Office of Chief Counsel
Internal Revenue Service
memorandum

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from: Lewis K Brickates
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subject: Imposition of the Accumulated Earnings Tax

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =
State 1 =
Date =
Shareholder =
City 1 =
Officer =
Year 2 =
Partnership 1 =
Partnership 2 =
Partnership 3 =
Partnership 4 =

Partnership 5 =
Partnership 6 =
Partnership 7 =
Partnership 8 =
Founder =

City 2	=
Year 1	=
Year 3	=
Year 4	=
Year 5	=
Position	=
Department	=
Salary 1	=
Salary 2	=
Salary 3	=
Dividend 1	=
Dividend 2	=
Dividend 3	=
Interest 1	=
Interest 2	=
Interest 3	=
CG 1	=
CG 2	=
CG 3	=
4797 Gain 1	=
4797 Gain 2	=
4797 Gain 3	=
Other 1	=
Other 2	=
Other 3	=
Total 1	=
Total 2	=
Total 3	=
Amount 1	=
Amount 2	=
RE 1	=
RE 2	=
RE 3	=
RE 4	=
Tax Liability 1	=
Tax Liability 2	=
Tax Liability 3	=
Amount 3	=
Amount 4	=
Amount 5	=
State 2	=
Country	=
Rate 1	=
Rate 2	=

SUMMARY

This memorandum responds to your request for help in determining whether a taxpayer may avoid the accumulated earnings tax solely because it lacks liquidity from which to pay dividends to its shareholders. For the reasons we discuss below, we conclude that, irrespective of Taxpayer's lack of liquidity from which to make distributions to its sole shareholder, Taxpayer nevertheless may be subject to the accumulated earnings tax. Please contact Jason Kristall at (202) 317-7003 if you would like further assistance or have any questions about this memorandum or our conclusion.

FACTS

Taxpayer was incorporated in State 1 on Date, by Shareholder. Shareholder is a U.S. citizen who resided and worked in City 1 during the years at issue: Year 3, Year 4, and Year 5. Shareholder served as Taxpayer's director, and Officer served as its president.

On Date, Shareholder transferred to Taxpayer his entire interest in several partnerships. According to the statement attached to his Year 2 Federal Income Tax Return as required by § 1.351-3(b) of the Income Tax Regulations, Shareholder transferred to Taxpayer his interests in the following limited partnerships and limited liability companies that were treated as partnerships for Federal income tax purposes:

1. Partnership 1
2. Partnership 2
3. Partnership 3
4. Partnership 4
5. Partnership 5
6. Partnership 6
7. Partnership 7
8. Partnership 8

Partnership 1 served as the manager for all of the entities contributed to Taxpayer.[1] Partnership 1 itself was managed by a board consisting of six members, including Taxpayer. Each member of the board was a "Director" with power to vote on partnership matters. With certain exceptions, any action taken by the board required approval by a majority of the board. Each Director on the board was entitled to one vote, except for Founder, who was entitled to two votes. Founder was the founder and majority owner of Partnership 1.

Each of the partnership agreements contained a provision allowing the partnership to make distributions to its partners sufficient to pay the respective partner's federal and

[1] Although Partnership 4 was the general partner of Partnership 5, and Partnership 6 was the general partner of Partnership 7, Partnership 1 was essentially the manager of all the entities since it served as the Managing Member of these General Partners.

state tax liability, but the remainder of the respective partner's distributive share of the partnership income was retained in the partnership. Accordingly, Taxpayer reported its share of distributive partnership income but only received distributions sufficient to pay its tax liability.

Partnership 1 is an SEC registered investment adviser to hedge funds and institutional accounts and is located in City 2. Shareholder joined Partnership 1 as a partner in Year 1 and, in Year 3, was Position. In that capacity, Shareholder was responsible for overseeing the firm's Department. During Year 3, Year 4, and Year 5, Shareholder received wages from Partnership 1 of Salary 1, Salary 2, and Salary 3, respectively.

Virtually all of the income reported by the various partnerships owned by Taxpayer consists of fund management fees and offshore incentive fees (reported as other income on the respective partnership tax return), less any deductions.

All of the income and essentially all of the expenses reported by Taxpayer were flow-through items from the various partnerships. As determined by Exam, the flow-through income consisted of dividends, interest, capital gain, Form 4797 gain, and other income. The other income as reported on Taxpayer's tax returns consisted of Schedule K-1s' ordinary income (line 1) and Schedule K-1s' other income (line 11) (less any interest income, dividend income, capital and ordinary gains that were included in the Schedule K-1s' other income, and netted with any net section 988 gains or losses, net swap expense, trade or business interest expense, and other trade or business expenses) flowing through from the various related partnership tax returns.

