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NOTE

PERSONAL HOLDING COMPANIES AND GROSS INCOME

*by Harvey Mahlig**

THE "INCORPORATED POCKETBOOK," prevalent in the 1920's and early 1930's, was a device whereby a man could shift income from the high personal surtax rates to the then very low corporation income tax rates. He would form a corporation and transfer thereto his holdings in various income producing properties, receiving all of the stock of the corporation in exchange therefor.[1] Income from the transferred property would be taxed at the low corporate rates. Unless dividends were paid, the income would not be subject to personal surtax and could be accumulated as surplus of the corporation. Although the Government was provided with a weapon[2] to prevent the improper accumulation of surplus, it was relatively ineffective to discourage the formation and use of these so-called personal holding companies.

After giving consideration to this problem[3] the 73rd Congress, in the Revenue Act of 1934,[4] levied a tax upon the undis-

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[1] The Ways and Means Committee Report No. 704, 73rd Cong. 2nd Sess., p. 11 (1934), gives the following example:

> "For instance, suppose a man has $1,000,000 annual income from taxable bonds. His tax under existing law will be $571,000. However, if he forms a holding company to take title to the bonds and to receive the income therefrom, the only tax paid will be a corporate tax of $137,500 as long as there is no distribution of dividends. Thus a tax saving of $433,500 has been effected."

[2] INT. REV. CODE § 102.

[3] See discussion in Preliminary Report of a Subcommittee of the Committee on Ways and Means, 73rd Cong., 2nd Sess., and Finance Committee Report No. 558, 73rd Cong., 2nd Sess.

[4] Revenue Act of 1934, § 351. This section was the forerunner of the present Chapter 2, Subchapter A of the Internal Revenue Code relating to personal holding companies. Except for a change in rates the provisions of section 351 were not changed in the 1935 and 1936 Revenue Acts. The failure of

tributed portion of a personal holding company's income. On the first $2,000.00 of "undistributed income" the rate was 75%; on the excess the rate was 85%.[5] Originally the law was a single paragraph and was not effective in accomplishing its intended purpose. In order to overcome the many deficiencies which destroyed its effectiveness, the law was expanded until now there are eleven sections with many subparagraphs.[6] The rates were not changed and still remain at 75% and 85% of undistributed net income as defined.[7]

Because of these discriminatory rates, it is important for a corporation to know whether or not it is a personal holding company as defined by the Internal Revenue Code. By their very nature most corporations will not qualify as personal holding companies. The tests set forth in the Internal Revenue Code[8] are designed to cover those corporations that are closely controlled and which have a large amount of "personal holding company income." Personal holding company income[9] includes dividends, royalties, rents, annuities, gains from sale or exchange of stock, securities and interests in estates or trusts, income arising from personal service contracts and amounts received from the use of property by a shareholder entitled to the use thereof. Further, such income must constitute at least 80% of total gross income before the requirements of the section are met.[10] Further a corporation will escape application of the per-

this provision to prevent tax avoidance resulted in a complete revision of the provision in the Revenue Act of 1937, the changes being substantially continued in the 1938 Revenue Act and in the Internal Revenue Code which, in 1939, codified the revenue laws.

[5] INT. REV. CODE § 500.

[6] Subchapter A of Chapter 2 of the Internal Revenue Code deals with additional income taxes with respect to personal holding companies and contains the following Code sections:

Sec. 500—Surtax on Personal Holding Companies
Sec. 501—Definition of Personal Holding Company
Sec. 502—Definition of Personal Holding Company Income
Sec. 503—Requirements of Stock Ownership
Sec. 504—Undistributed Subchapter A Net Income (upon which the tax provided in section 500 is levied)
Sec. 505—Subchapter A Net Income
Sec. 506—Deficiency Dividends—Credits and Refunds
Secs. 507-511—Definitions, administrative and technical provisions.

[7] INT. REV. CODE § 504.

[8] INT. REV. CODE § 501 (a) (1) and (2).

