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Adjusted Personal Holding Company Income Concepts Under the Revenue Act of 1964

William J. Vesely

INTRODUCTION

The personal holding company tax is a penalty tax imposed on the income of certain corporations which accumulate income rather than distributing it to shareholders as dividends.¹ This tax was added to the United States income tax law by the Revenue Act of 1934.² The stated Congressional purpose in enacting the tax was to deprive persons having substantial income from investments from the benefit of lower tax rates which they enjoyed by using the corporate form to hold their investments, the so-called "incorporated pocketbook."³

Unlike the penalty tax imposed on the income of a corporation which accumulates its earnings for the purpose of avoiding the income tax which its shareholders would pay if the earnings were paid out as dividends, commonly called the "tax on unreasonable accumulation of earnings,"⁴ the corporation's intent or purpose in not paying out its income to shareholders has no relevance to the personal holding company tax. The applicability of this tax is determined by arbitrary, mechanical tests applied to the income of corporations which have a relatively small number of shareholders who own a substantial part of its shares. The personal holding company tax is imposed only upon "passive income," for example, income from dividends, interest, rents and mineral royalties. It does not apply to income realized from the active conduct of a trade or business.

The personal holding company tax is imposed annually on the personal holding company income which is not distributed to shareholders.⁵ The Revenue Act of 1964 has fixed the penalty tax rate at 70%. This is the maximum income tax rate applicable to individual taxpayers beginning in the year 1965. It represents a reduction from the penalty tax rates previously in effect of 75% on the first \$2,000 and 85% on the excess over \$2,000 of undistributed personal holding company income.

1. Sections 541 through 547 of the Internal Revenue Code apply to domestic corporations. Sections 551 through 558 of the Code apply to foreign corporations. INT. REV. CODE OF 1954 [hereinafter cited as CODE §].

2. Revenue Act of 1934, § 351, 48 Stat. 680.

3. H.R. REP. NO. 704, 73d Cong., 2d Sess. 11 (1934).

4. CODE §§ 531-37.

5. CODE § 541.

CLASSIFICATION AS A PERSONAL HOLDING COMPANY

To be classified as a personal holding company, a corporation must satisfy two conditions: it must have (1) a limited group of shareholders; and (2) a proportionately large amount of investment income.

Stock Ownership Requirement

The shareholder test has not been changed by the Revenue Act of 1964. To be classified as a personal holding company five or less individual shareholders still must own more than 50% in value of the corporation's outstanding stock at any time during the last six months of the corporation's taxable year.⁶ Attribution rules are used in determining stock ownership.⁷

Income Requirement

The income test has been changed substantially by the 1964 Act. The prior test required that personal holding company income be more than 80% of the corporation's *gross income*. The new standard is that personal holding company income must constitute more than 60% of the corporation's *adjusted ordinary gross income*.⁸ The addition of the words "adjusted" and "ordinary" to the previous term "gross income" reflects a number of important changes in the statutory rules for determining whether certain kinds of income constitute personal holding company income, as well as representing a major change in the income test for determining whether a corporation is a personal holding company.

The addition of the word "ordinary" reflects the elimination from personal holding company income of all capital gains, whether realized from the sale of stock or securities, from the sale of depreciable property used in business, or from any other transaction which results in capital gains income.⁹ Heretofore, capital gains realized on the sale of stock or securities were included as personal holding company income in determining whether the corporation met the income test. The net capital gains less applicable income taxes were excluded, however, from the undistributed income to which the personal holding company tax applied.¹⁰

The addition of the word "adjusted" reflects changes made by the 1964 Act with respect to gross income from rents and mineral, oil and gas royalties.¹¹ This kind of income is now reduced by allocable income

6. CODE § 542(a) (2).

7. CODE § 544.

8. CODE § 542(a) (1).

9. CODE § 543(b) (1).

10. CODE § 545(b) (5).

11. CODE § 543(b) (2).

tax deductions in determining whether it is sufficiently large in relation to the corporation's other income to be classified as "personal holding company income" and, if it is so classified, in computing the amount of such income which constitutes personal holding company income.

