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PERSONAL HOLDING COMPANIES AND THE REVENUE ACT OF 1964

Jerome B. Libin*

By 1964, many years had elapsed since significant changes were made in the federal income tax treatment of so-called "personal holding companies." For that reason alone, any amendments contained in the Revenue Act of 1964 that dealt with personal holding companies would have deserved attention. But the fact is that the changes made by the 1964 Act are so powerful in their thrust that they require the most careful kind of study by every practitioner charged with advising closely held corporations. Since the new provisions are rather complicated in nature, such a study cannot lead to a full understanding of their scope and effect without a proper appreciation of the reasons behind their enactment.

I. INTRODUCTION

A. The Problem in General

Marked differences in the taxation of income based solely upon the nature of the earning entity have long stimulated fertile imaginations interested in achieving significant tax savings. Wealthy individuals with sizeable amounts of investment income would particularly benefit if careful planning could prevent a substantial portion of their income from being subjected to a federal tax bite. To serve this end, unquestionably the most popular technique employed has been the use of a corporation to conduct one's business or investment activities with little or no distribution of corporate earnings. Income generated in this manner would be taxed only at relatively low corporate rates, and a much greater proportion of total earnings could thus be accumulated and held available for later use in whatever manner was desired.

B. Initial Congressional Approach to the Problem

Since the revenue laws are designed, in general terms, to tax all income that is "fairly" attributable to each particular taxpayer, Congress recognized from the outset that certain safeguards would be needed to thwart schemes formulated for the sole purpose of escaping taxes that should fairly be incurred. In fact, the Revenue Act of 1918, our first modern-day income tax act, was partially de-
signed to reduce the potential use of a corporation for just such a purpose.

To blunt the effectiveness of using the corporate form to escape individual income taxes, the 1913 Act contained a provision that taxed directly to individual stockholders their pro rata share of any corporate earnings that had been accumulated rather than distributed if the purpose of the accumulation was avoidance of the surtax then imposed on individuals receiving dividend income. By way of presumption, it was further provided that, if the corporation in question was a "mere holding company" or if earnings were accumulated beyond reasonable business needs, that would be prima facie evidence of the proscribed purpose. Application of this provision could be prevented, however, if the Commissioner failed to carry the ultimate burden of proving that the accumulation of earnings actually was for the purpose of avoiding the surtax on stockholders.

Succeeding revenue acts contained accumulated earnings provisions in essentially the same form. But, in 1921, as a result of certain language in the Supreme Court decision of *Eisner v. Macomber* that raised some doubt about the constitutionality of taxing stockholders on their pro rata share of undistributed corporate income, the burden of the tax was shifted from the stockholders to the corporation, and the tax thus became an additional penalty tax at the corporate level. Imposition of the tax could still be prevented, however, if the Commissioner failed to establish that the accumulation was for the proscribed purpose.

In any event, regardless of the form of the tax on accumulated earnings, it did not prove to be a universal deterrent to tax avoidance schemes. Litigation under the applicable provisions found the Commissioner of Internal Revenue meeting with only limited success, and use of the corporate form to accumulate business and investment income continued in a relatively unabated manner.

Finally, in 1933, a subcommittee of the House Ways and Means

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2. Ibid.
4. 252 U.S. 189, 217-19 (1920). It seems clear, however, that the Court was concerned with the constitutionality of a tax on the stockholder's share of earnings and profits "accumulated" by the corporation, rather than with a tax imposed at the time such profits were earned.
Committee undertook a special study of prevalent tax avoidance schemes. Its conclusion was that use of the so-called "incorporated pocketbook"—a corporation formed merely to hold securities or other income-producing property and to accumulate investment income without making significant distributions to its stockholders—had become perhaps the most prevalent tax avoidance scheme of all. The subcommittee recommended the enactment of new provisions to deal specifically with the incorporated pocketbook problem. The Treasury, although it found fault with the details of the subcommittee's recommendations, nevertheless also urged the Congress to enact appropriate legislation. The accumulated earnings provision was proving too easily avoidable in application due to the necessity of establishing a tax-avoidance purpose for the accumulation; it was the feeling of all concerned that more effective statutory provisions were needed to cope with the incorporated pocketbook type of abuse.

