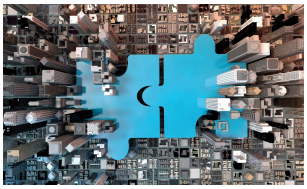

Dealing with Excess Accumulated Earnings in a Qualified Small Business – A Section 1202 Planning Guide

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This article 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. The C corporation has gained favor since 2017 as an entity of choice because of the 21% corporate tax rate and the potential for benefiting from Section 1202's gain exclusion. Additional information regarding Section 1202's eligibility requirements and Section 1202 and Section 1045 tax planning can be found on our ***QSBS & Tax Planning Services page****.*

Double taxation, dividend avoidance and excess accumulated earnings.

Section 1202 provides for a substantial exclusion of gain from federal income taxes if a stockholder transfers QSBS in a taxable sale or exchange.[1] Section 1202 has a number of eligibility requirements, including the requirement that a corporation issuing QSBS must be a domestic (US) C corporation. This requirement means that unlike many owners of closely-held businesses that operate as partnerships (LPs/LLCs) or S corporation ("Pass Thru Entities"), stockholders of qualified small businesses must cope with tax issues arising out of operating the business through a C corporation, including the potential for double taxation of distributed earnings.

When tax professionals refer to the potential for double taxation, they are referring to the fact that when operating through a C corporation, net corporate taxable income (whether it is capital gain or net income from operations) is taxed at a 21% corporate rate, and then if the net earnings are distributed to stockholders as a dividend, the distribution is taxed a second time at capital gains rates (often 20%), plus an additional 3.8% investment income tax amount. If $1,000 of net corporate taxable income is subject to

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double taxation, stockholders will have $601.98 in their pocket after the earnings run the gauntlet of double taxation, resulting in a combined effective tax rate of 39.8%.[2] Not surprisingly, stockholders seek to avoid double taxation by limiting the distribution of accumulated earnings to stockholders. But, as discussed more fully below, accumulating earnings in a C corporation (including a "qualified small business" as defined in Section 1202) can result in significant tax issues for both the corporation and its stockholders.

A plan for mitigating the accumulated earnings problem should be a consideration when deciding whether to operate through a C corporation in the first place. Of course, excess earnings can also spring up while operating through a corporation, and management must counter the problem with strategies for mitigating the potential tax impact.

This article first identifies the tax problems created by excess accumulated earnings and then suggests possible strategies to avoid the tax problems.

What are the potential tax problems associated with accumulating earnings in a C corporation?

Potential loss of QSBS eligibility. Section 1202 has a number of eligibility requirements, including the "active business requirement." This requirement applies on an ongoing basis during a stockholder entire QSBS holding period. Section 1202(e)(1) sets forth one of the active business requirements – that at least 80% (by value) of a corporation's assets must be used in the active conduct of qualified business activities (the "80% Test"). Section 1202(e)(6) elaborates on this requirement by providing that assets earmarked as working capital (money plus cash management assets)[3] count towards meeting the 80% Test only if held for the corporation's reasonably required working capital needs. Cash and investment assets not meeting the requirements of Section 1202(e) count against meeting the 80% Test. If the aggregate assets not used in undertaking the corporation's qualified business activities exceed 20% (by value) of the corporation's assets (by value), the corporation will fail the "active business requirement" for the applicable period. And if the

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period during which the corporation fails the "active business requirement" exceeds 20% to 25% of a stockholder's holding period for his QSBS, he will not be eligible to claim Section 1202's gain exclusion.[4]

Section 1202(e)(6) further provides that once a corporation has been in existence for at least two years, if the aggregate of cash and cash management assets exceed 50% of the corporation's assets (by value), the excess over 50% will count against meeting the 80% Test. In most cases, this limitation isn't a problem since the 50% test is based on comparing the aggregate of money and cash management assets against the fair market value of all assets. But, this limitation can become an issue when original QSBS sales proceeds have been reinvested in replacement QSBS of a created start-up, and that corporation has not sufficiently spent down its up-front cash infusion by the second anniversary of operations. Where a Section 1045 rollover is involved, Section 1202 doesn't state whether Section 1202(e)(6)'s two-year period runs from the date of organization of the corporation issuing the original QSBS or the corporation issuing the replacement QSBS. We believe that the two-year period should start when the replacement QSBS is issued – otherwise situations would arise where the two-year period would have passed prior to the issuance of the replacement QSBS, leading to the requirement that 50% of the rolled over proceeds would need to be immediately spent on the qualified activity. Obviously, a critical part of maintaining a "qualified small business" is to avoid failing the 80% Test.

