REVENUE REGULATIONS NO. 2 - 2001

SUBJECT : Implementing the Provision on Improperly Accumulated Earnings Tax Under Section 29 of the Tax Code of 1997

TO : All Internal Revenue Officers and Others Concerned

SECTION 1. Scope. – Pursuant to Section 244 of the Tax Code of 1997, in relation to Section 29 of the same Code, these Regulations are being issued to prescribe the rules governing the imposition of Improperly Accumulated Earnings Tax.

SEC. 2. Concept of Improperly Accumulated Earnings Tax (IAET). - Pursuant to Section 29 of the Code, there is imposed for each taxable year, in addition to other taxes imposed under Title II of the Tax Code of 1997, a tax equal to 10% of the improperly accumulated taxable income of corporations formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting the earnings and profits of the corporation to accumulate instead of dividing them among or distributing them to the shareholders. The rationale is that if the earnings and profits were distributed, the shareholders would then be liable to income tax thereon, whereas if the distribution were not made to them, they would incur no tax in respect to the undistributed earnings and profits of the corporation. Thus, a tax is being imposed in the nature of a penalty to the corporation for the improper accumulation of its earnings, and as a form of deterrent to the avoidance of tax upon shareholders who are supposed to pay dividends tax on the earnings distributed to them by the corporation.

The touchstone of the liability is the purpose behind the accumulation of the income and not the consequences of the accumulation. Thus, if the failure to pay dividends is due to some other causes, such as the use of undistributed earnings and profits for the **reasonable needs of the business**, such purpose would not generally make the accumulated or undistributed earnings subject to the tax. However, if there is a determination that a corporation has accumulated income beyond the reasonable needs of the business, the 10% improperly accumulated earnings tax shall be imposed.

SEC. 3. Determination of Reasonable Needs of the Business. - An accumulation of earnings or profits (including undistributed earnings or profits of prior years) is unreasonable if it is not necessary for the purpose of the business, considering all the circumstances of the case. To determine the "reasonable needs" of the business in order to justify an accumulation of earnings, these Regulations hereby adhere to the so-called "Immediacy Test" under American jurisprudence as adopted in this jurisdiction. Accordingly, the term *"reasonable needs of the business"* are hereby construed to mean the immediate needs of the business, including reasonably anticipated needs. In either case, the corporation should be able to prove an immediate need for the accumulation of the earnings and profits, or the direct correlation of anticipated needs to such accumulation of profits. Otherwise, such accumulation would be deemed to be not for the reasonable needs of the business, and the penalty tax would apply.

For purposes of these Regulations, the following constitute accumulation of earnings for the reasonable needs of the business:

a. Allowance for the increase in the accumulation of earnings up to 100% of the paid-up capital of the corporation as of Balance Sheet date, inclusive of accumulations taken from other years;
b. Earnings reserved for definite corporate expansion projects or programs requiring considerable capital expenditure as approved by the Board of Directors or

equivalent body;

c. Earnings reserved for building, plants or equipment acquisition as approved by the Board of Directors or equivalent body;
d. Earnings reserved for compliance with any loan covenant or pre-existing obligation established under a legitimate business agreement;
e. Earnings required by law or applicable regulations to be retained by the corporation or in respect of which there is legal prohibition against its distribution;
f. In the case of subsidiaries of foreign corporations in the Philippines, all undistributed earnings intended or reserved for investments within the Philippines as can be proven by corporate records and/or relevant documentary evidence.

SEC. 4. Coverage. The 10% Improperly Accumulated Earnings Tax (IAET) is imposed on improperly accumulated taxable income earned starting January 1, 1998 by domestic corporations as defined under the Tax Code and which are classified as closely-held corporations. Provided, however, that Improperly Accumulated Earnings Tax shall not apply to the following corporations:

a. Banks and other non-bank financial intermediaries;
b. Insurance companies;
c. Publicly-held corporations;
d. Taxable partnerships;
e. General professional partnerships;
f. Non- taxable joint ventures; and
g. Enterprises duly registered with the Philippine Economic Zone Authority (PEZA) under R.A. 7916, and enterprises registered pursuant to the Bases Conversion and Development Act of 1992 under R.A. 7227, as well as other enterprises duly registered under special economic zones declared by law which enjoy payment of special tax rate on their registered operations or activities in lieu of other taxes, national or local.

For purposes of these Regulations, closely-held corporations are those corporations at least fifty percent (50%) in value of the outstanding capital stock or at least fifty percent (50%) of the total combined voting power of all classes of stock entitled to vote is owned directly or indirectly by or for not more than twenty (20) individuals. Domestic corporations not falling under the aforesaid definition are, therefore, publicly-held corporations.

