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The corporate form, or something close to it, has existed in law at least since the time of the Romans. Over the centuries, the corporation has become the premier means for concentrating capital and management into an effective commercial investment vehicle. In the United States, where the corporate concept was borrowed from British practice, the creation of the modern business corporation is probably the most important development in 19th- and 20th-century legal history. Arguably, the creation of the corporation might have also been the greatest single way to increase a government's revenues, simply by artificially increasing the number of taxpayers.

However, the use of the corporate form is also cause for continuing concern, especially in the United States. The U.S. Congress has adopted several sets of provisions to prevent individuals from using corporations to defer or avoid U.S. taxes in ways that it deems improper. The accumulated earnings tax (AET) is one such example.[1]

The purpose of that tax is to prevent corporations from accumulating their earnings and not distributing the earnings as taxable dividends. The tax is imposed in addition to other taxes, such as the regular corporate tax. In other words, the AET is a penalty tax on a corporation's accumulated taxable income.

Recently the U.S. Internal Revenue Service seems to have increased its examination of foreign-controlled U.S. entities and U.S. branches of foreign corporations. While the AET has rarely been imposed because of the statutory exclusions and because taxpayers generally can show reasonable business needs for accumulations of income, practitioners have noted that the returns being selected are especially those that may support the imposition of the AET because of the accumulation of earnings "beyond the reasonable needs of the business."[2]

Accordingly, from an Italian investor's perspective, the issue arises whether the AET is applicable to Italian corporations doing business in the United States through a permanent establishment and to U.S. subsidiaries of Italian corporations.

As a general rule, an Italian corporation is subject to the AET, but only regarding income derived from U.S. sources, and only if any of its shareholders are subject to income tax on the distributions of the corporation because they are:

(1) U.S. citizens or residents;

(2) nonresident alien individuals subject to U.S. tax; or

(3) foreign corporations in which a beneficial interest is owned directly or indirectly by stockholders in (1) or (2).[3]

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[1]U.S. Internal Revenue Code section 531. Since post-2002 qualified corporate dividends are taxed to noncorporate shareholders at a maximum 15 percent rate, the Jobs and Growth Tax Relief Reconciliation Act of 2003, section 302(e)(5), reduced the rate for the accumulated earnings tax to 15 percent. As a result of sunset provisions in the 2003 and prior legislation, however, the rate for the AET will increase to 35 percent for tax years starting after 2008 and to 39.6 percent for tax years starting after 2010.

[2]"Reasonable needs of the business" include accumulations for the bona fide expansion of the business, bona fide replacement of a plant, acquisition of the stock or assets of another business enterprise, retirement of bona fide trade or business debt, and provision of working capital for the business. Treas. reg. section 1.537-2(b). In the case of a U.S. subsidiary of an Italian corporation, it is uncertain whether the postponement of the payment of dividends to the Italian parent for non-U.S. tax reasons, including the Italian tax ramifications of those dividends, would be acceptable as "reasonable needs of the business." Also, while the AET applies to current accumulations and is not a tax on earlier years' accumulations, prior accumulations — to the extent they are available to meet business needs — may mean there is less, or no, justification for current accumulations.

[3]Treas. reg. section 1.532-1(c). Also, the AET does not apply to earnings to which the U.S. branch profits tax applies. Thus, if an Italian corporation is considered to pay U.S.-source dividends and the corporation is subject to the U.S. branch profits tax, dividends paid from such earnings would not be taxable in the hands of non-U.S. shareholders. IRC section 884(e)(3). Because the branch profits tax imposes its

(Footnote continued on next page.)

Thus, if none of an Italian corporation's shareholders are subject to U.S. income tax, the corporation should not be subject to the AET. That limited application of the AET to foreign corporations is consistent with the AET's underlying policy — that is, penalizing corporations that try to avoid a U.S. individual income tax at the shareholder level on the corporation's distributions.[4] That the focus of the AET remains on the potential avoidance of individual income taxes has been confirmed by the IRS on a number of occasions.[5]

Those few Italian corporations to which the AET may apply would not find relief from the tax in the Italy-U.S. tax treaty currently in force. Because of a reservation entered by the United States on article 10(5) of the OECD model treaty (which includes a prohibition on a contracting state's right to tax undistributed profits), many U.S. treaties, including the treaty with Italy, exclude the AET from the covered taxes. However, the United States revised its position concerning the AET in the 1996 U.S. model treaty.[6] That change of policy by the U.S. authorities is reflected in the new treaty between the United States and Italy, signed on August 25, 1999, but not yet ratified. (For prior coverage, see *Tax Notes Int'l*, Aug. 29, 2005, p. 791.)

As to U.S. subsidiaries of Italian corporations, they should avoid tax liability under section 531 as long as no shareholder of the Italian parent company is subject to individual income tax liability in the United States. A similar conclusion was reached in LTR 9422028, in which the IRS's reasoning was that the AET will not apply to a corporation unless the ultimate owners of the corporation would be subject to U.S. income tax on distributions made regarding interests in such corporation. However, Italian investors should be aware that this interpretation of section 531 is directed only at the taxpayer who requested it and cannot be relied on or cited as precedent. ◆

own test to determine whether accumulated earnings should be taxed, the AET test would be inappropriate.

[4]Proposed regulations were issued in 1980 that would have extended the proscribed purpose to include the avoidance of U.S. corporate income tax. However, those regulations were withdrawn without explanation in 1983. LR-125-78 (prop. reg. sections 1.532-1(a)(1), 1.532-1(c)), 45 *Fed. Reg.* 84088 (Dec. 22, 1980), withdrawn, LR-125-78, 48 *Fed. Reg.* 26226 (June 6, 1983).

[5]LTRs 9330010 and 9330011. Under these rulings, it seems that for the purpose of the AET, the IRS considers the tax imposed on nonresident individuals under section 871 to be an individual income tax. Conversely, avoidance of the tax imposed on foreign corporations under section 881 would not trigger the application of the AET. *See also* LTR 9422028, discussed below.

[6]The United States realized that under U.S. domestic law, the AET: (a) will not apply anyway to most foreign corporations; and (b) in the few cases in which it may apply to a foreign corporation, the AET due is likely to be insignificant. Therefore, treaty coverage would confer little if any benefit. *See* article 2 of the Treasury technical explanation of the 1996 U.S. model treaty.

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