Potential exposure to the accumulated earnings tax. One of the benefits of operating in a C corporation is the low 21% corporate tax rate applicable to all corporate-level net income and gain. A key goal of QSBS planning is to minimize taxes during operating years and then knock the tax saving ball out of the park by claiming Section 1202's gain exclusion when the QSBS is transferred in a taxable sale or exchange. Naturally, during the years between formation and sale there is a desire to minimize exposure to the double taxation regime which usually means avoiding the payment of dividends.[5] To discourage corporations from avoiding dividends and accumulating earnings, Section 531 and companion provisions (collectively, the "AET") impose an additional 20% tax on a

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corporation's "accumulated taxable income." The AET applies to accumulations beyond a corporation's reasonable future needs, but the burden of proof is on the taxpayer if challenged to establish that such accumulations are reasonable.[6] The AET applies to current accumulations. It is not a tax on earlier years' accumulations, but previous accumulated funds may mean that there is less justification to accumulate funds in the current year. Obviously, exposure to a combined 39.8% tax on net corporate taxable income paid out as dividends isn't a great result, but most business owners would rather suffer double taxation than expose earnings to the AET, which means that there is both a 21% tax on the accumulated earnings, *plus* an additional 20% tax on the accumulated earnings without an actual distribution.[7] If that isn't enough, there would be an additional 23.8% tax if the earnings are distributed out as dividends in later years. Planning must include consideration of whether the corporation risks exposure to the accumulated earnings tax and ways to mitigate that risk.

Potential exposure to the personal holding company penalty tax. Section 541 imposes a 20% penalty tax on personal holding company ("PHC") income. The penalty tax is imposed on any corporation that meets the ownership and income tests and is in addition to the 21% corporate income tax. A PHC is not subject to the accumulated earnings tax. A domestic corporation meets the "stock ownership test" if, at some time during the last half of the taxable year, more than 50% (in value) of the corporation's outstanding stock was owned, directly or indirectly, by five or fewer individuals. The "income test" is met if 60% or more of the corporation's "adjusted ordinary gross income" is "personal holding company income" which is defined to include dividends, interest, rents, and certain royalties (excluding royalties that qualify as active business computer software royalties).[8] Personal holding company income does not include capital gains from the sale or exchange of property used in a trade or business or ordinary operating income.

In general, a corporation that engages in the "active conduct" of one or more activities for purposes of Section 1202 is unlikely to fall into the PHC trap. But if funds are rolled into a created start-up under

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Section 1045 or are held by a corporation engaged in the search for an acquisition target, it is possible that the corporation could fall within the scope of a PHC if the corporation is engaged in start-up activities and research and development and the corporation's funds are invested in instruments that throw off personal holding company income (e.g., dividends and interest). Also, a corporation that doesn't generate net positive operating income could potentially fall into the PHC trap and be exposed to the 20% penalty tax.

Solving the PHC penalty tax problem.

Obviously, increasing a corporation's non-PHC income would be the best solution. Unlike situations where the accumulated earning tax might apply, merely paying dividends does not reduce the imposition of the PHC tax at the corporate level. A corporation has been determined to be liable for a deficiency under the PHC tax can reduce or eliminate the deficiency, or obtain a refund of the deficiency paid, by making a "deficiency dividend" distribution, and then claiming a deduction for the dividend in the computation of the undistributed PHC income. Note that the payment of a "deficiency dividend" first requires a "determination" that there is a deficiency (i.e., a final decision by a court, a formal "closing agreement" with the IRS, or an informal agreement with the IRS made on Form 2198. A deficiency dividend is a taxable dividend at the stockholder level.

Solving the excess accumulated earnings problem.

Before converting to a C corporation, consider whether it would make more sense to operate the business as a pass-thru entity (i.e., S corporation or partnership). There are some businesses that are expected to generate so much excess cash flow that planning for significant dividends payments should be considered a reasonable expectation (i.e., paying out all of the excess cash as compensation could be considered unreasonable from a tax standpoint or won't work from a business standpoint). If the business is expected to accumulate excessive earnings,

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thoughtfully comparing the tax relative benefits of the C corporation versus the pass-thru entity makes even more sense as part of choice of entity planning. Of course, it will be difficult to put hard numbers on the potential associated with Section 1202's gain exclusion, given the greater than five year holding period requirement and the risks that the stock won't qualify or Section 1202 will be amended, but some assessment of the issue should be undertaken.