The income, as reported on Taxpayer's income tax returns for the Year 3, Year 4, and Year 5 tax years is as follows:

ITEM	YEAR 3	YEAR 4	YEAR 5
Dividends	Dividend 1	Dividend 2	Dividend 3
Interest	Interest 1	Interest 2	Interest 3
Capital Gain	CG 1	CG 2	CG 3
Form 4797 Gain	4797 Gain 1	4797 Gain 2	4797 Gain 3
Other Income	Other 1	Other 2	Other 3
Total Income	**Total 1**	**Total 2**	**Total 3**

Since its inception and during the years at issue, Taxpayer conducted no business activity other than holding and maintaining the various partnership interests contributed to it by Shareholder. Taxpayer had no employees and paid no wages or expenses, other than a minimal amount of approximately Amount 1 for accounting and other fees. Additionally, Taxpayer neither declared any dividends nor did it otherwise make any distributions to its sole shareholder, Shareholder. Furthermore, while nothing has been provided to show Taxpayer made any loans or advances to Shareholder or paid anything on his behalf, Taxpayer did report a receivable of Amount 2 due from him for all three years at issue.

Taxpayer reported retained earnings for the tax years ended December 31, Year 3, Year 4, and Year 5, of RE 2, RE 3, and RE 4, respectively.[2] It also reported total federal tax liability of Tax Liability 1, Tax Liability 2, and Tax Liability 3, respectively, for the tax years ended December 31, Year 3, Year 4, and Year 5.

Distribution of Taxpayer's earnings and profits for the three years at issue would have resulted in additional tax to Shareholder of Amount 3, Amount 4, and Amount 5, respectively, for Year 3, Year 4, and Year 5.[3]

No valid business purpose seems to exist for Shareholder's incorporation of Taxpayer. According to Taxpayer's representative, Shareholder contributed his partnership interests to Taxpayer to avoid potential taxation by various tax jurisdictions, such as State 2 where Partnership 1 is located, and Country where Shareholder resides. Taxpayer has not otherwise provided any information to show a reason for the accumulation of retained earnings, and a review of its Board of Director minutes for all three years at issue did not contain or provide any plans or information relating to the reasons for the accumulation.

LAW

Section 531 imposes a tax on the accumulated taxable income of each corporation described in § 532.

Under § 532 the tax is imposed on every corporation (other than those described in § 532(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. Avoidance of tax "need not be the sole, dominant, controlling, or impelling motive; it is sufficient if it is one of the motives for the accumulation." Cataphote Corp. of Miss. v. Commissioner, 535 F.2d 1225, 1228 (Ct. Cl. 1976) (citing U.S. v. Donruss Co., 393 U.S. 297 (1969). See also Turner v. Commissioner, T.C. Memo. 1965-101 (the "intent to avoid taxes need only be one purpose for the accumulation, it need not be the only or primary purpose").

Section 533(a) provides that for purposes of § 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the

[2] Taxpayer's reported retained earnings for the tax year ended December 31, Year 2, its year of inception, were RE1.
[3] Tax is based on an individual income tax rate (married filing joint) of Rate 1 for Year 3 and Rate 2 for Year 4 and Year 5. Though beyond the scope of this advice, had distribution of Taxpayer's earnings and profits for the three years at issue given rise to "qualified dividend income" as defined in § 1(h)(11) of the Internal Revenue Code, the resultant additional tax that would have been owed by Shareholder would have been calculated at capital gains rates instead.

business shall be determinative of the purpose to avoid the income tax with respect to shareholders unless the corporation by a preponderance of the evidence shall prove to the contrary.

Although the term "earnings and profits" is not statutorily defined, it is generally described in judicial and administrative rulings as referring to the excess of the net amount of assets of a corporation over the capital contributions of its shareholders. Earnings and profits is an economic concept that is generally based on principles of taxable income, with certain adjustments. There are no adjustments relating to a partner's distributive share of a partnership's income.

Section 534 places on the Internal Revenue Service (the Service) the burden of proving that all or any part of the taxpayer's earnings and profit has been permitted to accumulate beyond the reasonable needs of the business. Prior to the issuance of a statutory notice of deficiency, the Service must notify the taxpayer of this position and give the taxpayer an opportunity to specify the grounds on which it intends to rely to establish that all or part of the alleged unreasonable accumulation of earnings and profits was reasonable for the needs of its business.[4]

Section 1.537-2 lists some reasons which are acceptable for accumulating earnings and profits. They include: debt retirement, business expansion and plant replacement, acquisition of another business by purchase of stock or assets, working capital, investments or loans to suppliers or customers necessary to maintain the corporation's business, and reasonably anticipated product liability losses. This regulation also sets forth some grounds which do not justify the accumulation of earnings and profits. These include: loans to shareholders and expenditures for their personal benefit, loans to others which have no reasonable connection to the business, loans to a related corporation, investments that are not related to the business, and any accumulations to provide for unrealistic hazards.

