



How Corporations May Run Afoul of the Accumulated Earnings Tax – A Section 1202 Planning Brief

Feb 16, 2022

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We have discussed in previous articles the potential benefits of operating a start-up as a C corporation. These benefits include the low 21% corporate tax rate and the potential benefit of Section 1202's generous gain exclusion.^[i] Although businesses that don't generate excess revenues during their early years are good candidates for operating through a C corporation, some start-ups become strong revenue producers. Owners of these strong revenue producers need to plan to avoid the imposition of the accumulated earnings tax (AET), which can result in an extra 20% tax being imposed on a corporation's "accumulated taxable income."^[ii]

This is one in a series of articles and blogs addressing planning issues relating to qualified small business stock (QSBS) and the workings of Sections 1202 and 1045. During the past several years, there has been an increase in the use of C corporations as the start-up entity of choice. Much of this interest can be attributed to the reduction in the corporate rate from 35% to 21%, but savvy founders and investors have also focused on qualifying for Section 1202's generous gain exclusion. Recently proposed tax legislation sought to curb Section 1202's benefits, but that legislation is currently stalled in Congress, along with the balance of President Biden's Build Back Better bill.

How the accumulated earnings tax interacts with basic C corporation planning

Choice-of-entity planning involving C corporations often revolves around a plan to operate a business through a C corporation to take advantage of the low 21% federal corporate income tax rate, retain earnings in the corporation by minimizing compensation and dividends, and generating liquidity for owners through an eventual stock sale.^[iii] The AET will interfere in a painful way with this

planning strategy if the IRS asserts that the corporation was formed or availed of “for the purpose of avoiding the income tax with respect to its shareholders... by permitting earnings to accumulate instead of being divided or distributed.” The AET is usually imposed on closely-held businesses generating significant cash revenues, but it can also be an issue for start-ups and blocker corporations. [\[iv\]](#)

How the accumulated earnings tax functions

The prohibited purpose triggering potential imposition of the AET is an intention to avoid a second-tier tax on dividends paid to individual shareholders.[\[v\]](#) The determination of whether there is a prohibited purpose is technically a matter of establishing subjective intent. But because Section 533(a) provides that the existence of accumulations of earnings beyond the reasonable needs of the business establishes a presumption in favor of the IRS of the taxpayer’s proscribed intent, the ultimate determination in Tax Court will hinge on the available objective evidence. Red flag that the AET might be an issue include the holding by a closely-held business of substantial cash not earmarked for capital investments or working capital and investment assets.

The AET is generally determined by the IRS on audit, employing the following formula:

- Determine current and accumulated earnings and profits (akin to financial statement retained earnings);
- Determine nonliquid investments that have no relationship to the business;[\[vi\]](#)
- Determine net current assets (excess of current assets over current liabilities, including federal income taxes due); and
- Add items 2 and 3 and compare the total with item 1; compare the lower of these with the total of the working capital needs and other specific and definite future needs.[\[vii\]](#)

For purposes of determining a corporation’s specific and definite future needs, Treasury Regulation Section 1.537-2(b) provides that the reasonable needs of a business can include:

- Bona fide expansion of business or replacement of plant;
- Acquisition of a business enterprise through purchasing stock or assets;
- Retirement of bona-fide business debt;
- Working capital for inventories;
- Providing capital or loans to suppliers or customers if necessary in order to maintain the business; and
- Providing for the payment of reasonably anticipated liability losses.

Courts have found that there are numerous other categories of legitimate business needs beyond this list. The AET regulations state that a corporation's plans, in order to constitute a reasonably anticipated business need, must be specific, definite, and feasible. The AET's legislative history provides that it isn't necessary that earnings be invested immediately so long as there is a definite plan.

Treasury Regulation Section 1.537-2(c) lists several red flags that often indicate that there is an unreasonable accumulation of income:

- Loans to shareholders or corporate level expenditures for the personal benefit of shareholders;
- Loans having no reasonable relation to the business made to relatives or friends of shareholders, or to other persons;
- Loans to brother-sister corporations;
- Investment in properties or securities which are unrelated to the activities of the business; and
- Retention of earnings to provide against unrealistic hazards.