Rents

Prior to the 1964 Act, rents were not personal holding company income if they were at least 50% of the corporation's gross income. This single test has been replaced by a dual test.¹² For rents to escape classification as personal holding company income under the 1964 Act, the following two tests must be met. First, the *adjusted* income from rents must be at least 50% of the corporation's *adjusted* ordinary gross income. Adjusted income from rents is the gross rental income reduced by depreciation, obsolescence and amortization, property taxes, interest and rent expenses.¹³ Second, the corporation's *undistributed* personal holding company income for the taxable year, excluding rents and any compensation received by the corporation for the use of its property by persons owning 25% or more of its stock, must not be more than 10% of its ordinary gross income. For this purpose personal holding company income includes the adjusted income from mineral, oil and gas royalties and copyright royalties, whether or not such royalties satisfy the conditions which exempt them from classification as personal holding company income.^{13a}

In applying the 10% limitation, personal holding company income is reduced by the dividends paid, or considered as paid, and consent dividends for the taxable year.¹⁴ A corporation which might otherwise fail to satisfy the 10% test for excluding rents from personal holding company income can thus assure compliance by a timely dividend payment or consent dividend.

If rents constitute personal holding company income under the 1964 Act, the adjusted income from rents, not the gross income as under the prior law, is considered to be personal holding company income. This change should not affect the computation of the amount of undistributed personal holding company income to which the tax is applicable, but will affect the determination as to whether the corporation satisfies the income test for classification as a personal holding company.

12. CODE § 543(a)(2).

13. CODE § 543(b)(2)(A).

13a. Royalties received from patents, inventions, models, designs, secret formulas or processes, or other similar property rights are to be treated as "rent" in applying the 10% test where these items are also used by the corporation in the manufacture of tangible personal property held by it for lease to customers, provided that the rental income from leases is more than 50% of the adjusted ordinary gross income. CODE § 543(a)(2).

14. CODE § 543(a)(2)(B). The net effect is that the 10% limitation on the use of rents applies to other *undistributed* personal holding company income.

Mineral, Oil and Gas Royalties

The changes in the rules applicable to this category of income correspond, in general, to the changes in the rules applicable to rents. Previously, this class of income was excluded from personal holding company income if it constituted at least 50% of gross income and if business expense deductions, excluding deductions for compensation paid to shareholders, were at least 15% of gross income. Under the 1964 Act, mineral royalties are excluded from personal holding company income if (1) the adjusted income from such royalties is 50% or more of adjusted ordinary gross income; (2) the corporation's other personal holding company income is not more than 10% of its ordinary gross income; and (3) the corporation's business expense deductions are at least 15% of its adjusted ordinary gross income.¹⁵ The items deducted in computing adjusted income from mineral royalties correspond to the deductions used in computing adjusted income from rents. If the corporation has working interests in oil or gas wells as well as mineral royalties, the adjusted income from each of these sources is computed separately in determining adjusted ordinary gross income.¹⁶ The deduction allowable for this purpose in respect of each kind of income can not exceed the amount of that income. In computing the permissible 10% limitation upon other personal holding company income, the dividends paid deduction is not taken into account. In applying the 15% test for business expense deductions, items for which a deduction is specifically allowed under a section of the Internal Revenue Code other than section 162, authorizing deductions for trade or business expenses generally, are not taken into account.

The 1964 Act expressly provides that production payments and overriding royalties are includable in this category of income.¹⁷ This reflects the position of the Internal Revenue Service under the prior law.¹⁸

As in the case of rents, the adjusted income of this kind is the amount of income which is taken into account as personal holding company income.

Copyright Royalties

Two of the three conditions which must be satisfied to exclude copyright royalties from personal holding company income, *i.e.*, the requirements that such royalties represent at least 50% of ordinary gross income and that other personal holding company income be not more than

15. CODE § 543(a)(3).

16. CODE § 543(b)(2)(B).

17. CODE § 543(b)(4).

18. Treas. Reg. § 1.543-1(b)(11)(ii) (1958); *cf.* 525 *Company v. United States*, 230 F. Supp. 803 (N.D. Tex. 1964).

10% of ordinary gross income,¹⁹ represent essentially a continuation of the corresponding rules which applied under the prior law. The adjusted income concept has not been made applicable to copyright royalties. In applying the 10% test, however, the adjusted income from rents and the adjusted income from mineral royalties is now considered to be personal holding company income.²⁰

The 1964 Act has revised the third condition, the business expense test, which must be met in order to exclude copyright royalties from personal holding company income. In place of the previous requirement that business expenses, excluding compensation and copyright royalties to shareholders, be 50% or more of gross income, the 1964 Act has substituted a requirement that business expense deductions (excluding deductions for compensation to shareholders and royalties paid or accrued, and deductions specifically allowed under a section of the Internal Revenue Code other than section 162, allowing trade or business expenses generally) be at least 25% of the amount by which ordinary gross income exceeds the sum of royalties paid or accrued and depreciation deducted in respect of copyright royalties.²¹ The definition of the term "copyright royalties" also has been broadened to include amounts received for the use of, or right to use, films, except produced film rents.²² Such rents are now a separate category of personal holding company income.²³

Produced Film Rents

Prior to the 1964 Act, produced film income was classified as "rents." Now, produced film rents represent personal holding company income, unless they constitute more than 50% of the corporation's ordinary gross income. This term is expressly defined in the statute as meaning payments received with respect to an interest in a film for the use of, or right to use, the film, but only to the extent that such interest was acquired before the production of the film was substantially completed.