II. CONGRESSIONAL RESPONSE TO USE OF THE "INCORPORATED POCKETBOOK"

A. The Revenue Act of 1934

The concern expressed by both the subcommittee on tax avoidance and the Treasury provided the impetus for enactment of the first "personal holding company" provisions in 1934. The basic evil of the incorporated pocketbook was use of the corporate form to realize and accumulate purely passive investment income—income normally not associated with the active conduct of a business enterprise—in order to avoid the high individual surtaxes to which such income would have been subjected if personally realized by the individual investor. Regardless of the nontax reasons that might be advanced for use of the corporate form, the integrity of the federal income tax laws required that income earned by a mere corporate shell and not generally associated with corporate business activity should not be taxed at low corporate rates. Investment income in particular was considered more properly the subject of an individual income tax, since its realization is, in most cases, more directly associated with individual rather than business activity. Both the rather descriptive "incorporated pocketbook" label and the more subtle "personal holding company" designation selected by the Con-

7. See SUBCOMMITTEE OF THE HOUSE COMM. ON WAYS AND MEANS, 75th Cong., 2d Sess., PRELIMINARY REPORT ON THE PREVENTION OF TAX AVOIDANCE 6-8 (1933).
8. See H.R. REP. No. 704, 73d Cong., 2d Sess. 1 (1934). In a statement by then Acting Secretary Morgenthau, the Treasury criticized the proposed legislation on the ground that it was overspecific and thus could be too easily avoided. Id. at 8.
gress served to underscore the feeling that personal income-producing activity should not be allowed to benefit from the relatively low, business-oriented corporate tax. Moreover, there was no good reason why a corporation used for such a purpose should not be the subject of a special tax without need for further proof of tax avoidance motives.

With this in mind, the House and Senate agreed upon a set of provisions that defined a “personal holding company” as any corporation that derived at least eighty per cent of its gross income for the year from royalties, dividends, interest, annuities, and gains from the sale of stock or securities and that had more than fifty per cent in value of its outstanding stock owned by not more than five individuals at any time during the last half of the year. If a corporation qualified as a “personal holding company,” it would be subject to a tax on its “undistributed adjusted net income” at the rate of thirty per cent on the first one hundred thousand dollars of such income and forty per cent on the excess of such income. “Undistributed adjusted net income” was, essentially, the corporation’s net income after certain adjustments. The principal adjustments included an arbitrary allowance for a reasonable reserve for contingencies, a deduction for reasonable amounts used or set aside for the retirement of indebtedness that had been incurred prior to 1934, and a deduction for all dividends paid during the year.10

B. The Revenue Acts of 1935 and 1936

In 1935, the tax rates on personal holding companies were altered upward;11 but, in 1936, the rates were adjusted downward slightly.12 The Revenue Act of 1936 also extended the dividends-paid credit claimed by personal holding companies to amounts distributed in liquidation, even though such amounts were treated by individual


11. Revenue Act of 1935, ch. 829, § 109, 49 Stat. 1020. The new rates ranged from twenty per cent of the first two thousand dollars of undistributed adjusted net income to sixty per cent of such income in excess of one million dollars.

12. Revenue Act of 1936, ch. 690, § 351, 49 Stat. 1732. The new rates ranged from eight per cent of the first two thousand dollars of undistributed adjusted net income to forty-eight per cent of such income in excess of one million dollars.
shareholders as having been received in exchange for their stock rather than as ordinary dividends.¹³

C. The Revenue Act of 1937

Not satisfied that the ultimate in corrective legislation had been achieved, and in conjunction with the Treasury's continued efforts to uncover tax avoidance schemes, a special Joint Committee on Tax Evasion and Avoidance of the Congress undertook a further study of the tax avoidance problem. The Committee held hearings and rendered its report in early 1937.¹⁴ Its recommendations for legislation included a number of provisions designed specifically to broaden the reach of the personal holding company rules as well as to strengthen their effectiveness.

Most of the recommendations of the Joint Committee were enacted as part of the Revenue Act of 1937. These included the following:

1. Extension of the “incorporated pocketbook” concept to cover what had become known as the “incorporated talent” abuse by treating as personal holding company income amounts received by a closely held corporation from contracts for personal services when some person other than the corporation had the right to designate who would perform the services and the person who could be designated to perform the services was at least a twenty-five per cent stockholder.¹⁵

2. Further extension of the personal holding company concept to cover the “incorporated yacht” abuse by treating as personal holding company income certain amounts received by a closely held corporation as compensation for the use of, or the right to use, corporate property when the person using the property was at least a twenty-five per cent stockholder.¹⁶

¹³. Revenue Act of 1936, ch. 690, §§ 27(£), 115(c), 351(b)(£)(C), 49 Stat. 1665, 1687, 1732. While the House Ways and Means Committee had proposed complete elimination of the personal holding company provisions in conjunction with its proposal for an undistributed profits tax, the Senate rejected this approach and retained the personal holding company provisions with minor changes. See generally S. REP. No. 2156, 74th Cong., 2d Sess. 17 (1936).