Once a business is operating as a C corporation, it is usually prohibitively expensive from a tax standpoint to convert back to a partnership, as the conversion triggers a deemed sale of assets subject to the 21% corporate income tax and a liquidating distribution treated as a taxable exchange.[9] An S corporation election is a possibility, but a corporation with partnerships (LLCs/LPs) or corporations as stockholders are not eligible to elect S corporation status, and there is a five-year "built-in gains" period where a corporate level tax would be imposed in connection with an asset sale.[10]

The optimal strategy is to reinvest earnings into qualified activities or use the funds to start-up or acquire additional qualified business assets. Business owners looking to benefit from Section 1202's gain exclusion should want to maximize the value of their QSBS, which is usually accomplished by reinvesting earnings into the business to increase the value of the QSBS. A corporation following this strategy benefits from the low 21% corporate tax rate, avoids the potential for double taxation, and when the QSBS is sold, presumably maximizes Section 1202's gain exclusion. One possible approach would be to plan on acquiring additional assets (i.e., engaged in the same or different activities) within the corporation and potentially taking advantage of the tax benefits associated with structuring stockholder distributions as partial liquidations under Section 302(b)(4).[11]

Aggressively (but not unreasonably) pay deductible compensation. The concept of zeroing out of the income of a C corporation with compensation has been popular since Congress first enacted a corporate income tax. But, over the decades, the IRS and courts have pushed back on this approach for avoiding double

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taxation. Today, compensation and bonus plans must be structured to avoid "unreasonable compensation" challenges by the IRS.[12] Section 162(a) permits a deduction for a "*reasonable allowance for salaries or other compensation for personal services actually rendered*." Treasury Regulation Section 1.162-7(b) provides that "*an ostensible salary paid by a corporation may be a distribution of a dividend on stock. . . . If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock*." [13]

For 2023, single individuals were taxed at 35% on taxable income from $231,251 to $578,125, and 37% for amounts above $578,125. Plus, additional self-employment taxes start at 15.3% on the first $147,000 and 3.8% thereafter. Assuming that the corporation pays $1,000 in compensation, there will be a $210 deduction at the corporate level. Assuming that employment taxes have been paid on the first $147,000 of income, excess amounts would be taxed at rates up to 37%, plus an additional 3.8% payroll taxes – if we assume the applicable tax rates are 35% plus 3.8%, there would be $612 ($1,000 x (1 – (.35 + .038)) remaining in the stockholder's pocket after tax.

Pay deducible management fees, license fees and/or rent payments. Another approach is to establish a structure where certain assets are held outside of the C corporation and leased or licensed to the C corporation (e.g., real estate, equipment or intellectual property). Further, it should also be possible to create a flow of income out of the C corporation through a management services structure (e.g., establishing a "typical" PE management services arrangement). The IRS might challenge any one of these arrangements as disguised dividends where the level of services or products delivered do not merit the fees paid.

Operate activities generating the excess earnings outside of the corporation. Another possible approach would be to separate out the activities that generate too much cash flow and operate them

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outside of the corporation. This approach won't work in many cases, since the goal is to build up value in the corporation issuing the QSBS with the goal of maximizing the sale price of the QSBS. If the cash flow generating activities are where the value of the business resides in a sale process, then keeping those activities outside the corporation would be self-defeating when the QSBS and the equity of the outside Pass Thru Entities are sold. Another problem is that it might not be possible for the corporation (i.e., issuer of QSBS) to maintain "active conduct" of its activities if significant cash generating activities are undertaken outside of the corporate form. Nevertheless, this option should be explored as it may on case-by-case basis help solve or at least meaningfully mitigate the accumulated earnings problem,

Fund stock redemptions. Stock redemptions should work to reduce excess working capital for purposes of Section 1202(e)(6), but accumulations for the purpose of funding redemptions may run afoul of the AET.

Under Section 302, a redemption of stock can be treated as a dividend payment or as a taxable exchange (with gain eligible for Section 1202's gain exclusion). But although there are no tax authorities addressing the issue, presumably cash accumulated to fund redemption payments would not be considered working capital used in qualified business activities for purposes of Section 1202. So, while the redemption itself would flush the funds out of the corporation and take the pressure off of satisfying the 80% Test, the period leading up to the redemption might suffer if the cash accumulation tips the corporation into the red in terms of failing the 80% Test.

The application of the AET to accumulations for redemption of stock has been dealt with inconsistently in a substantial body of court decisions. Whether the accumulation is subject to the AET has hinged on whether the redemption was driven by a valid business purpose. Buying out a dissident minority stockholder can be an acceptable reason for accumulation, but the retirement of preferred stock to benefit common holders was not considered a valid business purpose.[14] So, while the redemption of stock might be a good way to rid a corporation of excess cash, it may not

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qualify as a valid excuse for accumulating the cash in the first place. The analysis of whether funds should be accumulated for the purpose of funding redemptions will require consideration of the business purposes behind the redemption, along with careful consideration of the numerous applicable tax authorities.