Other Provisions Concerning Classification of Income

Interest received on United States obligations by a dealer who makes a primary market in such obligations and interest on condemnation awards is excluded from interest income.²⁴ The statutory provision relating to amounts received for the use of the corporation's property by a

19. CODE §§ 543(a)(4)(A),(B).

20. CODE § 543(a)(4)(B)(iii).

21. CODE § 543(a)(4)(C).

22. CODE § 543(a)(4).

23. CODE § 543(a)(5).

24. CODE § 543(b)(2)(C).

shareholder owning more than 25% in value of its stock²⁵ now includes adjusted income from mineral royalties as other personal holding company income for the purpose of computing the 10% limitation on such income. This parallels the change applicable to rents. The statutory provision dealing with income from estates and trusts²⁶ has been amended so that gain from the sale or other disposition of an interest in an estate or trust no longer is classified as personal holding company income.

Excluded Corporations

Certain classes of corporations are expressly excepted from the definition of a personal holding company, whether or not these corporations meet the personal holding company stock ownership and income requirements. The 1964 Act has amended the provision excepting banks²⁷ to include domestic building and loan associations. For this purpose, the building and loan association is not required to satisfy the tests restricting its investments in property other than residential and church real property²⁸ which it otherwise must satisfy for classification as a building and loan association under the Internal Revenue Code.

A major revision has been made of the provisions which exclude lending and finance companies. In place of the previous four separate categories for corporations of this kind, there is now a single category²⁹ for all corporations and a single set of rules. To qualify under this new provision the corporation must satisfy four tests. They are: (1) 60% or more of its ordinary gross income must be derived directly from the active and regular conduct of a lending or finance business; (2) its personal holding company income, with certain exclusions and inclusions, must not be more than 20% of its ordinary gross income; (3) deductions directly allocable to the lending or finance business must be at least 15% of the ordinary gross income up to \$500,000 and 5% of any additional ordinary gross income up to \$1,000,000; and (4) loans to any shareholder owning 10% or more in value of the corporation's stock must not at any time exceed \$5,000. The 1964 Act expressly defines what constitutes a lending or finance business.³⁰ It also expressly provides that the only deductions to be taken into account as being directly allocable to its business are those deducted under section 162, relating to trade or business expenses, and section 404, relating to contributions to qualified employee plans, except deductions for compensation to shareholders.³¹ In

25. CODE § 543(a)(6).

26. CODE § 543(a)(8).

27. CODE § 542(c)(2).

28. CODE §§ 7701(a)(19)(D); (E).

29. CODE § 542(c)(6).

30. CODE § 542(d)(1).

31. CODE § 542(d)(2)(A).

addition, deductions for depreciation and real property taxes are allowed only to the extent that the property with respect to which such deductions are allowable is used directly in the corporation's lending or finance business.³²

DIVIDENDS PAID DEDUCTION FOR LIQUIDATING DISTRIBUTIONS

Several relatively obscure changes reflect the concern of the government that unintended tax benefits were heretofore realizable by a personal holding company when it liquidated. Under the rules applicable to corporations generally, distributions in complete liquidation occurring within twenty-four months after adoption of a plan of complete liquidation are considered to be dividends paid from current earnings and profits of the corporation for the purpose of determining the amount of its dividends paid deduction.³³ The consequence to a personal holding company before the 1964 Act was that in the years in which it made liquidating distributions the corporation paid no personal holding company tax on its personal holding company income distributed in liquidation while this same income was taxed to its shareholders as capital gain. Under the 1964 Act, liquidating distributions of a personal holding company to its individual shareholders qualify for the dividends paid deduction only if, and to the extent that, the corporation designates that such distributions are ordinary dividends.³⁴ Furthermore, the dividends paid deduction for liquidating distributions made to corporate shareholders is limited to the corporate shareholders' allocable share of the personal holding company income for the year in which the distributions are made.³⁵ The effect of this latter amendment is to preclude the personal holding company from deriving a dividends paid deduction in excess of its personal holding company income in the year of liquidation.

A foreign personal holding company is no longer allowed any dividends paid deduction for liquidating distributions.³⁶ The net effect is that shareholders of a foreign personal holding company in liquidation are taxed on their distributive shares of the foreign personal holding company's income³⁷ reduced by any part of such income distributed to them as part of a liquidating distribution.