¹⁵. Revenue Act of 1937, ch. 815, § 1, 50 Stat. 813, adding § 353(£) to the 1936 Act. See H.R. Doc. No. 337, 75th Cong., 1st Sess. 13-14 (1937). See also H.R. REP. No. 1546, 75th Cong., 1st Sess. 5-6 (1937). The Commissioner's inability to impose an accumulated earnings tax on a corporation formed by a leading cartoonist, which then employed the cartoonist and in effect earned and accumulated his income, helped to highlight the need for this provision. See Fisher & Fisher, Inc., 32 B.T.A. 211 (1935), aff'd per curiam, 84 F.2d 996 (2d Cir. 1936).

¹⁶. Revenue Act of 1937, ch. 815, § 1, 50 Stat. 813, adding § 353(£) to the 1936
3. Recognition of the fact that rental income may, in some instances, be purely passive in character by treating “rents” as personal holding company income unless they amounted to at least fifty per cent of gross income. It was felt that application of a fifty per cent test in the case of rental income would bring non-bona fide real estate companies within the scope of the personal holding company provisions and would, at the same time, protect legitimate operating companies. The fifty per cent test was also designed to prevent a corporation from avoiding personal holding company treatment merely by investing enough in rents to produce twenty-one per cent of its total gross income, while deriving the remainder of its income from dividends and interest.

4. Reduction of the overall percentage of “gross income” requirement for acquiring personal holding company status from eighty to seventy per cent for each year following the year in which a corporation was first treated as a personal holding company until the corporation’s personal holding company income fell below seventy per cent of its gross income for three successive years or until a year in which the stock ownership test was not met, thereby making it more difficult to avoid personal holding company treatment in years after such status was once acquired.

5. An increase in the rate of personal holding company tax to sixty-five per cent on the first two thousand dollars of undistributed personal holding company income and seventy-five per cent on the excess over two thousand dollars to discourage further the use of personal holding companies.

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Act. This provision stemmed from a discovery that certain high-bracket individuals were incorporating their yachts, country estates, and similar property along with their income-producing securities, were paying the corporation only a minimum “rent” to cover the expenses incurred in their use of the property, and were absorbing and deducting the balance of their operating expenses against dividend or interest income. See H.R. Doc. No. 337, 75th Cong., 1st Sess. 12-13 (1937). See also H.R. Rep. No. 1546, 75th Cong., 1st Sess. 6 (1937).

To restrict further the use of this avoidance device, it was also provided that, in computing the personal holding company tax, the deductions allowed for expenses incurred in maintaining property owned by a personal holding company could not exceed the amount of compensation received for use of the property except under certain specific conditions that would tend to show genuine business activity. Revenue Act of 1937, ch. 815, § 1, 50 Stat. 815, adding § 356(b) to the 1936 Act.

17. Revenue Act of 1937, ch. 815, § 1, 50 Stat. 815, adding § 353(g) to the 1936 Act.
6. Elimination of the cushion afforded by the arbitrary accumulation allowance. At the same time, however, Congress rejected a recommendation of the Joint Committee to eliminate the deduction allowed for amounts set aside to retire pre-1934 indebtedness.

In addition to the foregoing changes, the 1937 Act also altered the treatment of income from mineral, oil, or gas royalties. Such income would no longer be considered personal holding company income if it exceeded fifty per cent of gross income and if business expenses incurred in connection with such mineral royalty income were equal to fifteen per cent of gross income.

D. 1938 Amendments

The following year the House Ways and Means Committee urged the enactment of an additional, new penalty tax, to be imposed automatically on certain closely held corporations having net incomes in excess of 75 thousand dollars that did not qualify as personal holding companies but that, in general, distributed less than sixty per cent of their net incomes.

Interestingly, the House rejected the proposed new tax, but the Senate felt some action was needed and responded by "dealing with this problem where it should be dealt with," in the accumulated earnings area. It proposed the enactment of an amendment to the accumulated earnings provision that would shift to the corporation the burden of proving, by a clear preponderance of the evidence, the absence of a purpose to avoid the surtax on its stockholders once it was determined by the Commissioner that earnings had been unreasonably accumulated. It was believed that such a shift in the burden of proof would strengthen the accumulated earnings provision considerably, and the amendment was therefore included in the Revenue Act of 1938. The accumulated earnings tax thus would be imposed on the full amount of earnings that were accumu-

24. The new tax was proposed because of a continuing belief that some closely held corporations that fell outside the reach of the personal holding company provisions were unquestionably being used to avoid the imposition of surtaxes on their stockholders, while the accumulated earnings provision was not successfully policing such tax avoidance due to the difficulty involved in establishing the proscribed purpose for the accumulation. See H.R. REP. No. 1860, 75th Cong., 3d Sess. 53-57 (1938).
lated unless the corporation clearly established the absence of the proscribed purpose with respect to the entire accumulation. 27