Reduce a current accumulation of earnings by paying dividends. A corporation that can't justify an accumulation of then-current year earnings can avoid paying the AET by paying a dividend during the applicable taxable year or on or before the 15th day of the fourth month of the following tax year. Payment of these dividends will trigger taxable income at the stockholder level, subject to any applicable dividends received deductions.

Fund the corporation with loans instead of payment for stock. If a business intends to operate in a C corporation and there is the significant concern that excess earnings will be a persistent problem, one useful strategy might be to primarily fund the corporation with loans rather than as payment for stock or capital contributions. Loans permit the payment of interest, and more importantly, can be repaid out of the corporation's earnings. Of course, this approach may not be optimal if the funds could instead have been used to purchase QSBS, paving the way for potentially utilizing Section 1202's 10X gain exclusion cap. Strategies such as this one should only be undertaken if the funds cannot be gainfully reinvested into the corporation's qualified business activities.

A popular strategy that generally doesn't work – making stockholder loans with excess earnings. Stockholder loans can be an attractive tool, since a loan by a corporation to a stockholder generally won't be treated as a taxable dividend. Under Section 1202, it might be possible to make stockholder loans as a cash management tool if cash is genuinely earmarked for working capital purposes and established with market terms. But stockholders should be prepared to defend an argument by the IRS that a shareholder loan is dispositive evidence that the funds are not required for working capital purposes and count against satisfying the 80% Test. Stockholder loans are also often cited in an accumulated earning tax dispute as evidence that a company is accumulating earnings beyond the corporations reasonable working

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capital needs.[15]

Another strategy that generally doesn't work – purchasing investment assets or investing in non-qualified business activities. Investment assets count against meeting Section 1202's 80% Test, unless they qualify as cash management assets held for working capital purposes under Section 1202(e)(6). Further, Section 1202(e)(5) provides that a corporation will fail the active business requirement for any period during which more than 10% of the value of its assets (in excess of liabilities) consists of stock or securities in other corporations which are not subsidiaries. Accumulating earnings to acquire non-qualified business assets and activities will help avoid the accumulated earnings tax but will count against meeting Section 1202's 80% Test.

With respect to the accumulated earnings tax, the investment in assets having no reasonable connection with the corporation's business is cited in Treasury Regulations as a fact evidencing the forbidden purpose of avoiding the income tax on stockholders.[16] On the other hand, investment for replacement and expansion of the business is generally not challenged by the IRS as evidence of accumulated earnings. Likewise, Treasury Regulations refer favorably and without qualification to accumulations to "*acquire a business enterprise through purchasing stock or assets.*"[17]

Closing Remarks

Despite 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 Sections 1202 and 1045 planning opportunities are directed to our **QSBS & Tax Planning Services page**.

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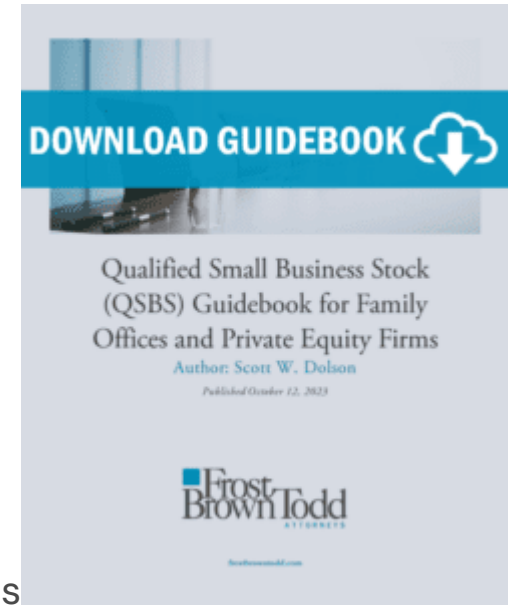

More QSBS Resources

- Section 1202 (QSBS) Planning for Sales, Redemptions and Liquidations
- Can Stockholders of Employee Leasing or Staffing Companies Claim Section 1202's Gain Exclusion?
- Qualified Small Business Stock (QSBS) Guidebook for Family Offices and Private Equity Firms
- Conversions, Reorganizations, Recapitalizations, Exchanges and Stock Splits Involving Qualified Small Business Stock (QSBS)
- Navigating Section 1202's Redemption (Anti-churning) Rules
- A Section 1202 Walkthrough: The Qualified Small Business Stock Gain Exclusion
- Determining the Applicable Section 1202 Exclusion Percentage When Selling Qualified Small Business Stock
- Selling QSBS Before Satisfying Section 1202's Five-Year Holding Period Requirement?
- Part 1 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045
- Part 2 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045
- Section 1202 Qualification Checklist and Planning Pointers

