classes set out by *T.D.* 4914⁹ are:

(1) Corporations which have not distributed at least seventy percent of their earnings as taxable dividends.

(2) Corporations which have invested earnings in securities or other properties unrelated to their normal business activities.

(3) Corporations which have advanced sums to officers or shareholders in the form of loans out of undistributed profits or surplus from which the taxable dividends might have been declared.

(4) Corporations, a majority of whose stock is held by a family group or other small group of individuals or by a trust or trusts for the benefit of such groups.

(5) Corporations the distributions of which, while exceeding seventy percent of their earnings, appear to be inadequate when considered in connection with the nature of the business or the financial position of the corporation or corporations with accumulations of cash or other quick assets which appear to be beyond the reasonable needs of the business.

The statements seen above from the Treasury Regulations and *T.D.* 4914 indicate that the needs of the business should be immediate if the retention of earnings is to be considered as reasonable. It is in regard to that policy that the *Internal Revenue Code of 1954* has created a change. Section 537 of the *Internal Revenue Code of 1954* contains the following provision:

“For purposes of this part, the term ‘reasonable needs of the business’ includes the reasonably anticipated needs of the business.”

From the above cited section it can be seen that the retention of earnings and profits may be in accordance with plans for the future as well as for plans of immediate expansion provided that such plans are definite and bona fide. In regard to this new policy it is of note that accumulations made in pursuance of a definite and bona fide plan for the future will not later be declared unreasonable due to events discovered at the end of the taxable year.

The next consideration will be in regard to the provisions of Section 534 (a), (b) and (c). It is therein stated:

“(a) General Rule.—In any proceeding before the Tax Court involving a notice of deficiency based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, the burden of proof with respect to such allegation shall—

⁹ 1939-2 C.B. 108, amended by *T.D.* 5398, 1944 C.B. 194.

- (1) if notification has not been sent in accordance with subsection (b), be on the Secretary or his delegate, or
- (2) if the taxpayer has submitted the statement described in subsection (c), be on the Secretary or his delegate with respect to the grounds set forth in such statement in accordance with the provisions of such subsection.

"(b) Notification by Secretary.—Before mailing the notice of deficiency referred to in subsection (a), the Secretary or his delegate may send by registered mail a notification informing the taxpayer that the proposed notice of deficiency includes an amount with respect to the accumulated earnings tax imposed by section 531.

"(c) Statement by the Taxpayer.—Within such time (but not less than 30 days) after the mailing of the notification described in subsection (b) as the Secretary or his delegate may prescribe by regulations, the taxpayer may submit a statement of the grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business."

The section of the *Internal Revenue Code of 1954* which has just been cited brings about the most outstanding change in the new tax law with regard to corporations improperly accumulating surplus. The first taxes upon such improper accumulation of surplus had been rendered quite helpless as a result of the difficulty the Commissioner had in proving that the retention of earnings by the corporation had been unreasonable. As a result, the provision in Section 102 (c)¹⁰ of the *Revenue Act of 1938* was enacted thereby placing the burden of proof upon the corporation. Thus, we can see that under the *Internal Revenue Code of 1939* the Commissioner merely had to assert that the corporation was retaining earnings and profits beyond the reasonable needs of business. The effect of that assertion would be to bring into play the presumption that the unreasonable retention indicated an intent to avoid the payment of the income tax, and the corporation was faced with the burden of rebutting this presumption. Even with the benefit of this presumption we find that only fifty percent of the cases were decided in favor of the Commissioner.¹¹ The provision found in Section 534 of the present act causes a back-tracking toward the policy embodied in the earliest acts dealing with the improper accumulation of surplus by corporations. Under the present law we find that if a corporation mails a statement to the Commissioner containing the grounds upon which it relies in asserting the retention was not beyond the reasonable needs of the business and such statement has been mailed within the specified period afforded by the section, then the burden of proving the unreasonableness of the retention shall be upon the Commissioner. Such a provision as

¹⁰ Section 102(c) of the Internal Revenue Code of 1939 provides: "Evidence Determinative of Purpose.—The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by a clear preponderance of evidence shall prove to the contrary."

¹¹ See n. 7, *supra*, pp. 154-155.

this would appear to be an unsurmountable barrier for the Commissioner since he would have to prove subjective intention on the part of the corporation through books and records within the control of the corporation.

Amount to Which the Tax Will Apply

Section 533 (c) of the *Revenue Act of 1954* contains the following provision which brings about a substantial change from the existing law. It provides:

“(c) Accumulated Earnings Credit.—

(1) General Rule.—For purposes of subsection (a),¹² in the case of a corporation other than a mere holding company the accumulated earnings credit is (A) an amount equal to the earnings and profits for the taxable year as are retained for the reasonable needs of the business, minus (B) the deduction allowed by subsection (b) (6). For purposes of this paragraph, the amount of the earnings and profits for the taxable years which are retained is the amount by which the earnings and profits for the taxable year exceed the dividends paid deduction (as defined in section 561) for such year.

(2) Minimum Credit.—The credit allowable under paragraph (1) shall in no case be less than the amount by which \$60,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

(3) Holding and Investment Companies.—In the case of a corporation which is a mere holding or investment company, the accumulated earnings credit is the amount (if any) by which \$60,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

(4) Accumulated Earnings and Profits.—For purposes of paragraphs (2) and (3), the accumulated earnings and profits at the close of the preceding taxable year shall be reduced by the dividends under which section 533 (a) (relating to dividends paid after the close of the taxable year) are considered as paid during such taxable year.”