E. Changes Made in 1954 and Subsequent Years

After this flurry of legislative activity in the 1930's, no further changes of any substance were made in either the personal holding company provisions or the accumulated earnings provisions for many years. 28

In 1954, amendments were made to the personal holding company rules that included elimination of the seventy per cent gross income test for determining personal holding company status in succeeding years and restoration of the straight annual eighty per cent gross income test for that purpose, 29 modification of the "incorporated yacht" provisions, 30 and a limitation on the treatment of capital gains from the sale of stocks or securities to include only the net capital gains from such sales as personal holding company income. 31

Also in 1954, because of numerous complaints that had been received from various taxpayers, a number of liberalizing changes were made in the accumulated earnings provisions. 32 These included: first, an amendment designed to shift to the Commissioner the burden of proving the unreasonableness of an accumulation in certain cases, 33 and, second, a change in the basic application of the tax through the allowance of a credit for the amount of earnings that were accumulated for reasonable business needs. 34

27. It seems clear that rejection by Congress of the proposed new tax, coupled with the decision to strengthen the accumulated earnings provisions, reflected a strong belief that an automatic penalty tax, such as that imposed by the personal holding company rules, should be limited to those situations that more or less on their face revealed rather obvious tax avoidance motives.

28. The rates of tax on undistributed personal holding company income were increased in 1942 to seventy-five per cent of the first two thousand dollars of such income and eighty-five per cent of the excess over two thousand dollars. Revenue Act of 1942, ch. 619, § 181, 56 Stat. 894, amending § 500 of the Int. Rev. Code of 1939.

29. INT. REV. CODE OF 1954, § 542(a)(1), as originally enacted. The explanation offered for this change was that it would "provide for more uniform treatment of taxpayers and will avoid the entrapment of taxpayers which may occur under present law." S. REP. No. 1622, 83d Cong., 2d Sess. 73 (1954).

30. INT. REV. CODE OF 1954, § 543(a)(b), as originally enacted. The amendment required that other personal holding company income equal ten per cent or more of gross income before amounts received from a twenty-five per cent shareholder as compensation for the use of property would be treated as personal holding company income. It was felt that, without appreciable amounts of other personal holding company income, "rental" income received from shareholders did not pose a serious avoidance problem. See S. REP. No. 1622, 83d Cong., 2d Sess. 73 (1954).

31. INT. REV. CODE OF 1954, § 543(b), as originally enacted.


33. INT. REV. CODE OF 1954, § 534.

34. INT. REV. CODE OF 1954, § 535(a)(1). A minimum credit of sixty thousand dollars was provided, and this figure was increased to one hundred thousand dollars in 1958.
Then, in 1960, the treatment of copyright royalties in the personal holding company setting was relaxed.35

Notwithstanding the various changes made in 1954 and thereafter, however, the basic outlines of the personal holding company rules as first shaped in 1934 and as broadened in 1937 continued over the years to provide the principal firepower for the attack against this abuse of the corporate form.

III. Soft Spots and Supplemental Weapons

Perhaps the primary reason for the general lack of significant changes in the personal holding company rules from 1937 to 1964 was the unquestioned success that the original provisions enjoyed. There can be no doubt that enactment of the first personal holding company provisions in 1934, together with the strengthening amendments of 1937, swiftly put an end to most, if not all, of the flagrant tax avoidance schemes that had formed the basis for legislative action. Yet it was not to be doubted that the passage of time would eventually bring to light various weaknesses in the existing set of rules.

A. The Eighty Per Cent Gross Income Requirement

One soft spot in the personal holding company provisions that gradually became more and more apparent involved the overall eighty per cent gross income test for determining personal holding company status. It was true that, by requiring only eighty per cent of a closely held corporation's gross income to be derived from essentially passive sources before the corporation would qualify as a personal holding company, those corporations that had been used by their stockholders for the purpose of housing exclusively investment-type income were forever doomed. But, for those stockholders willing to have their corporations undertake a limited amount of operating activity sufficient to produce at least twenty-one per cent of total gross income, personal holding company status could be avoided with relative ease.

Perhaps because it came too soon after the original provisions had been enacted, the study undertaken by the Joint Committee on
Tax Evasion and Avoidance in 1937 had not produced any recommendation in this regard. Apparently satisfied with the eighty per cent test as a starting point, the Joint Committee had expressed concern only with the fact that a corporation that qualified as a personal holding company could avoid that classification in subsequent years without altering the nature of its operations to any substantial extent. The Committee's proposal to reduce the gross income test from eighty to seventy per cent for all years after the year in which a corporation was first classified as a personal holding company unless the corporation's personal holding company income fell below seventy per cent for three successive years in no way hampered a corporation which, from its inception, had so arranged its affairs as to shelter investment income equal to no more than seventy-nine per cent of its total gross income.

