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Some Problems in Liquidating Personal Holding Companies

Elliott H. Kajan* and Martin C. Spector**

General Problems in Liquidation

Dividend Paid Deduction

Ordinarily, distributions by a personal holding company qualify for the dividends paid deduction only if they are "dividends" under section 316.1 However, certain distributions in liquidation may also qualify.2 These liquidating distributions of a personal holding company are divided into two categories:

(1) Distributions to the extent of earnings and profits for the taxable year (computed without regard to capital losses) made in complete liquidation of the corporation occurring within 24 months after the adoption of the plan of liquidation; and

(2) distributions in liquidation properly chargeable to earnings and profits accumulated after February 28, 1913.3

Under the first category, if the corporation in its final 24 months made distributions equal to or in excess of its earnings and profits for taxable years within the 24-month period, the corporation was entitled to a dividends paid deduction for distributions which resulted in the elimination of any undistributed personal holding company income.4


2 Internal Revenue Code § 562(b) (1954) (prior to 1964 amendments). Hereinafter this will be cited as I. R. C. (1954). See Treas. Reg. § 1.562-1(b) (1) (1958), which states that in order to qualify for the dividends paid deduction a liquidating distribution "must be one either in complete or partial liquidation of a corporation pursuant to sections 331, 332, or 333." I. R. C. § 346(a) (1954) defines a partial liquidation for this purpose as including a redemption of stock to which section 302 applies.
3 I. R. C. § 27(g) (1939) contained a provision similar to § 562(b) except that it contained no provision for a complete liquidation within 24 months after the adoption of the plan of liquidation.
A corporation is entitled to a dividends paid deduction under the second category, if any part of its distribution is properly chargeable to earnings and profits accumulated after February 28, 1913. Thus, that part of the liquidating distribution which is properly chargeable to the capital account must first be deducted; the remainder of the distribution is applied against earnings and profits, and qualifies for dividends paid deduction.

The Regulations deny the dividends paid deduction under the second category if "there is a deficit in earnings and profits on the first day of a taxable year, and the earnings and profits for such taxable year do not exceed such deficit..." Several cases have held that even though the liquidating personal holding company had a deficit in earnings and profits at the beginning and end of the taxable year, it was entitled to a dividends paid deduction if it had current earnings and profits. The courts reasoned that the purpose of the personal holding company surtax is to induce distribution of current earnings by placing a prohibitive tax on undistributed personal holding company income. Denying the liquidating corporation the dividends paid deduction would penalize it for distributing current income, and thus would have nullified the purpose of the statute.

Suppose a corporation using the 24 months liquidation has no accumulated earnings and profits, and its current earnings and profits are completely eliminated by a capital loss. The corporation is still entitled to a dividends paid deduction to the extent of the current earnings and profits, without reduction for capital losses. Without this provision, a corporation which had current earnings and profits which were fully absorbed by capital losses might find itself unable to escape the penalty surtax.

7 Ibid.
9 I. R. C. § 541 (1954) provides that the personal holding company surtax shall equal 70 percent of the undistributed personal holding company income.
by the dividends paid deduction, even if it distributed the earnings and profits.\textsuperscript{11}

\textbf{Taxation of Liquidating Distributions to Shareholders}

Prior to the Revenue Act of 1964, distributions made by a personal holding company in complete or partial liquidation were treated as being made in exchange for the distributee's stock, even though the liquidating corporation was entitled to a dividends paid deduction for such distribution.\textsuperscript{12} That is, there was no differentiation at the shareholder level from liquidation of an ordinary corporation.

\textbf{Revenue Act of 1964}

The Revenue Act of 1964 made three significant modifications of existing tax law with respect to personal holding companies. It harmonized the treatment of liquidating distributions between a personal holding company and its shareholder-distributees. Second, it eliminated the dividends paid deduction carryover from a liquidating personal holding company subsidiary to its surviving parent. Finally, it provided relief provisions to mitigate the effects of the amended definitions of personal holding companies\textsuperscript{13} and personal holding income.\textsuperscript{14}

\textbf{Liquidating Distributions}

The personal holding company surtax\textsuperscript{15} is applied to certain undistributed income; if dividend distributions are made the surtax will not be imposed on that income.\textsuperscript{16} Prior to the Revenue Act of 1964, distributions in liquidation of personal holding companies were treated as dividend distributions eligible for a dividends paid deduction to the extent of earnings and profits accumulated.