It can be seen from the provision just cited that the tax under Section 531 will apply only to that part of the earnings and profits of the taxable year which are unreasonably accumulated. This brings about a change from the prior law since such prior law had provided for that tax to be applied to the full earnings and profits once it was determined that any part of such earnings and profits had been unreasonably accumulated. There is a further change brought about by Section 535 in that in no event will there be any tax assessed under Section 531 until the corporation has accumulated \$60,000 in the current and preceding years.

A practical illustration of the section is seen from the following:¹³

¹² Section 535(a) of the Internal Revenue Code of 1954 provides: “Definition.—For purposes of this subtitle, the term ‘accumulated taxable income’ means the taxable income, adjusted in the manner provided in subsection (b), minus the sum of dividends paid deduction (as defined in section 561) and the accumulated earnings credit (as defined in subsection (c)).”

¹³ This illustration can be seen as a result of the statements found in the Official Explanation of the Internal Revenue Code of 1954 under the appropriate section heading. The illustration can also be found in the Concise Explanation of the Internal Revenue Code of 1954 as assembled by Prentice-Hall, Inc., p. 26.

Example: In its first taxable year, a corporation accumulates \$20,000 of its earnings. The penalty tax does not apply because the accumulation is less than \$60,000.

In its second taxable year, the corporation accumulates \$50,000 of its earnings all of which is deemed to be an unreasonable accumulation. Nevertheless, the basis of the penalty tax is limited to \$10,000, total accumulations of \$70,000 minus the permissible \$60,000 accumulation.

If it were assumed that \$40,000 or the \$50,000 was reasonably accumulated, the result is the same. Reasonable accumulations as well as unreasonable accumulations, are charged against the \$60,000 exemption. If \$45,000 of the \$50,000 was reasonably accumulated, the basis of the penalty tax is only \$5,000.

There is a further change brought about by Section 535. This is seen by the reference to Section 563 (a) of the *Internal Revenue Code of 1954* in Section 535 (c) (4). Section 563 (a) states:

"Accumulated Earnings Tax.—In the determination of the dividends paid deduction for the purposes of the accumulated earnings tax imposed by section 531, a dividend paid after the close of any taxable year and on or before the 15th day of the third month following the close of such taxable year shall be considered as paid during such taxable year."

Under the former law only those dividends which had been paid in the taxable year were to be considered as distributed. The provision cited above clearly changes this by allowing any dividend paid within two and one half months of the close of the taxable year to be considered as distributed in the taxable year.

Summary and Conclusions

It has been shown that the corporate retention of earnings has been used as a means of avoiding the personal surtax. The reason for this method of avoidance has been the wide divergence between the income tax rates imposed upon the individual and those imposed upon the corporation. As long as such a divergence continues there will be a need for some sort of a penalty provision to prevent corporate surplus accumulations from getting out of hand.

When first introduced into law, the provisions were limited in many respects. As time passed the provision gained stature through the placing of the burden of proof upon the corporation in regard to the purpose and intent behind the accumulation of earnings and profits of the corporation. It was through that addition that the provision gained enough force to accomplish some of its purpose. We have noted, however, that even with the benefit of the presumption, the Commissioner was able to succeed in only fifty percent of cases selected by him and, therefore, those more advantageous to him.

As a result of the numerous complaints against the provisions in the old Section 102, amendments were adopted in the *Internal Revenue Code of 1954*. These amendments brought about four principal changes as we have noted, the

most important of which was the shifting of the burden of proof back to the Commissioner. The amendments represent a compromise between those who sought the complete abolishment of the provision and those who sought its continuance.

With the foregoing history of the act in mind, now examine it in respect to its application under the new amendments and its possibilities in the future. It is this writer's opinion that the changes brought about by the *Revenue Act of 1954* will cause more harm than good. It is believed the changes will leave the Commissioner in an almost helpless position since the shifting of the burden of proof has taken away the one advantage afforded him under the prior law. In addition, it is believed there will be further harm resulting from the amendments in that the inclusion of the penalty tax will tend to make Congress less conscious of the problems involved irrespective of the fact that the provision will be almost completely ineffective.

There have been other remedies suggested to handle this problem. They include: (1) a shifting of the burden of proof back to the corporation with an addition to the present tax rate on corporations thereby closing the gap between the rates imposed upon an individual and those imposed upon a corporation; (2) an increase in the tax rate upon corporate earnings to the extent that there would be no benefit to an individual in seeking the corporate form of business as a means of avoiding personal liability; and (3) an instituting of a tax program whereby the individual's pro rata share of corporate earnings would be taxable to him in the year when earned regardless of whether or not such earnings had been actually distributed to him. There are obvious objections to all of these suggestions, and in many cases the objections would be as valid here as against the continuance of the present state of this tax.

In conclusion it can be said that there is a serious problem involved in the retention of earnings and profits by a corporation. There is a definite need in this regard, and it does not appear as though the present law has reached a satisfactory solution. Therefore, the Congress of the United States must continue to seek some plan for safeguarding against the avoidance of personal surtax through the improper accumulations of surplus by corporations.

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