As has been seen, from 1937 to 1964 the only congressional action involving this area came in 1954 when the seventy per cent test was eliminated. No steps were taken to tighten the eighty per cent test in any way, and the opportunity for sheltering sizeable benefits thus continued unrestrained.

B. Other Techniques for Sheltering Investment Income

In addition to the possibility of using a relatively small amount of operating income to shelter substantial amounts of investment income, it was also possible for the sheltering itself to be done by certain other types of income that were not necessarily derived from operating activity. Gains from the sale of capital assets other than stocks, securities, and commodities, as well as gains from the sale of section 1231 property, provided one such sheltering opportunity. Although gains of this type were included in total gross income for purposes of applying the eighty per cent test, they were not treated as personal holding company income. Thus, if sufficient in amount and properly timed, they could, of themselves, serve to block personal holding company treatment.

Similarly, items such as rents or mineral royalties, if equal to fifty per cent of gross income, could effectively shelter an equivalent amount of dividend or interest income without fear of personal holding company problems. While it was thought that the fifty per

36. See text accompanying note 18 supra.
37. See text accompanying note 28 supra.
38. See INT. Rev. CODE OF 1954, § 543(a), as originally enacted.
39. INT. Rev. CODE OF 1954, §§ 543(a)(7) and (8), as originally enacted. In the case of mineral, oil, or gas royalties, there was an additional requirement that allowable trade or business expense deductions equal fifteen per cent or more of gross income.
cent of gross income requirement, as applied to rents and mineral royalties, would assure non-personal holding company treatment only for the income derived from bona fide real estate or mineral operations, this was not necessarily so. Moreover, the investment needed to produce gross rents or royalties equal to fifty per cent of total gross income would in many instances prove to be far less than the corporation's investment in securities producing the other fifty per cent of gross income. Thus, it was not too difficult for corporations having a sizeable investment in income-producing securities to avoid personal holding company status through a relatively small, passive investment in real estate or mineral properties.

C. Certain Other Types of Passive Income

Still further, it was soon to become apparent that the personal holding company provisions did not reach all types of passive income, even when no sheltering scheme was involved. For example, it had become a known and frequent practice for a corporation to be formed for the purpose of purchasing the negative of a motion picture film with the intention of distributing the film for public consumption. Since income realized by the corporation from the distribution of its negative was treated as rental income and since such income typically represented the entire gross income of the corporation, personal holding company status would be avoided notwithstanding the fact that one hundred per cent of the corporation's income was essentially passive in nature.

D. Liquidations

Another soft spot in the personal holding company area involved the opportunities presented on liquidation for converting ordinary investment income into capital gain in the hands of stockholders without the corporation incurring a personal holding company tax. This was possible because the dividends-paid deduction allowed to corporations under the personal holding company provisions included amounts distributed in liquidation, although such distributions were not treated as regular dividends to the shareholders. 42
While the apparent reason for this favorable treatment was to encourage the liquidation of personal holding companies,\textsuperscript{43} it was clear that such treatment of liquidating distributions could not be reconciled with the basic purpose of the personal holding company provisions—to force the distribution of income that would be taxed to shareholders as though it had been earned by them.

\textbf{E. The Commissioner's Other Weapons}

The Commissioner, of course, was not powerless to deal with situations where investment income had been accumulated rather than distributed by a corporation that nevertheless managed to avoid personal holding company classification. He could always turn to the accumulated earnings provision, and, theoretically at least, he would seem to have a reasonable chance of prevailing in those instances in which it was relatively apparent that a limited amount of operating income was being used merely to shelter substantial amounts of investment income. Yet surprisingly, since the enactment of the personal holding company provisions, there have been only a very few reported cases under the accumulated earnings provision in which the Commissioner has challenged the accumulations of a corporation that appeared to be of the holding company variety.\textsuperscript{44} There is, of course, no way to ascertain the number of instances in which the proposed imposition of an accumulated earnings penalty tax on such a corporation has led to a distribution of corporate earnings. Nevertheless, the paucity of litigated cases of this type suggests that the Commissioner's experience generally under the accumulated earnings provision may have led to the conclusion that a more vigorous litigation policy with respect to corporations that were almost, but not quite, personal holding companies would somehow not bear fruit. No doubt the liberalizing amendments made to the accumulated earnings provisions in 1954 and 1958 contributed heavily to this line of reasoning.