\textsuperscript{11} I. R. C. § 1211(a) (1954) provides that losses suffered by a corporation from the sale or exchange of capital assets are allowable deductions only to the extent of gains from the sale or exchange of capital assets.

\textsuperscript{12} I. R. C. §§ 331, 332 and 333 (1954) (prior to the Revenue Act of 1964). The liquidating distribution by a personal holding company was treated the same by the distributee-shareholder as a liquidating distribution received from a corporation not subject to the personal holding company surtax under § 541. \textit{Ibid.}

\textsuperscript{13} I. R. C. § 542(a) (1954).


\textsuperscript{15} I. R. C. § 541 (1954).

\textsuperscript{16} I. R. C. § 545(a) (1954).
mulated since 1913. As a result, a liquidating distribution by a personal holding company would very often relieve it of the penalty surtax; yet the recipient shareholder could treat the distribution as capital gains rather than a dividend (ordinary income). The Revenue Act of 1964 eliminates this tax anomaly to a large extent.

The 1964 Revenue Act amended the definition of “dividend” to include distributions of property by a personal holding company in complete liquidation. But, the application of this rule is hedged with several conditions, the primary one requiring that the liquidation must occur within 24 months after the adoption of the plan of liquidation. It is limited to distributions to non-corporate shareholders; and the liquidating corporation must designate such amounts as dividend distributions, and notify the distributees of the designation. Finally, to qualify as a dividend, the liquidating distribution cannot exceed the sum of the noncorporate distributee’s allocable share of the undistributed personal holding company income for the year of the distribution. The effect of this amendment is that by designating all or a part of its liquidating distributions to noncorporate shareholders as dividends, a personal holding company may escape from personal holding company tax by eliminating its undistributed income.

18 S. Rep. No. 830, 88th Cong., 2d Sess. 112 (1964); See President's 1963 Tax Message, Hearings Before the Committee on Ways and Means of the House of Representatives, 88th Cong., 1st Sess., pt. 1 at 125 (1963), which stated, "A corporation which is formed to hold assets producing personal holding company income can avoid personal holding company tax if it is liquidated before the end of its first year, since its undistributed personal holding company income is reduced to zero by the liquidating distribution. The shareholders are taxed at only capital gains rates on the liquidating distribution." 19 See supra n. 1.
22 I. R. C. § 316(b)(2)(B)(ii) (1954). The notification to the noncorporate distributees of the designation will be made in accordance with Regulations to be issued.
LIQUIDATING PERSONAL HOLDING CO.

It was earlier noted that prior to the 1964 Act, any distribution in partial or complete liquidation of a corporation resulted in capital gains to the shareholder distributees. To prevent capital gains treatment by noncorporate shareholders on receipt of a liquidating distribution designated as a dividend by a personal holding company, such distributions are now taxable as dividends.

The changes with respect to liquidating distributions by a personal holding company to its corporate shareholders are embodied in section 562(b) of the Code. When a personal holding company completely liquidates, a distribution of property to a corporate shareholder qualifies as a dividend for purposes of the dividends paid deduction, if such distribution is made within 24 months after the adoption of a plan of liquidation. However, the distribution qualifies only to the extent that such amount represents the corporate-distributee's allocable share of undistributed personal holding company income for the taxable year of the distribution. There are several modifications of the past law under section 562(b)(2). First, liquidating distributions qualify for the dividends paid deduction only if paid to corporations. Secondly, prior to the 1964 Act, the personal holding company was not required to liquidate within 24 months after adoption of a plan of liquidation, yet could still enjoy a dividends paid deduction for liquidating distributions chargeable to accumulated earnings and profits. It is now compulsory for the personal holding company to liquidate within 24 months after the adoption of a plan, and it can no longer claim a dividends paid deduction out of accumulated earnings and profits. Finally, section 562(b)(2) limits the amount of the distribution which may qualify as a dividends paid deduction to the corporate dis-

