

CHAPTER 14 - PENALTY PROVISIONS

Problem, page 492

- 14-1. If we make four assumptions, we can show that there is no need for the accumulated earnings tax or the personal holding company tax. Those assumptions are: 1) the same rate of tax for individuals and corporations; 2) the same rate of return for individuals and corporations; 3) no capital gains/ordinary income differential; and, 4) the elimination of §1014, which provides a step-up (or step-down) of basis at death.

Consider X Corp. formed by B with \$0. X Corp. earns \$100. (For ease of calculation, assume that there is no cost of earning this income). The rate of taxation for both X Corp. and B is 30 percent. Both X Corp. and B can earn a 10 percent pre-tax rate of return. Assume that there is no capital gains preference and no §1014 provision. Consider two choices for X Corp. It earns \$100 at the end of year 1 and distributes in liquidation the after-tax income to B who earns a 10 percent return in year 2. Alternatively, X Corp. accumulates the after-tax income in year 1 and distributes the proceeds in liquidation at the end of year 2. Since the purpose of the accumulated earnings tax and personal holding company provisions is to protect the fisc, that must be our vantage point.

Under the first alternative, the Treasury collects \$30 when X Corp. earns its income in year 1 and an additional \$21 when X Corp. distributes the \$70 after-tax proceeds. Note that the liquidation produces a \$70 gain since B has a \$0 basis in the X Corp. stock under §358, and there is no capital gains preference. In year 2, B collects \$4.90 on its \$49 after-tax income from year 1. The Treasury collects \$1.47 of the year 2 return plus a \$5.10 return on the \$51 collected in year 1. The total collection for the Treasury after two years is \$57.57.

Under the second alternative, the Treasury collects \$30 when X Corp. earns its income in year 1. In year 2, X Corp. earns a \$7 return, and the Treasury collects \$2.10. When X Corp. distributes the \$74.90 after-tax return, the Treasury collects an additional \$22.47. Finally, the Treasury collects \$3 interest on the \$30 it collected in year 1. The total collection for the Treasury is \$57.57, precisely what the Treasury earned when there was no deferral. Note that since the Treasury earns a return on income it collects in year 1, it is appropriate to sum up the total collection - the advantage of early collection is reflected in the return on that collection.

Under these rigorous assumptions, this example demonstrates that there is no need for any tax aimed at corporate accumulations. For an excellent article on this observation, see Warren, *The Timing of Taxes*, 39 Nat. Tax. J. 499 (1986).

However, this example should not be carried too far. One cannot say that deferral has no value solely because it saved the Treasury nothing in the first example. If the assumptions are relaxed, accumulation (deferral) will save B, the shareholder, money at the expense of the Treasury.

Suppose that the rate of tax at the corporate-level was 20 percent while the individual rate was 30 percent - the same relationship (although not as dramatic) between corporate and individual rates that existed prior to the Tax Reform Act of 1986. Consideration of the two alternatives of immediate distribution and deferred distribution demonstrates that now deferral causes a drain on the Treasury. Under the immediate distribution alternative, in year 1 the Treasury collects \$20 on the \$100 earned by X Corp. and \$24 on the distribution of the \$80 after-tax proceeds to B. In year 2, B earns \$5.60 on B's \$56 after-tax distribution. The Treasury's take is \$1.68 plus an additional \$4.40 return on the income collected in year 1. The total Treasury collection is \$50.08.

Under the deferral alternative, the Treasury collects \$20 in year 1 from X Corp. In year 2, the Treasury collects an additional \$1.60 on X Corp.'s \$8 return and \$25.92 on B's after-tax distribution of \$86.40. The Treasury also earns a \$2 return on the \$20 collected in year 1. The total amount collected would be \$49.52 - less than the \$50.08 collection under the immediate distribution alternative. With larger amounts, greater rate differentials, and longer time frames, the advantages of deferral can be quite significant. This observation gives rise in part to the existence of the accumulated earnings tax and personal holding company tax provisions currently in place.

In those cases where individual tax rates are lower than corporate tax rates, does deferral make sense? Do the penalty provisions still make sense? Suppose X Corp. was taxed at a 40 percent rate while B was taxed at a 30 percent rate. Under the immediate distribution alternative, the Treasury would collect \$40 in year 1 from X Corp. earning \$100. On the distribution at the end of year 1 of the \$60 after-tax proceeds, the Treasury would collect an additional \$18 from B. In year 2, B would earn \$4.20 on B's \$42 of after-tax distribution proceeds, and the Treasury would collect \$1.26 of that amount. In addition the Treasury would earn a \$5.80 return on the \$58 collected in year 1. The total collection would be \$65.06.

Under the deferred distribution alternative, the Treasury would collect \$40 in year 1 from X Corp. In year 2, X Corp. would earn \$6 on the \$60 after-tax income and would pay \$2.40 of that to the Treasury. The Treasury also would collect \$19.08 on the \$63.60 distribution to B. Finally the Treasury would collect a \$4 return on the \$40 it collected in year 1. The total amount collected is \$65.48, or more than under the immediate distribution alternative.

This observation suggests that rather than deferral being a problem to the Treasury, accumulation will produce more income for the Treasury. This observation would be correct under the remaining three rigorous assumptions, and there would be no need for the accumulated earnings tax and the personal holding company tax.

But consider the assumptions for the moment. We already have relaxed the equal tax rate assumption. The constant rate of return assumption is probably reasonable and will not be relaxed. But what about the §1014 basis provision? Does that provision create an incentive for deferral even when corporate rates are higher than individual rates?

The answer is almost unequivocally “yes.” Reconsider the last example with a corporate rate of 40 percent and an individual rate of 30 percent. Assume that B dies at the end of year 2 and that his stock basis is stepped up under §1014 to the \$63.60 after-tax value of X Corp. Now when X Corp. liquidates in year 2, there will be no income at the shareholder level and no collection by the Treasury. The total Treasury collection in the deferred distribution alternative would be \$46.40 compared with \$65.06 upon immediate distribution.

Section 1014 then creates the strongest incentive for deferral. While it is possible to imagine circumstances where the tax savings from the basis step-up of §1014 would not offset higher corporate-level taxes paid every year, those circumstances are not likely to occur when the corporate rate is only a few percentage points higher than the individual rate.

There are other advantages of deferral that have been overlooked in this analysis. For example, the slight graduation of individual and corporate rates may make deferral somewhat attractive for income-splitting purposes. So too might statutory restrictions on the ability to deduct losses. There also may be state tax and non-tax considerations that play a role.