\textit{Indeed, it may well be that the general frustration experienced history of these provisions is traced to the Revenue Act of 1936. See text accompanying note 13 \textit{supra}.}


\textsuperscript{44} See, e.g., Nemours Corp., 38 T.C. 585 (1962), \textit{aff'd} \textit{per curiam}, 325 F.2d 559 (3d Cir. 1963); Wellman Operating Corp., 33 T.C. 162 (1959); Semagraph Co., 3 P-H \textit{Tax Ct. Mem.} \textit{¶} 44264 (1945), \textit{aff'd}, 152 F.2d 62 (4th Cir. 1945). The overwhelming majority of cases decided under the accumulated earnings tax provision that have involved taxable years subsequent to 1937 have concerned genuine operating corporations. The accumulated earnings tax is, of course, inapplicable to corporations that meet the personal holding company test. \textit{Int. Rev. Code of 1954}, \textsection 532(b)(1).
in this area is what recently led the Commissioner to try a wholly new approach to the problem. Section 269 of the 1954 Code does not ordinarily come to mind when probing the personal holding company area. But, in a recent case, the Commissioner sought to invoke that provision to disallow the eighty-five per cent dividends-received deduction claimed by a corporation whose sole stockholder had transferred to it a block of dividend-paying stock of another corporation. The potential use of section 269 as a weapon against corporations that stand beyond personal holding company classification appears at first blush to be formidable, for, if that statute can be invoked to disallow the dividends-received deduction, corporations utilized to receive sizeable amounts of dividend income will provide substantially reduced tax benefits to their stockholders. A regular corporate tax on a full one hundred per cent, rather than only fifteen per cent, of dividends received will in most cases cost the corporation in taxes an additional forty per cent of the dividends received.

While the Commissioner was unsuccessful in his one litigated effort to invoke section 269 in this manner against the dividends-received deduction, the court chose to rest its decision on the facts there involved and did not undertake to analyze the legal soundness of the Commissioner's new approach. If the Commissioner is to pursue this course in the future, however, he might do well to consider that the objective of section 269, as revealed by its legislative history in 1943, was "to prevent the distortion ... of the deduction, credit, or allowance provisions of the code." On the other hand,

45. Section 269 of Int. Rev. Code of 1954 is captioned: "Acquisitions made to evade or avoid income tax." It provides in pertinent part that, if any person acquires "control of a corporation ... and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy," the Commissioner may disallow all or any part of such deduction, credit, or other allowance.

46. Armais Arutunoff, 22 P-H Tax Ct. Mem. ¶ 63192 (1963). The Commissioner contended that the sole stockholder of the dividend-receiving corporation had acquired control of that corporation for the purpose of avoiding taxes by securing indirectly the benefit of the dividends-received deduction allowed to the corporation.

47. Ibid. In Commodores Point Terminal Corp., 11 T.C. 411 (1948) (Acq. 1949-1 Cum. Bull. 1), the only other case in which § 269 was invoked in an effort to disallow the dividends-received deduction, the Commissioner took a different tack and did not contend that the individual stockholder of the dividend-receiving corporation had acquired control of that corporation to secure the benefit of the dividends-received deduction.

48. See S. REP. No. 627, 78th Cong., 1st Sess. 58 (1943). The general legal effect of the provision was expected to be that of emphasizing "the ineffectiveness of arrangements distorting or perverting deductions, credits, or allowances so that they no longer bear a reasonable business relationship to the interests or enterprises which produced
the purpose of the dividends-received deduction was to permit only a relatively minimal second tax at the corporate level on income that remained in corporate solution. If section 269 is ever utilized to disallow the dividends-received deduction, the effect would be to subject dividend income to a second full tax at the corporate level, contrary to the very purpose behind the dividends-received deduction. Ironically, such an application of section 269 thus would produce a distortion of the purpose behind the deduction. Such a result would unquestionably conflict with the objectives of the statute. For this reason, it may well be that the Commissioner's use of section 269 in this manner will never be sustained by the courts, notwithstanding the broad language of the statute itself.

At any rate, while the Commissioner was not without supplemental weapons to invoke against the accumulation of investment income by corporations outside the reach of the personal holding company provisions, his general difficulty in employing those weapons unquestionably bolstered the case for additional statutory assistance.

IV. THE REVENUE ACT OF 1964

It was against this background that a strengthening of the personal holding company provisions was considered by the Kennedy-Johnson Administration as a part of the modest "tax reform" program that it had been committed to undertake.