25 I. R. C. § 331(a) (1954); supra n. 18.
27 I. R. C. § 331(b) (1954).
28 I. R. C. § 562(b) (2) (1954). Computation of the shareholder's allocable share is made without taking into account liquidating distributions to any other corporate or noncorporate distributees.
29 I. R. C. § 562(b)(2) (1954). It should be noted that the old rules for the dividends paid deduction are still applicable in computing accumulated taxable income under § 535, investment company taxable income under § 852, and real estate investment trust taxable income under § 587, which may be found in I. R. C. § 562(b)(1) (1954).
tributee's allocable share of the undistributed personal holding company income for the year of the distribution. This modifies the old rule which did not speak of the corporation's allocable share, and used the corporation's current "earnings and profits (without regard to capital losses)," as the limitation.32

In light of the foregoing, it can readily be judged that liquidating distributions from a personal holding company qualify for a dividends paid deduction to noncorporate distributees only if such distributions are treated as dividends under section 316(b)(2)(B), and to corporate distributees only if in pursuance of section 562(b)(2). The House committee report33 points out that although a corporate shareholder may treat a distribution as a dividend for purposes of the dividends paid deduction, since it does not qualify as a dividend under section 316(b)(2)(B) it "cannot be treated by such corporate shareholder as a dividend."34 As a result, the corporate distributee is denied the 85-percent dividends-received deduction35 with respect to such distribution, and must treat it under the higher corporate capital gains tax.

**Carryover From Subsidiaries**

Before the 1964 Revenue Act, a problem existed where a parent and subsidiary were both personal holding companies, and the subsidiary was liquidated.36 If the subsidiary's undistributed personal holding income was less than its accumulated earnings and profits in the year of liquidation, then such excess could be carried over to the surviving parent to be used in com-
puting its dividends paid deduction. This carryover privilege no longer exists since the dividends paid deduction is now limited to the parent's allocable share of the liquidating subsidiary's undistributed personal holding company income for the taxable year of the distribution, regardless of any accumulated earnings and profits in the liquidating subsidiary.

**Relief Provisions**

Because of the new personal holding company provisions many corporations not previously so classified will now be personal holding companies and subject to the high personal holding company tax rates. Both the House and Senate committee reports point out that "it would be unfortunate to apply these provisions without any alternatives being available . . . it would be unfair to require such companies to pay personal holding company tax if they are willing to liquidate." As a result, certain relief provisions were added to afford a means of avoiding the personal holding company tax, and encourage the liquidation of personal holding companies. The basic qualification which a corporation must meet to escape all or a part of the new rules is that it must not have been a personal holding company in at least one of its two most recent tax years ending before February 26, 1964, but that it would have been one under the new law. The burden of tax consequences to such "qualified cor-

37 I. R. C. § 381(c) (14) (1954). This results in reducing the parent's own undistributed personal holding company income in the year of distribution and also in the two subsequent years under I. R. C. § 564 (1954). See H. R. Rep. No. 749, 88th Cong. 1st Sess., 82 (1963); and President's 1963 Tax Message, supra n. 18.

38 I. R. C. § 562(b) (2) (1954); supra n. 29.

39 The new rule applies only to distributions made in taxable years of the liquidating corporation beginning after December 31, 1963, supra n. 21. As a result, any "excess dividends arising from a 1963 liquidating distribution can be carried forward by the parent into 1964 and 1965." 1 The Research Institute of America Tax Coordinator ¶ D-2426 (1964).


42 I. R. C. § 333 (g) (3) (1954); P. L. No. 272, 88th Cong., 2d Sess. § 225(h) (1) (1964). If a calendar year corporation was not a personal holding company, under the old requirements, in neither 1962 nor 1963, it could not qualify under the relief provisions. Corporations which meet the above requirement shall hereinafter be referred to as "qualified corporations."
corporations” depends upon the time of liquidation, i.e. before January 1, 1966, before January 1, 1967, or after December 31, 1966.