[9] INT. REV. CODE § 502.

[10] INT. REV. CODE § 501 (a) (1). This section requires at least 80% of total gross income to be "personal holding company income" in order for the surtax to apply. However, if a corporation meets the 80% tests in one year, the percentage is reduced to 70% of the following three consecutive years.

sonal holding company definition if its stock is widely held. Only those corporations in which more than 50 per centum in value of the outstanding stock is owned, directly or indirectly, by or for not more than five individuals during the last half of the taxable year are concerned with these provisions.

But there are many small corporations, the ownership of which is in the hands of a family group or a few individuals, which are susceptible to personal holding company rules. These require a careful analysis of stock ownership and gross income. While it may not have been the intention of an individual or of a group to form a personal holding company, circumstances may arise during a year which would qualify the corporation as one. A change in stock ownership, a change in the type of gross income or a change in the amount of gross income could very well transform an operating company into a personal holding company. This transformation often goes unobserved. When it is not recognized, a penalty for the failure to file a personal holding company return can be imposed.[11]

To ascertain whether any corporation is or is not a personal holding company two tests are to be applied: one relates to stock ownership,[12] the other involves gross income.[13] There are certain corporations, however, which are exempt regardless of the two tests.[14] First, it should be determined if five or fewer individuals own, directly or indirectly, 50% or more of the corporation's stock. If this stock ownership test is passed, then it is necessary to examine the gross income of the corporation. Much difficulty can be avoided if the rules concerning gross income as applicable to personal holding companies are studied and understood.

Section 501(a) (1) of the Internal Revenue Code, dealing with the gross income requirement, states that the corporation is a personal holding company if:

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[11] For a discussion of the penalty imposed for failure to file a return, see *Hatfried, Inc. v. Comm.*, 162 F. (2d) 628 (3d Cir. 1947) and *Haywood Lumber & Mining Co. v. Com.*, 178 F. (2d) 769 (2d Cir. 1950).

[12] INT. REV. CODE § 501; *See also* § 503 (a) as to the rules concerning constructive ownership.

[13] INT. REV. CODE § 501 (a) (1).

[14] INT. REV. CODE § 501 (b). This section lists seven exceptions; tax exempt corporations, certain banks, life insurance companies, surety companies, foreign personal holding companies, certain licensed personal finance companies and certain loan or investment companies.

"at least 80% of its gross income for the taxable year is personal holding company income defined in Section 502." [15]

The relationship between personal holding company income and gross income is the important factor, while the amount of each is relatively insignificant. Although personal holding company income is defined with some degree of exactitude by the Internal Revenue Code, gross income is not. This lack of a specific definition often results in a difference of opinion of just what is gross income, particularly as it is used in connection with personal holding companies. In the section of the Internal Revenue Code dealing with personal holding companies, gross income is not specifically defined, but it is provided that the terms used shall have the same meaning as when used in the sections relating to income tax.[16] The Regulations[17] issued by the Commissioner of Internal Revenue state:

> "In determining whether the personal holding company income is equal to the required percentage of the total gross income, the determination must not be made upon the basis of gross receipts, since gross income is not synonymous with gross receipts. For a further discussion of what constitutes 'gross income,' see section 22(a) and sections 29.22(a)-1 to 29.22(a)-20, inclusive." [18]

The Code section referred to above is not particularly helpful in defining gross income for this purpose. It is an all inclusive provision[19] and is too broad to account for the many varied situations in which gross income is involved. The Commissioner's Regulations, however, attempt to define gross income as it applies to various situations.[20] The Courts have also advanced their in-

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[15] The percentage requirement is reduced to 70% for three consecutive years following the years in which the 80% test is met.

[16] INT. REV. CODE § 507 (a).

[17] U. S. Treas. Reg. 111, § 29.501-2.

[18] The reference "22 (a)" refers to the Internal Revenue Code while the reference "29.22 (a)-1" refers to the applicable section of the regulations.