For purposes of determining whether the corporation is closely held corporation, insofar as such determination is based on stock ownership, the following rules shall be applied:

1. Stock Not Owned by Individuals. - Stock owned directly or indirectly by or for a corporation, partnership, estate or trust shall be considered as being owned proportionately by its shareholders, partners or beneficiaries.
2. Family and Partnership Ownership. – An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family, or by or for his partner. For purposes of this paragraph, the 'family of an individual' includes his brothers or sisters (whether by whole or half-blood), spouse, ancestors and lineal descendants.
3. Option to Acquire Stocks. - If any person has an option to acquire stock, such stock shall be considered as owned by such person. For purposes of this paragraph, an option to acquire such an option and each one of a series of option shall be considered as an option to acquire such stock.
4. Constructive Ownership as Actual Ownership. - Stock constructively owned by

reason of the application of paragraph (1) or (3) hereof shall, for purposes of applying paragraph (1) or (2), be treated as actually owned by such person; but stock constructively owned by the individual by reason of the application of paragraph (2) hereof shall not be treated as owned by him for purposes of again applying such paragraph in order to make another the constructive owner of such stock.

Provided, however, that a branch of a foreign corporation is not covered by these Regulations, the same being a resident foreign corporation.

SEC. 5. Tax Base of Improperly Accumulated Earnings Tax. - For corporations found subject to the tax, the *"Improperly Accumulated Taxable Income"* for a particular year is first determined by adding to that year's taxable income the following:

a. income exempt from tax;
b. income excluded from gross income;
c. income subject to final tax; and
d. the amount of net operating loss carry-over (NOLCO) deducted.

The taxable income as thus determined shall be reduced by the sum of:

a. income tax paid/payable for the taxable year;
b. dividends actually or constructively paid/issued from the applicable year's taxable income;
c. amount reserved for the reasonable needs of the business as defined in these Regulations emanating from the covered year's taxable income.

The resulting *"Improperly Accumulated Taxable Income"* is thereby multiplied by 10% to get the Improperly Accumulated Earnings Tax (IAET).

Once the profit has been subjected to IAET, the same shall no longer be subjected to IAET in later years even if not declared as dividend. Notwithstanding the imposition of the IAET, profits which have been subjected to IAET, when finally declared as dividends, shall nevertheless be subject to tax on dividends imposed under the Tax Code of 1997 except in those instances where the recipient is not subject thereto.

For purposes of determining the source of earnings or profits declared or distributed from accumulated income for each taxable year, the dividends shall be deemed to have been paid out of the most recently accumulated profits or surplus and shall constitute a part of the annual income of the distributee for the year in which received pursuant to Section 73(C) of the Code. Provided, however, that where the dividends or portion of the said dividends declared forms part of the accumulated earnings as of December 31, 1997, or emanates from the accumulated income of a particular year and, therefore, is an exception to the preceeding statement, such fact must be supported by a duly executed Board Resolution to that effect.

SEC. 6. Period for Payment of Dividend/Payment of IAET. - The dividends must be declared and paid or issued not later than one year following the close of the taxable year, otherwise, the IAET, if any, should be paid within fifteen (15) days thereafter.

SEC. 7. Determination of Purpose to Avoid Income Tax. - The fact that a corporation is a mere holding company or investment company shall be *prima facie* evidence of a purpose to avoid the tax upon its shareholders or members. Likewise, the fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the tax upon its shareholders or members. In both instances, the corporation may, by clear preponderance of evidence in its favor, prove the contrary.

For purposes of these Regulations, the term *"holding or investment company"* shall refer to a corporation having practically no activities except holding property, and collecting the income therefrom or investing the same.

The following are *prima facie* instances of accumulation of profits beyond the reasonable needs of a business and indicative of purpose to avoid income tax upon shareholders:

a. Investment of substantial earnings and profits of the corporation in unrelated business or in stock or securities of unrelated business;
b. Investment in bonds and other long-term securities;
c. Accumulation of earnings in excess of 100% of paid-up capital, not otherwise intended for the reasonable needs of the business as defined in these Regulations.

In order to determine whether profits are accumulated for the reasonable needs of the business as to avoid the imposition of the improperly accumulated earnings tax, the controlling intention of the taxpayer is that which is manifested at the time of accumulation, not subsequently declared intentions which are merely the product of afterthought. A speculative and indefinite purpose will not suffice. The mere recognition of a future problem or the discussion of possible and alternative solutions is not sufficient. Definiteness of plan/s coupled with action/s taken towards its consummation are essential.

SEC. 8 . Transitory Provision. - The IAET shall not apply on improperly accumulated income as of December 31, 1997 in the case of corporations using the calendar year basis. In the case of corporations adopting the fiscal year accounting period, the IAET shall not apply on improperly accumulated taxable income as of the end of the month comprising the twelve-month period of fiscal year 1997-1998.

Taxable income improperly accumulated, as heretofore discussed, prior to the effectivity of these regulations if declared as dividend and paid/issued within one month from the effectivity hereof will not be subjected to the 10% Improperly Accumulated Earnings Tax.

SEC. 9. Effectivity. - These Regulations shall take effect fifteen (15) days after publication in any newspaper of general circulation and shall cover Improperly Accumulated Taxable Income earned starting January 1, 1998.

(Original Signed)
ALBERTO G. ROMULO
Secretary of Finance

Recommending approval:

(Original Signed)
RENÉ G. BAÑEZ
Commissioner of Internal Revenue