TAX LAW FOR BUSINESS
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BDB Law's "Tax Law for Business" *appears in the opinion section of* ***Business Mirror*** *every Thursday.*

Improperly accumulated earnings: BIR vs SEC

SECTION 29 of the 1997 Tax Code provides for the imposition of improperly accumulated earnings tax (IAET) on improperly accumulated taxable income. The IAET applies to every corporation formed or used for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

To implement this provision of the Tax Code, the Bureau of Internal Revenue (BIR) issued Revenue Regulations 02-01. In that regulation, it is emphasized that the imposition of IAET is in the nature of penalty for the improper accumulation of earnings. Thus, the subsequent declaration of dividends will not exempt the corporation from the payment of any tax due, such as the tax on dividends.

The basis for the imposition of the IAET is the unreasonable accumulation of earnings or profits. And as described in the implementing regulations, an accumulation of earnings or profits is unreasonable if it is not necessary for the purpose of the business, considering all the circumstances of the case. However, it is said that the accumulation of earnings up to 100 percent of the paid-up capital of the corporation is considered reasonable.

Given that the paid-up capital is significant in the determination of whether there is unreasonable accumulation of earnings, it is crucial to understand what constitutes the paid-up capital of a corporation. Prior to the issuance of RMC 35-2011, clarifying what is meant by paid-up capital for purposes of this IAET, the paid-up capital was understood to refer to the capital stock and the additional paid-in capital. As such, this was the rule followed by corporations for compliance purposes. This new RMC, however, clarified that for purposes of determining the earnings that may be retained for purposes of the determination of improperly accumulated earnings subject to the 10-percent IAET, the basis of the 100-percent threshold or retention shall be the paid-up capital or the amount contributed to the corporation representing the par value of the shares of stock, excluding any excess capital over and above the par value.

For almost 14 years since the effectivity of the 1997 Tax Code where the IAET was imposed, it is only now that the BIR says the additional paid-in capital (excess capital over and above the par value) shall not be included for purposes of determining the 100-percent threshold. It should be noted that the Securities and Exchange Commission (SEC) in 2008 issued Memorandum Circular 11—Guidelines on the Determination of Retained Earnings available for Dividends Declaration, where paid-in capital was defined as the amount of outstanding capital stock and additional paid-in capital or premium paid over the par value of shares for purposes of determining the 100-percent threshold. The Corporation Code, likewise, provides that stock corporations are prohibited from retaining surplus profits in excess of 100 percent of their paid-in capital stock.

Following this SEC issuance in 2008, the BIR could have easily issued an RMC defining "paid-in capital" capital for purposes of the IAET implementation. As it did nothing, the issuance of the SEC memorandum circular only affirmed that the paid-in capital includes the amount of APIC.

We can only guess that the issuance of RMC 35-2001 is for purposes of having higher bases for the imposition of IAET and correspondingly, higher collection of penalties or taxes. And so for corporations, not until the validity of the RMC is questioned, there is no other choice but to comply with the said rules.

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