Where a “qualified corporation” completely liquidates before January 1, 1966, it is exempt from the new personal holding company provisions. The same rule may be applied to a subsidiary, where both the parent and subsidiary are personal holding companies, provided that: the parent itself is not a subsidiary which is liquidated pursuant to section 332; and all liquidating distributions by the parent must occur before the 91st day after its subsidiary’s last distribution, but not later than December 31, 1965.

Although “qualified corporations” would like to enjoy complete immunity from the new personal holding company rules, many are unable to do so because of the existence of large debts which renders it virtually impossible to liquidate before the debts are paid off. Congress recognized the plight of these corporations by enacting section 333(g) which facilitates their liquidation without having their shareholders bear the heavy tax burden incident to distributions of assets which have greatly appreciated in value.

The new section 333(g) provides different relief provisions, depending upon whether the one month in which complete liquidation must occur is before or after January 1, 1967, and whether the shareholder-distributees are corporate or noncorporate.

Where a “qualified corporation” completely liquidates within one calendar month before January 1, 1967, there is no differ-

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44 P. L. No. 272, 88th Cong., 2d Sess. § 225(h) (1) (1964) which also provides that there must be distribution of all the property under the liquidation before January 1, 1966. A problem exists where a qualified corporation does not liquidate until sometime during 1965. H. R. Rep. No. 749, 88th Cong. 2d Sess., A 113 (1963) points out that in such circumstances such corporations would be liable for personal holding company tax for 1964, but could file a claim for refund once liquidation is completed by December 31, 1965.


46 The House and Senate committee reports sagaciously expressed the underlying reasons for the enactment by stating, “Although it is understood that some of these [“qualified”] companies are willing to liquidate, nevertheless, it would represent a hardship under the existing law for them to do so. The hardship arises from the fact that if they liquidate under the provisions of section 331 of the code, not only would the earnings and profits of such corporations be taxed to the shareholders at capital gains rates but also any other appreciation which has occurred in the value of the assets would be so taxed to them. Such companies, in the absence of the new personal holding company provisions, would face no necessity of liquidating and therefore under these circumstances no tax would now be paid with respect to these unrealized increases in value.” Supra n. 41.
ence between the amount of a corporate or noncorporate shareholder's recognized gain. The general rule\(^\text{47}\) is that, of the total realized gain per share,\(^\text{48}\) each shareholder shall recognize an amount which is the larger of either: that shareholder's ratable share of the corporation's accumulated earnings and profits since February 28, 1913; or the sum of cash and the fair market value of securities received by the shareholder which were acquired by the corporation after December 31, 1962.\(^\text{49}\) The effect of the foregoing rule is to defer the recognition of gain on the receipt of such assets which were acquired by the "qualified corporation" on or before December 31, 1962, and any other assets regardless of when they were acquired, until such property is exchanged or sold by the shareholder.\(^\text{50}\)

The nature of the gain recognized to a non-corporate shareholder depends upon the source of the liquidating distribution, and the holding period of the shares in the "qualified corporation." Distributions to the extent of the non-corporate shareholder's ratable share of accumulated earnings and profits are treated as ordinary dividend income if the shareholder held the stock six months or less, and as long term capital gains if the stock was held more than six months.\(^\text{51}\) Any remaining balance

\(^{47}\) I. R. C. § 333 (g) (1) (1954).

\(^{48}\) Treas. Reg. § 1.333-4 (a) (1955) states that "Gain or loss must be computed separately on each share of stock owned by a qualified electing shareholder at the time of the adoption of the plan of liquidation."

\(^{49}\) I. R. C. § 333 (g) (1) (A) (1954). "Nonqualified" corporate shareholders must recognize gain upon receipt of such assets where the nonqualified corporation acquires them after December 31, 1953, under §§ 333 (e) (2), 333 (f) (1).


\(^{51}\) I. R. C. § 333 (g) (1) (B) (1954). I. R. C. § 333 (e) (1) (1954), non-corporate shareholders of "non-qualified" corporations are not afforded the privilege of enjoying capital gains to the extent of their share of earnings and profits regardless of their holding period.