Under § 533(b) if a corporation is a mere holding or investment company, that fact shall be prima facie evidence of the purpose to avoid income tax with respect to the corporation's shareholders.

Section 1.533-1(c) defines a "holding company" within the meaning of § 533(b) as a corporation having practically no activities except holding property and collecting the income therefrom or investing therein. If the activities further include, or consist substantially of, buying and selling stocks, securities, real estate, or other investment property (whether upon an outright or marginal basis) so that the income is derived not only from the investment yield but also from profits upon market fluctuations, the corporation shall be considered an investment company within the meaning of § 533(b).

[4] It is our understanding that the notification required by § 534(b) was given, and Taxpayer did not submit a statement as required by § 534(c).

ANALYSIS

Taxpayer has no activity other than holding and maintaining the various partnership interests transferred to it by Shareholder. Furthermore, none of the partnerships in which it owns an interest, controlling or otherwise, appears to perform any activity other than investment activity. Accordingly, Taxpayer is a mere holding or investment company, and there is at least prima facie evidence that the taxpayer was formed to avoid tax, as provided by § 533(b) and § 1.533-1(c).

Taxpayer argues 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. That is, because Taxpayer's taxable income is derived solely from partnerships from which Taxpayer cannot control distributions, 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.

Taxpayer seems to suggest that accumulated surplus must be represented by cash that is available for distribution. However, the Internal Revenue Code computes the accumulated earnings tax based on accumulated taxable income, and at least 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. Section 535 uses "taxable income" as a starting point for defining "accumulated taxable income," and none of the adjustments to taxable income provided in § 535(b) include the undistributed income of partnerships.

Moreover, the consent dividend procedures provided by § 565 would have allowed Taxpayer and Shareholder to avoid the accumulated earnings tax irrespective of any lack of liquidity. The Service has considered a similar case previously. In TAM 9124001, the Service explicitly rejected the argument that a lack of liquidity excuses a taxpayer from the accumulated earnings tax. That taxpayer's controlling shareholder controlled both the taxpayer and the partnership in question. Even still, the taxpayer had argued that it should not be liable for the accumulated earnings tax because it had only nominal amounts of cash and no property suitable for distribution as dividends to its shareholders.

In the TAM, the Service pointed to consent dividends under § 565 and the legislative history as manifesting Congress' intent to provide corporations treatment as if they made distributions even though they may lack the ability to actually do so. Because consent dividends could have been used by that taxpayer and its shareholders, the taxpayer's distributive share of partnership income was taken into account in determining whether the accumulated earnings tax should be imposed. Importantly, the TAM's rationale did not depend or rely on the controlling shareholder's control of the partnership that retained all of the earnings.

The consent dividend procedures provided by § 565 were enacted to address situations where a corporation that accumulated earnings beyond its reasonable needs may lack the ability to pay dividends because of a lack of liquidity or for other reasons. In pertinent part, § 565(a) provides that if any person owns consent stock (meaning common stock or participating preferred stock as defined in § 565(f)(1) and § 1.565-6(a)) in a corporation on the last day of the taxable year of such corporation, and such person agrees, in a consent filed with the return of such corporation in accordance with regulations prescribed by the Secretary, to treat as a dividend the amount specified in such consent, the amount so specified shall constitute a consent dividend. In explaining the effect of consent, § 565(c) provides that the amount of the dividend shall be considered (1) as distributed in money by the corporation to the shareholder on the last day of the taxable year of the corporation and (2) as contributed to the capital of the corporation by the shareholder on such day.

Congress intended to treat corporations declaring consent dividends as if they made distributions even though they may lack the ability to actually do so. Because Taxpayer permitted its earnings and profits to accumulate, and because consent dividends could have been used by Taxpayer and Shareholder, Taxpayer's sole and controlling shareholder, to divide or distribute those earnings and profits, Taxpayer remains subject to the accumulated earnings tax in spite of its lack of liquidity and lack of control over the partnerships in which it invests.

CONCLUSION

There is prima facie evidence that Taxpayer was formed to avoid income tax with respect to its shareholder. Taxpayer remains subject to the accumulated earnings tax irrespective of its lack of liquidity and lack of control over the partnerships in which it invests.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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