Imposition of the accumulated earnings tax

Section 531 imposes a 20% AET on a corporation's accumulated taxable income. The AET is imposed in addition to the regular 21% corporate income tax, and falls on the accumulated taxable income of the year or years for which the forbidden purpose is found. Accumulated earnings can be reduced by dividends actually or deemed paid, and corporations are entitled to an accumulated

earnings credit which will be the greater of (1) a minimum of a \$250,000 lifetime credit for most corporations (\$150,000 in the case of a corporation whose principal function is the performance of health, legal, engineering, accounting, or certain other services), or (2) such part (if any) of the earnings that are retained for the reasonable business needs of the business.^[viii]

Planning to avoid the accumulated earnings tax

Where the AET is identified as a potential issue, the business needs of a corporation for working capital and for all other needs should be documented in contemporaneous records such as the corporation's minutes, in accounting reserves, in financial statements, business plans, or strategic planning documentation. These records should reflect that the corporation has "specific, definite, and feasible plans for the use of the accumulated earnings."^[ix] Two particularly fruitful areas for managing earnings include reinvesting those earnings in the growth of the business and as capital for growing the business through acquisitions.

If a review of future capital and working capital requirements suggests that there is likely to be AET exposure, business owners should also consider making or increasing dividend payments and/or increasing reasonable compensation to reduce or eliminate accumulated earnings. One issue that should factor into AET planning is whether excess earnings can, in fact, be flushed out of the business as deductible compensation or whether the presence of passive owners will require the payment of nondeductible dividends.^[x]

The potential application of the AET should be considered in connection with up-front choice-of-entity planning (in particular when the planning involves the conversion of an already profitable partnership) if it is expected that a business will generate significant recurring revenues beyond what is needed for organic growth and acquisitions. For founders considering whether to pursue Section 1202's gain exclusion, the potential impact of the AET that must be considered.

Note that the purpose of this article is to merely alert readers to the AET's existence as a potential planning issue, and doesn't address in detail how the AET functions.

More Resources

In spite of the potential for extraordinary tax savings, many experienced tax advisors are not familiar with QSBS planning. Venture capitalists, founders and investors who want to learn more about QSBS planning opportunities are directed to several articles on the Frost Brown Todd website:

- [Section 1202 Planning: When Might the Assignment of Income Doctrine Apply to a Gift of QSBS?](#)
- [Planning for the Potential Reduction in Section 1202's Gain Exclusion](#)
- [Section 1202 Qualification Checklist and Planning Pointers](#)
- [A Roadmap for Obtaining \(and not Losing\) the Benefits of Section 1202 Stock](#)
- [Maximizing the Section 1202 Gain Exclusion Amount](#)
- [Advanced Section 1045 Planning](#)
- [Recapitalizations Involving Qualified Small Business Stock](#)
- [Section 1202 and S Corporations](#)
- [The 21% Corporate Rate Breathes New Life into IRC § 1202](#)
- [View all QSBS Resources](#)

Contact [Scott Dolson](#) if you want to discuss by video or telephone conference any [Section 1202, Section 1045 or other tax planning](#) issues.

[i] References to "Section" are to sections of the Internal revenue Code.

[ii] The AET is found at Sections 531 through 537. See *GDP, Inc. v. Commissioner*, 508 F.2d 1076 (6th Cir. 1974) for an extensive history of the AET. Treasury Regulation Section 1.537-3(b) states that if both a holding company and subsidiary have unreasonable accumulations, both may be liable for the penalty tax. A holding company may accumulate earnings for the reasonable business

needs of its subsidiary and, likewise, the subsidiary may accumulate earnings for the reasonable business needs of its parent. See *Inland Terminals, Inc. v U.S.*, 477 F.2d 836 (4th Cir. 1973).