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- A Roadmap for Obtaining (and not Losing) the Benefits of Section 1202 Stock
- Maximizing the Section 1202 Gain Exclusion Amount
- Dissecting 1202's Active Business and Qualified Trade or Business Qualification Requirements
- Recapitalizations Involving Qualified Small Business Stock
- The 21% Corporate Rate Breathes New Life into IRC § 1202

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[1] References to "Section" are to sections of the Internal Revenue Code of 1986, as amended. This article addresses federal income tax issues. This article focuses on federal income tax treatment and does not address foreign, state and local tax issues.

[2] Again, it should be noted that the calculations deal only with federal income taxes. The corporate income and stockholder distributions may also be subject to state and local income and license taxes. This article generally assumes that the corporation making a distribution has the necessary earnings and profits (E&P) to support dividend treatment.

[3] Section 1202(e)(6) provides that assets held for investment must be reasonably expected to be used within two years for research and development or to fund increases in the corporation's working capital needs.

[4] This article assumes that "substantially all" of a stockholder's holding period means at least 75% to 80% of the applicable holding period, but to date there are no tax authorities interpreting "substantially all" for purposes of Section 1202. "Substantially all" could potentially be anywhere from around 70% to 95%, but 75% to 80% makes the most sense when reviewing non-Section 1202 tax authorities.

[5] Usually at a 23.8% tax rate – 20% capital gains rate, plus 3.8% investment income tax for an effective rate of 39.8% taking into account the corporate level tax and stockholder level tax (i.e., for each $100 in net income earned by the corporation, a stockholder would end up with $60.20 in his pocket after taxes.

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[6] The AET regulations state that "*an accumulation of the earnings and profits (including the undistributed earnings and profits of prior years) is in excess of the reasonable needs of the business if it exceeds the amount that a prudent businessman would consider appropriate for the present business purposes and for the reasonable anticipated future needs of the business. The need to retain earnings and profits must be directly connected with the needs of the corporation itself and must be for bona fide business purposes*" and must be "*specific, definite, and feasible*." See the article by Scott Dolson on the Frost Brown Todd website: "How Corporations May Run Afoul of the Accumulated Earnings Tax – A Section 1202 Planning Brief."

[7] If the AET is imposed on retained accumulated income and held until QSBS is sold and Section 1202's gain exclusion is claimed, at least for the portion of the gain that falls under Section 1202's gain exclusion cap, the imposition of the AET means that the portion of the consideration paid for the QSBS representing the excess earnings of the corporation (perhaps through a distribution of that excess cash in connection with the stock sale), the excess earnings would have been taxed at the 20% AET rate, which essentially neutralized the benefits of Section 1202's gain exclusion for the portion of the overall stock sale consideration. Not a great result, but also not a complete strikeout from a tax standpoint.

[8] "Adjusted ordinary gross income" excludes gains from the sale of capital assets or Section 1231 property (see Section 543 for more detail).

[9] The liquidating distribution is treated as a taxable payment of the stockholders' stock under Section 331, triggering the stockholders' right to claim Section 1202's gain exclusion if all eligibility requirements are met.

[10] Section 1374.

[11] See the Scott Dolson article on the Frost Brown Todd website titled "Section 1202 Planning for Sales, Redemptions and Liquidations."

[12] See for example, *Elliots, Inc.*, 716 F.2d 1241 (9th Cir. 1983) and *Choate Construction Co.*, T.C. Memo 1997-495 for examples of

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unreasonable compensation challenges.

[13] See *H.W. Johnson, Inc. v. Commissioner*, TC Memo 2016-95; *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983); *Aspro, Inc. v. Commissioner*, 32 F.4th 673 (8th Cir. 2022); *Pediatric Surgical Associates P.C.*, TC Memo 2001-81.

[14] See *Gazette Publishing Co. v. Self*, 103 F Supp 779 (DC AR 1952); *Trico Products Corp.*, 137 F.2d 424 (2nd Cir. 1943).

[15] See Treasury Regulation Section 1.533-1(a)(2).

[16] See Treasury Regulation Section 1.533-1(a)(2) and *Northwest Ind. Tel. Co. v. Commissioner*, 127 F.3d 643, 648 (7th Cir. 1997) (forbidden purpose evidenced by use of accumulated earnings to "*fund other ventures of [shareholders'] family*").

[17] Treasury Regulation Section 1.537-2(b)(2).

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