However, under I. R. C. § 333 (g) (1) (1954) this substitution of capital gains for dividend income does not apply with respect to earnings and profits to which the corporation succeeds after December 31, 1963, pursuant

(Continued on next page)
of recognized gain derived from receipt of cash or stock or securities, which had been acquired by the distributing "qualified corporation" after December 31, 1962, are given capital gains treatment.\textsuperscript{52} The recognized gain to corporate shareholders is taxed at capital gains rates, regardless of the source of the distribution or the holding period of stock.\textsuperscript{53}

It has been previously noted that because of large debt structures "qualified corporations" are often unable to liquidate easily.\textsuperscript{54} As a result, Congress enacted a provision to afford such corporations the privilege of enjoying the one-month liquidation election even if they liquidate after December 31, 1966.\textsuperscript{55} Where the noncorporate shareholder has held stock in the liquidating "qualified corporation" more than six months, the recognized gain with respect to his ratable share of earnings and profits accumulated from February 28, 1913 to December 31, 1966 is treated as long-term capital gains. His ratable share of earnings and profits accumulated after December 31, 1966, is given dividend (ordinary income) treatment.\textsuperscript{56}

To qualify for section 333(g) liquidating provisions, a "qualified corporation" must meet several conditions. First, on January 1, 1964, it must owe (qualified) indebtedness incurred from December 31, 1933 to December 31, 1963, or incurred after December 31, 1963 which replaced such prior indebtedness.\textsuperscript{57} It must notify the Internal Revenue Service by December 31, 1967, of its intention to liquidate under Section 333 (g) (2).\textsuperscript{58} Finally,

(Continued from preceding page)

to any corporate reorganization or liquidation of its subsidiary. But, this limitation is inapplicable if such earnings and profits on December 31, 1963, belonged to a "qualified corporation," or were earned after such date by a "qualified corporation."

\textsuperscript{52} See \textit{supra} n. 49.

\textsuperscript{53} The rule for corporate shareholders was not changed. This prevents the corporate shareholder from enjoying the 85-percent dividends received deduction, which would have been allowed had they been given the same status as non-corporate shareholders.

For an excellent illustration of the foregoing rules see \textit{1 The Research Institute of America Tax Coordinator D-3545} (1964).


\textsuperscript{55} I. R. C. § 333(g) (2) (1954).

\textsuperscript{56} I. R. C. § 333(g) (2) (A) (ii) (1954). This rule is subject to the same limitation found in note 51 \textit{supra}.

\textsuperscript{57} I. R. C. §§ 333(g) (2) (B) (i), 545(c) (3) (A) (1954).

\textsuperscript{58} I. R. C. § 333(g) (2) (B) (ii) (1954).
it must liquidate prior to the end of the taxable year in which it no longer owes qualified indebtedness. But, if its "adjusted post-1963 earnings or profits" exceed its qualified indebtedness (computed on January 1, 1964) at an earlier time, then it must liquidate in that earlier year.  

Conclusion

The definition of personal holding company income has been greatly expanded by the Revenue Act of 1964. Many corporations will now find themselves in the position of either paying the personal holding company tax or liquidating. Congress realizing the plight of these companies has provided several devices whereby a corporation can liquidate and thereby mitigate the tax impact of the new law.

Whether the corporation should liquidate, pay greater dividends, or subject itself to the personal holding company tax must be decided in light of court decisions and the Internal Revenue Code.

59 I. R. C. § 333(g) (2) (C) (1954) defines "adjusted post-1963 earnings and profits" to include all earnings and profits accumulated after December 31, 1963, which are not reduced by dividend distributions or by depreciation and amortization deductions during such period.

H. R. Rep. No. 749, 88th Cong., 1st Sess. A 111 (1963) points out that ..., For this purpose a corporation is considered to have no accumulated earnings and profits on January 1, 1964. Thus, an accumulated deficit which exists on January 1, 1964, for purposes of section 316(a) is disregarded."

60 I. R. C. § 333(g) (2) (B) (iii) (1954).

Where an electing shareholder mistakenly believes that the corporation qualifies under Section 333(g), see I. R. C. § 333(g) (4) (1954).