One approach, of course, might have been to junk the personal holding company provisions completely and to revert to the pre-1934 policy of relying almost entirely upon the penalty tax on unreasonably accumulated earnings to prevent the evils at which the personal holding company rules had been aimed. In view of the Commissioner's mediocre record in this area, however, it unquestionably would have required a major revision of the accumulated earnings provisions to accomplish this objective, and neither the Treasury nor the Congress showed any inclination to pursue this course. Rather, the decision was to improve and strengthen the existing personal holding company provisions in such a way as to eliminate the various weaknesses that had come to light.

To this end, the Revenue Act of 1964 has introduced some rather complicated corrective amendments into the personal holding

them and for the benefit of which they were provided." The basic reason for enactment of the provision was the excessive "trafficicking" in loss corporations after high wartime income and excess profits tax rates were imposed.

company area. Notwithstanding this fact, however, the changes that have been made appear to be exceptionally effective. Indeed, some of the changes are so sweeping in nature that they have to a large extent restored the *in terrorem* flavor that accompanied enactment of the first personal holding company provisions thirty years ago.

While the basic approach of the personal holding company rules has been preserved, closely held corporations that have both operating and investment income and that previously were well outside the reach of the personal holding company net must now restudy their situations with great care. As a result of the new amendments, there exists the very real possibility that many such corporations might unwittingly fall within the vastly expanded definition of a "personal holding company." For this reason, a meticulous analysis of the 1964 amendments as they may affect any particular situation is essential as a supplement to the general outline of the new provisions that follows.  

**A. Gross Income Requirement**

Initially, it will be recalled that one of the principal faults found with pre-1964 law was the relative ease with which the overall eighty per cent of gross income test could be avoided. By deriving as little as twenty-one per cent of its income from non-personal holding company sources, a corporation was assured of avoiding the personal holding company rules, while at the same time passive investment income equal to seventy-nine per cent of its total gross income was effectively sheltered from high individual tax rates.

The first order of business, then, was to strengthen substantially the basic thrust of the personal holding company provisions. To this end, the Treasury recommended, and the Congress agreed, that the percentage of gross income that would qualify a corporation as a personal holding company should be reduced from eighty per cent to a more "realistic" figure of sixty per cent. In this way, a corporation having a mix of investment and operating income could no longer be used to shelter passive income equal to nearly four times the income it derived from operating activities. Rather, under the new requirement that non-personal holding company income must

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now, in general, exceed forty per cent of total income, operating activity will in many instances have to be virtually doubled if personal holding company treatment is to be avoided, and the maximum sheltering ratio is now fixed at something less than one and one-half to one. For these reasons, the new sixty per cent gross income test must loom large in the mind of every tax planner.

B. Other Techniques for Sheltering Investment Income

Notwithstanding the unquestioned potency of such a sharp reduction in the amount of passive income needed to produce personal holding company status, a series of further statutory changes was also considered necessary before the sheltering of sizeable amounts of investment income would be effectively restrained.

1. Capital Gains

As has been shown, one sheltering opportunity that existed under the pre-1964 rules stemmed from the fact that, although capital gains (other than those arising from the sale of stocks, securities, or commodities) and section 1231 gains were a part of "gross income," they were not considered personal holding company income. While such gains thus could prevent a finding of personal holding company status in a particular case, their very nature dictated against a rule that permitted them to be utilized in such a manner. Nonrecurring, extraordinary gains of this sort should have no real bearing on the tax status of corporations used primarily to realize investment income. By the same token, capital gains derived from the sale of stocks, securities, or commodities do no real violence to use of the corporate form, since individuals selling such items directly typically realize capital gains themselves. It is not essential to the basic personal holding company concept that such gains be treated as personal holding company income.

Accordingly, to limit the taint of personal holding company income to amounts that, in general, would be taxed as ordinary income if realized by individual stockholders and, at the same time, to foreclose the opportunity to use capital gains as a shelter for such income, the 1964 Act eliminates from both the "gross income" and "personal holding company income" definitions all gains from the sale of capital assets and section 1231 property. The elimination of

52. Otherwise, the corporation may be compelled to dispose of some of its income-producing securities.
such gains from gross income thus produces what is called “ordinary
gross income,” the basic figure used in most of the computations
now required under the new personal holding company provisions.  

2. Rents and Mineral, Oil, and Gas Royalties

While the capital gains shelter was one problem that readily
lent itself to correction, some of the other sheltering techniques fre­
quently employed were thought to require more complicated
policing devices.

