**8783. What is the accumulated earnings tax that a C corporation may be subject to? When does the tax apply?**

In addition to the graduated tax rate schedule outlined in Q 8779, a corporation will be subject to a penalty tax if, for the purpose of preventing the imposition of income tax upon its shareholders, it accumulates earnings instead of distributing them as dividends.[[1]](#footnote-1) The tax is 20 percent of the corporation’s *accumulated taxable income* (15 percent for tax years beginning prior to 2013).[[2]](#footnote-2)

“Accumulated taxable income” is taxable income for the year (after certain adjustments) minus the federal income tax, dividends paid to stockholders (during the taxable year or within 2½ months after the close of the taxable year), and the “accumulated earnings credit.”[[3]](#footnote-3)

A corporation is permitted to retain amounts required to meet the reasonable needs of the business—the tax will only be imposed upon amounts in excess of these amounts. To facilitate this permitted retention, an accumulated earnings credit is allowed. A corporation must demonstrate a specific, definite and feasible plan for the use of the accumulated funds in order to avoid the tax.[[4]](#footnote-4)

The use of accumulated funds for the personal use of a shareholder and family is evidence that the accumulation was to prevent the imposition of income tax upon its shareholders.[[5]](#footnote-5) In deciding whether a family owned bank was subject to the accumulated earnings tax, the IRS took into account the regulatory scheme the bank was operating under to determine its reasonable needs.[[6]](#footnote-6)

Most corporations are allowed a minimum accumulated earnings credit equal to the amount by which $250,000 ($150,000 in the case of service corporations in health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting) exceeds the accumulated earnings and profits of the corporation at the close of the previous taxable year.[[7]](#footnote-7) Consequently, an aggregate of $250,000 (or $150,000) may be accumulated for any purpose without danger of incurring the penalty tax.

Tax-exempt income is not included in the accumulated taxable income of the corporation, but will be included in earnings and profits in determining whether there has been an accumulation beyond the reasonable needs of the business.[[8]](#footnote-8) However, a distribution in redemption of stock to pay death taxes which is treated as a dividend does not qualify for the “dividends paid” deduction (Q 8780) in computing accumulated taxable income.[[9]](#footnote-9)

The accumulated earnings tax applies to all C corporations, without regard to the number of shareholders in taxable years beginning after July 18, 1984.[[10]](#footnote-10)

1. . IRC Secs. 531-537; *GPD, Inc. v. Comm.*, 75-1 USTC ¶9142 (6th Cir. 1974). [↑](#footnote-ref-1)
2. . IRC Sec. 531, as amended by ATRA. [↑](#footnote-ref-2)
3. . IRC Sec. 535. [↑](#footnote-ref-3)
4. . *Eyefull Inc. v. Comm.*, TC Memo 1996-238. [↑](#footnote-ref-4)
5. . *Northwestern Ind. Tel. Co. v. Comm.*, 127 F. 3d 643, 97-2 USTC ¶50,859 (7th Cir. 1997). [↑](#footnote-ref-5)
6. . TAM 9822009. [↑](#footnote-ref-6)
7. . IRC Sec. 535(c)(2). [↑](#footnote-ref-7)
8. . Rev. Rul. 70-497, 1970-2 CB 128. [↑](#footnote-ref-8)
9. . Rev. Rul. 70-642, 1970-2 CB 131. [↑](#footnote-ref-9)
10. . IRC Sec. 532(c). [↑](#footnote-ref-10)