



**KAKIMOTO AND CO.**  
**CERTIFIED PUBLIC ACCOUNTANTS**

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**IRS UPDATE ON THE DOCUMENTATION OF TRAVEL AND ENTERTAINMENT EXPENSES**

The IRS has changed the limit on the dollar amount of receipts businesses and their employees must keep to document the travel and entertainment expenses. All taxpayers still **must** retain receipts for all lodging expenses. Documenting evidence of business travel and entertainment expenses is not necessary for expenditures under \$75. All receipts for expenses which exceed the \$75 limit must be retained.

Our recommendation to all businesses and their employees is to consider retaining the current receipt standards and that the employees traveling on behalf of the Company should try to retain receipts within reason even those under the company policy.

**CITY OF LOS ANGELES AMNESTY PROGRAM**

The City of Los Angeles has established an amnesty program which waives all penalties on businesses which owe back Business Taxes or Payroll Expense Taxes. This waiver also applies to those businesses that failed to register to pay taxes. **This program is in effect during the period of October 1st through December 31st of this year.** All inquiries regarding this program should be directed to the City Clerk's office at (213) 368-7000. Installment payments may also be arranged if the total due is \$1,000 or more.

**IMPORTANCE OF OBTAINING A SOCIAL SECURITY NUMBER**

It has come to our attention that the Internal Revenue Service may propose changes on the individual income tax returns when "applied for" is used as a social security number for the dependents. This proposal will reduce the amount deducted for exemptions and, accordingly, increases taxes. The IRS may issue a notice at which time the individual must support the dependent's exemption by notifying the IRS of the appropriate social security number. Therefore, it is very important that the taxpayer obtain a social security number for his spouse and all dependents immediately after they arrive or are born in the United States.

**ACCUMULATED EARNINGS TAX - DOUBLE TAX CAN BE AVOIDED**

With the top tax rate for individuals being assessed as the accumulated earnings tax, corporations that retain earnings risk the IRS assessing this tax. In order to avoid the tax being assessed by the IRS, corporations must justify their retention of earnings.

The accumulated earnings tax is a penalty assessed on the portion of the current year's earnings that cannot be justified as being retained for reasonable business purposes. The current tax rate of 39.6%, which is the same as the top tax rate for individuals, is applied on any amount over \$250,000 (\$150,000 for service companies).

Section 532(a) provides that the accumulated earnings tax applies to every corporation formed or availed of to avoid income tax with respect to either its shareholders or the shareholders of any corporation, by permitting earnings and profit to accumulate instead of being distributed as dividends. The motive for

accumulating earnings rather than distributing them as dividends generally is to avoid double taxation. Although generally applied only to closely held companies, Section 532(c) states that the accumulated earnings tax is determined without regard to the number of shareholders.

Determining what is evidence of a purpose to avoid tax is a difficult issue. Reg.1.533-1(a)(2) provides limited guidance, merely stating that the following will be considered:

1. Dealings between the corporation and its shareholders (i.e. loans to shareholders or corporate funds spent for the personal benefit of shareholders).
2. Investment by the corporation of undistributed earnings in assets having no reasonable connection with the business of the corporation.
3. The extent to which the corporation has paid dividends.

The courts have placed considerable weight on whether the stockholders are in high personal tax brackets and how much need they had for dividends. The higher the tax bracket shareholders are in - and the less their need to obtain income from the corporation - the stronger the presumption of a tax avoidance purpose.

The vast majority of accumulated earnings cases rest on whether earnings have been unreasonably accumulated. Reg.1.537-1(a) states that the corporation's reasonably anticipated needs may be considered. To justify an accumulation for reasonably anticipated needs, Reg.1.537-1(b)(1) says that the business will require the accumulation in the future and the corporation must have specific, definite, and feasible plans to use it. The accumulation need not be used immediately and the plans need not be finalized within a short period after the tax year if the accumulation will be used in a reasonable time. On the other hand, vague or uncertain future plans or an indefinite postponement of the execution of plans is not sufficient justification for accumulating earnings.

Reg.1.537-2(b) says that reasonable grounds for accumulated earnings include the following:

1. Business expansion or plant replacement.
2. Acquisition of a business enterprise.
3. Retirement of business debt.
4. Necessary working capital for the business (i.e. for purchasing or producing inventory).
5. Funds for making investments or loans to suppliers or customers if necessary in order to maintain business.
6. Product liability loss reserves.

*Expansion or replacement:* Reasonable grounds for retaining earnings includes replacing worn-out or outdated equipment as well as purchasing or constructing assets. The business judgment of the corporate officers definitely carries weight and court opinions have stated that Section 531 does not empower judges to substitute their judgment for that of the corporate officers.

*Business acquisition:* The latitude to which a corporation has in acquiring unrelated businesses is a question. For example, will the acquisition of a totally unrelated business enable the corporation to avoid the accumulated earnings tax? Reg.1.537-3 appears to be relatively liberal in this respect, stating that "the business of a corporation is not merely that which it has previously carried on but includes, in general, any line of business which it may undertake."

*Debt retirement:* Accumulating earnings to retire debt held by outsiders should present no accumulated earnings tax problem. On the other hand, if the debt is held by a majority shareholder, the issue is not as clear.

*Investments and loans:* Reg.1.537-2(b)(5) approves the accumulation of earnings to provide for investments or loans to suppliers if necessary to maintain business. Accumulations made to satisfy the

business need of a brother or sister corporation are generally not sufficient to meet the business-needs test. In determining when an accumulation is "necessary to maintain business," the Second Circuit implied that the standard might be so strict that the survival of the customer or supplier would have to be in doubt.

*Contingencies:* In order to justify accumulation of earnings for contingencies, the contingency should be both specific and have a reasonable likelihood of occurrence; the more vague the contingency, the less likely that the courts will be sympathetic.

In conclusion, to withstand IRS attempts to levy the accumulated earnings tax successfully, corporation should treat the justification of accumulation of earnings as an on-going matter. Last-minute rationales, developed after an IRS examination has begun, are much less effective than careful and continual planning in this area.