32. CODE § 542(d)(2)(B).

33. CODE § 562(b)(1)(B).

34. CODE § 316(b)(2)(B). The election and the notification to shareholders are to be made in accordance with Regulations to be promulgated. The dividend may not exceed the individual shareholder's allocable share of undistributed personal holding company income.

35. CODE § 562(b)(2).

36. CODE § 562(b)(1).

37. CODE § 551(b).

RELIEF PROVISIONS

The new tests for determining whether certain kinds of income qualify as personal holding company income and whether a corporation's income classifies it as a personal holding company are intended to, and will, have the effect of subjecting additional corporations to personal holding company tax. To alleviate to some extent the hardship this would impose upon taxpayers who planned their affairs in reliance on previous law, the 1964 Act contains two relief provisions. One permits certain qualifying corporations to use undistributed personal holding company income to pay certain indebtedness without incurring liability for personal holding company tax.³⁸ The other provides more favorable rules for taxing the gain realized by shareholders of qualifying corporations which elect to liquidate.³⁹

Deduction for Payment of Qualified Indebtedness

A personal holding company, in computing its undistributed personal holding company income, is now allowed a special deduction for amounts used or irrevocably set aside in the taxable year to pay or retire its "qualified indebtedness." Thus, a personal holding company will not have any personal holding company tax liability, notwithstanding that it has personal holding company income which it does not distribute to its shareholders, to the extent that it uses such undistributed income to pay or to provide for the payment of its qualified indebtedness.

This new deduction is not allowed to personal holding companies generally, but only to those which for convenience can be called "would have been" corporations. To qualify, the corporation must be one which was not a personal holding company in either or both of its two taxable years next preceding the date of enactment of the 1964 Act, but which would have been a personal holding company in at least one of those years if the 1964 Act had then been in effect.⁴⁰

"Qualified indebtedness," in general, is indebtedness incurred after December 31, 1933, and before January 1, 1964.⁴¹ Indebtedness incurred after December 31, 1963 for the purpose of paying or setting aside funds for payment of qualified indebtedness also will qualify if the corporation elects not to deduct the amount so paid or set aside.⁴² Indebtedness which,

38. CODE § 545(c).

39. CODE § 333(g).

40. CODE § 545(c)(2). This special deduction also applies to a corporation which succeeds to the deduction of another qualifying corporation in a tax free acquisition within the purview of CODE § 381(c)(15). CODE § 545(c)(2)(B).

41. CODE § 545(c)(3).

42. CODE § 545(c)(3)(A)(iii). The election must be made on or before the 15th day of the third month following the close of the taxable year to which the election applies. CODE § 543(c)(4). It appears that the election may relate to all or any part of the amount otherwise qualifying for the special deduction.

at any time after 1963, was owed to a person who then owned more than 10% in value of the corporation's outstanding stock does not qualify irrespective of who owns it when it is paid or when an amount is set aside for payment.⁴³

The amount of qualified indebtedness to be taken into account in respect of a contract indebtedness must be reduced by amounts irrevocably set aside before the taxable year to pay or retire the indebtedness.⁴⁴ No deduction is allowed for payments thereafter made out of the amount so set aside. This limitation has reference primarily to sinking fund arrangements. Of course amounts added to the sinking fund in the taxable year and subsequent years would qualify for the deduction, subject to other applicable limitations. Qualified indebtedness is further reduced if depreciable property is disposed of after December 31, 1963 and the person acquiring the property assumes a part of the qualified indebtedness. The amount of the reduction is the excess of the adjusted basis of the property over the amount of the indebtedness assumed.⁴⁵

In computing the amount of the deduction for any taxable year, the amount actually paid or set aside is reduced by the corporation's allowances for depreciation, amortization and depletion, and the corporation's net long term capital gains, if any, less applicable income taxes for the period beginning January 1, 1964 through the end of the taxable year for which the deduction is claimed.⁴⁶ The effect of these adjustments is to treat the payment of qualified indebtedness in each taxable year as having come first from funds derived from post-1963 depreciation, amortization and depletion, and post-1963 net long term capital gains. Only the excess over such amount is considered as being paid from the corporation's undistributed personal holding company income for that year.