[iii] The planning idea is to avoid trading the 21% corporate rate for the higher rate on dividends (up to an aggregate 23.8% rate) or compensation (up to 35% on ordinary income, plus employment taxes). Further, revenues paid out as dividends or compensation won't benefit from Section 1202's gain exclusion. If the liquidity event is a stock sale, the intent would be to take advantage of favorable capital gains rates or potentially claim Section 1202's gain exclusion and avoid some or all of the Federal income tax liability triggered by the stock sale. The basic strategy is to attempt, to the fullest extent possible, to keep the overall federal tax on the business and its shareholders at the 21% corporate rate. In other words, if the funds remain in the corporation and the price ultimately paid for the corporation's stock is increased to include working capital and cash, then the shareholders may be able to avoid a second level of tax on earnings altogether.

[iv] In Chief Counsel Advice 201653017 (released December 30, 2016), the IRS advised an IRS Field Office that the AET applied to a hedge fund manager's "blocker" corporation. The IRS National Office concluded that the AET applied to the corporation because it was a "holding company" or "investment company" – the corporation did not do anything other than hold partnership interests. The taxpayer argued that the AET should not be imposed where most of the earnings consisted of allocation of profit rather than actual cash distribution. The CCA noted that in TAM 91234001, the IRS explicitly rejects the argument that a lack of liquidity excuses a taxpayer from the AET. The CCA went on to point out that the corporation could have taken advantage of the consent dividend procedure outlined in Section 565(a).

[v] Section 533(a) provides that an unreasonable accumulation is determinative of a tax avoidance intent unless the corporation proves otherwise by a preponderance of the evidence. The Supreme Court has held that a tax avoidance purpose need only be one of the purposes for accumulating earnings and profits, it need not be the sole, controlling, or dominant purpose. A corporation

cannot rebut the presumption of tax avoidance by providing the existence of alternative business purposes. The corporation will have to provide a complete lack of the tax avoidance intent. *United States v. Donruss Co.*, 384 F.2d 292 (6th Cir. 1967), *rev'd and rem'd* 393 U.S. 297 (1969).

[\[vi\]](#) Examples of investment assets might include real estate investments and the holding of equity investments representing less than 80% owned subsidiaries. See Treasury Regulation Section 1.537-3(b).

[\[vii\]](#) This computational approach (the *Bardahl* formula) first set forth in a Tax Court decision allows a corporation to accumulate enough working capital to cover its reasonable business needs. *Bardahl Mfg. Corp. v. United States*, T.C. Memo 1965-200 (1965) and *Bardahl Int'l Corp. v. United States*, TC Memo 1966-182 (1966). The *Bardahl* formula provides a baseline for establishing the working capital needed to cover a corporation's reasonably anticipated costs of operating for a single operating cycle (taking into account the inventory and receivable cycle). Tax decisions confirm that the formula is a yardstick for measuring whether there are any accumulated earnings and the determination of whether there are needs of the particular business outside of those included expressly within the formula are to be determined on a case-by-case basis. See *Dixie, Inc. v. Commissioner*, 277 F.2d 526 (2nd Cir. 1960) and *Apollo Industries, Inc. v. Commissioner*, 44 T.C. 1 (1965).

[\[viii\]](#) See Section 535(c)(1). See Section 565 for a consent dividend procedure if actual dividends cannot or will not be made but a corporation nevertheless wants to reduce accumulated earnings.

[\[ix\]](#) See Treasury Regulation Section 1.537-1(b)(1). For example, in *Gustafson's Dairy Inc. v. Commissioner*, T.C. Memo 1997-519 (1997) and *Empire Steel Castings, Inc. v. Commissioner*, T.C. Memo 1974-34 (1974), the corporations documented business expansion plans over a five-year period, revising those plans as appropriate. The Tax Court concluded that those expansion plans were allowable as reasonable business needs, even where such plans were not ultimately followed through on as originally intended.

[x] Any planning that involves the payment of compensation will need to take into account a potential argument by the IRS that the payments represent unreasonable compensation and should be recharacterized as nondeductible dividends.

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