[19] INT. REV. CODE § 22 (a). This section defines gross income to be gains, profits and income derived from salaries, wages or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from *any source whatever.* (Emphasis supplied.)

[20] U. S. Treas. Reg. 111, §§ 29.22 (a)-1 through 22. The most important of these are paragraphs 1 ("in general"), 5 ("from business") and 7 ("of farmers").

terpretations as the occasion arose. No specific rule can be given which would cover all taxpayers and all situations. Each instance must be examined in the light of the Regulations and the Court decisions.

It must be remembered that it is gross income, not gross receipts, which is important. Even though the Regulations[21] require farmers to include gross receipts in gross income such is not the case where a personal holding company is in issue. For that purpose gross receipts are to be reduced by the cost of production.[22] Since income from farming is not personal holding company income, a reduction of farm gross income by cost of production would increase the ratio of personal holding company income to total gross income. The change in the ratio might transform an indicated operating company into a personal holding company.

Again, in reporting gain from the sale of securities on an income tax return, the net gain is shown, in other words, losses on sale are deducted from gains. However, for personal holding company purposes, gross income includes only the gains.[23] Thus, more than a superficial look at an income tax return is needed to determine the relationship of personal holding company income to total gross income.

Many other problems may arise regarding the relationship between personal holding company income and gross income. A few examples will suffice. A parent corporation may perform a service for its subsidiary for which it makes a service charge. The question arises whether the service charge is gross income or whether it is a reimbursement of amounts advanced for expenditures. The corporation may even incur a loss in this respect, but still may be classed as a personal holding company, if it is determined that the service charge is gross income.[24]

A merchandising or manufacturing corporation which also has some personal holding company income (such as royalties

[21] U. S. Treas. Reg. 111, § 29.22 (a)-7.

[22] Woodside Acres, Inc. v. Com., 134 F. (2d) 793 (2d Cir. 1943); Garrett Holding Co., 9 T. C. 1029 (1947). In the opinion of the Court, the regulation relating to gross income of farmers was not written with the personal holding company problems in mind, consequently the regulation should not be followed "blindly."

[23] Telegram dated March 4, 1952 signed by Acting Deputy Commissioner reproduced at 1 P-H 1952 Fed. Tax Serv., § 4812-B.

[24] Andrew Jergens Co., 40 BTA 868 (1939); Com. v. Kresge Department Stores, 134 F. (2d) 76 (3d Cir. 1942).

or dividends) may find itself concerned with this problem. Suppose in a given year sales decline; as a result, gross income from operations may be reduced to the extent that its personal holding company income constitutes more than 80% of the total. If management's attention is not called to this situation in order to take preventive measures, the corporation will be subject to the personal holding company surtax. A corporation may feel secure in that 60% of its gross income in one year is personal holding company income. Suppose, however, that a revenue agent concludes that a portion of its non-personal holding company income should have been reported in some other year. Possibly he may increase gross income by disallowing some item included in cost of sales; or he may determine that an item included in cost of sales should be classified as some other type of expense. Either of the above could change the relationship between personal holding company income and gross income to such an extent that the personal holding company provisions would apply.

Under the above situations, corporations which were not created or intended to be personal holding companies may unwittingly become so classified. A reclassification of deductions by a revenue agent, a disallowance of an item of cost of sales, business reverses, an arbitrary conclusion as to type of deduction, a fortuitous gain resulting from a sale of securities, all of the foregoing and more, may transform an operating company into a personal holding company. There may have been no thought on the part of the stockholders to avoid surtax and no intention to create a personal holding company. Yet through circumstances over which the corporation and its management probably had no control, the almost confiscatory personal holding company surtax will be imposed.

It is unlikely that the law could be rewritten to exclude such corporations from undeserved penalties without providing loopholes for those which are truly personal holding companies. Therefore, it is up to management, their attorneys and accountants, to be on the alert for the various possibilities and to recognize them in time to take corrective measures.