Special Liquidation Rules

Any corporation which finds that it will become subject to personal holding company tax may, of course, escape the tax consequences by liquidating. The resultant income tax liabilities of the shareholders by reason of the liquidation will depend upon whether the liquidation is made under the normal corporate liquidation provision⁴⁷ or whether an election is made to have the special one-month liquidation provision of the Internal Revenue Code apply.⁴⁸ The shareholders of a corporation

43. CODE § 545(c)(3)(B).

44. CODE § 545(c)(3)(C).

45. CODE § 545(c)(6).

46. CODE § 545(c)(5).

47. CODE § 331.

48. CODE § 333.

which qualifies as a "would have been" corporation, if they make a proper election to liquidate under the one-month liquidation provision, will be taxed in accordance with more favorable rules than apply to one-month liquidations generally.⁴⁹

In general, a corporation must liquidate before January 1, 1967 in order to qualify.⁵⁰ If it has qualified indebtedness, however, it will qualify if it liquidates on or before the end of the taxable year in which its qualified indebtedness is fully paid.⁵¹

If the liquidation is effected before 1967,⁵² individual shareholders who have held their shares for more than six months will have their gain taxed only to the extent of (1) their pro rata share of the corporation's post-1963 accumulated earnings and profits,⁵³ and (2) any excess over this amount of the total of any money and the fair market value of stock or securities distributed in liquidation which were acquired by the corporation after 1962. Individual shareholders who have held their shares six months or less will treat their share of the corporation's earnings and profits as a dividend.⁵⁴ The balance of the gain realized on the liquidation will not be subject to tax. If the liquidation is not effected until 1967 or a later year in which the qualified indebtedness is paid, individual shareholders will be taxed in essentially the same way except that all shareholders will treat their pro rata shares of post-1966 accumulated earnings and profits as dividends.

A different rule applies to corporate shareholders. The gain which a corporate shareholder realizes is taxed to the extent of the greater of (1) the amount of money and the value of any stock or securities acquired after 1962 distributed to it in the liquidation, or (2) its pro rata share of the personal holding company's accumulated earnings and

49. CODE § 333(g).

50. CODE § 333(g)(1).

51. CODE § 333(g)(2). Notice must be given to the Internal Revenue Service before January 1, 1968 that the corporation may wish to liquidate under this special provision. If the qualified indebtedness could have been paid in an earlier year if all post-1963 depreciation, amortization and depletion and all post-1963 earnings and profits were used for such payment, then the liquidation must occur before the close of such year. CODE §§ 333(g)(2)(B),(C).

52. If the liquidation is effected on or before December 31, 1965, the corporation's status as a personal holding company and its personal holding company tax liability, if any, will be determined under the rules in effect prior to the Revenue Act of 1964. Revenue Act of 1964, § 225(h)(1), Pub. L. No. 88-272, 88th Cong., 2d Sess. (Feb. 26, 1964).

53. Earnings and profits do not include the earnings and profits of another corporation to which a corporation succeeds after December 31, 1963 in a tax free carryover situation except those of a corporation which would qualify under the special provision. CODE § 333(g)(2).

54. The general rules applicable to one-month liquidations treat the individual shareholder's pro rata share of earnings and profits as a dividend. The excess over this of the amount of any money and the fair market value of stock and securities distributed in liquidation which were acquired after 1953 is taxed as long term capital gain. CODE § 333(e).

profits.⁵⁵ Corporate shareholders are taxed in the same way regardless of the year in which the liquidation occurs.

The existing rule for determining the basis to the shareholders of the property received in a one-month liquidation continues to apply.⁵⁶ The shareholder's basis for such property is the basis of the stock cancelled in the liquidation, decreased by money received and increased by gain realized. This basis is allocated among the properties received, other than money, in accordance with their fair market values.

The election is made in accordance with the existing rules applicable to one-month liquidations.⁵⁷ The 1964 Act has a unique provision that recognizes the diversity of views that often attends the interpretation of a new income tax statute, and further recognizes that an election under the new statute based on a mistaken assumption that the personal holding company qualifies might have unexpectedly harsh tax consequences.⁵⁸ If the election expressly states that it is based on the assumption that the corporation qualifies under the new rule, and if it should develop that it does not, then the shareholders will be taxed in accordance with the rules applicable to liquidations generally, rather than in accordance with the rules applicable to one-month liquidations.

55. The only difference from the rules applicable to corporate shareholders in one-month liquidations generally is the limitation of the value of stock and securities to be taken into account to those acquired after 1962. The general rule requires that stock and securities acquired since 1953 be taken into account. CODE § 333(f).

56. CODE § 334(c).

57. CODE §§ 333(c),(d). Shareholders possessing at least 80% of the total combined voting power of all classes of stock entitled to vote on the liquidation must make the election. The written election must be filed with Internal Revenue Service within 30 days after the date of adoption of the plan of liquidation.

58. CODE § 333(g)(4).