Among the more popular methods utilized for the sheltering of
investment income has been the acquisition of income-producing
real estate that would generate gross rental income equal to the
passive income being earned in the form of dividends and interest.
Under pre-1964 law, if rental income was fifty per cent or more of
gross income, it did not constitute personal holding company in­
come. If rents thus equalled fifty per cent of total income, an equiva­
 lent amount could be earned in the form of dividends and interest
without fear of running afoul of the personal holding company pro­
visions. Yet, contrary to earlier beliefs, it had become increasingly
clear that the mere receipt of rental income equal to fifty per cent
of total gross income did not always prove the existence of a bona
fide business operation. Moreover, the amount of capital needed
to produce a specific amount of gross rents was likely to be much less
than the amount needed to produce an equivalent amount of divi­
dends and interest. It might be true, of course, that after allowances
for depreciation, interest, and taxes there would be little or no net
rental income. But, to the investor more concerned about sheltering
his dividend and interest income than about earning a profit from
real estate, the fifty per cent of gross income test for rents provided
an easy opportunity to shelter an equivalent amount of dividend or
interest income through a much smaller capital investment than
the amount committed to income-producing securities.

Much the same could be said of income derived from mineral,  

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same line, gain from the sale or other disposition of any interest in an estate or trust
is no longer treated as personal holding company income. See INT. REV. CODE OF 1954,
§ 543(a)(4), as amended, 78 Stat. 81 (1964). Since gain from the sale of stocks and
securities no longer constitutes personal holding company income, many corporations
may be encouraged to dispose of some of their income-producing securities in light of
the new amendments.
oil, and gas royalties. Under pre-1964 law, such royalties, like rents, were not treated as personal holding company income if they constituted more than fifty per cent of total gross income. There was, however, an additional requirement that trade or business deductions relating to the royalty income (other than as compensation for personal services rendered by shareholders) had to equal fifteen per cent or more of gross income in order for the royalties to escape treatment as personal holding company income. While the existence of the business expense requirement in the mineral royalty setting helped somewhat to assure that an active business was being carried on, the use of a pure “gross income” yardstick to measure both the fifty and fifteen per cent requirements for mineral royalties again permitted the sheltering of sizeable amounts of dividend income with a much smaller amount of capital committed to real business activity.

A combination of rather complicated changes was decided upon by the Treasury and the Congress to remedy the abuses that frequently resulted in those cases where rents and mineral royalties were earned by closely held corporations.

(a) Fifty Per Cent Test. As the first step, there came a substantial modification in the fifty per cent of gross income test for rents and mineral royalties. While the fifty per cent concept has been preserved, it has in a sense been dropped from the income level to the investment level. Before the fifty per cent test is now applied, gross rental and mineral royalty income must be adjusted downward by the amount of certain deductions attributable to the investment made in the rental- or royalty-producing property. Thus, for purposes of all personal holding company computations, gross rental income must now be reduced by the deductions allowable for depreciation or amortization, property taxes, interest, and rents paid. Similarly, gross income from mineral, oil, and gas royalties must now be reduced by the deductions allowable for depletion, amortization and depreciation, property and severance taxes, interest, and rents.

55. See Int. Rev. Code of 1954, §§ 548(2)(2), (b)(2), (b)(2)(A), as amended, 78 Stat. 81 (1964). The deductions for “allowable depreciation” undoubtedly include amounts allowable for additional first-year depreciation under § 179. See H.R. REP. No. 749, 88th Cong., 1st Sess. A101 (1963). The adjustments to be made are lumped together and applied against the total gross income from rents, rather than computed on a “separate property” basis. Any problems of allocation among rental and nonrental property are left to the Regulations, and the amount of the adjustments is limited to the total gross income from rents. No adjustment for allowable depreciation is required in the case of rents derived from tangible personal property that is not customarily retained by any one lessee for more than three years.
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paid. The resulting figure is termed "adjusted income from rents" or "adjusted income from mineral, oil, and gas royalties," as the case may be, and it is this figure that must now satisfy the fifty per cent test.

To maintain consistency in the computations, it is also necessary to reduce the denominator used in the test by the same amounts before undertaking to determine whether the fifty per cent figure is satisfied. Accordingly, the "ordinary gross income" figure described earlier must be modified still further by the downward adjustments listed above when rents or mineral royalties figure in the computations. The resulting figure, designated "adjusted ordinary gross income," serves as the new denominator in applying the fifty per cent test.

In short, rents or mineral royalties will now constitute personal holding company income unless the "adjusted income from rents" or the "adjusted income from mineral, oil and gas royalties" is equal to fifty per cent or more of "adjusted ordinary gross income," all calculated as outlined above.

(b) Ten Per Cent Test. Not completely satisfied that the "adjusted income" approach would fully serve to prevent the use of rents as a pure sheltering device, however, the Treasury also recommended the adoption of a second test aimed more precisely at the sheltering problem.

As originally proposed and as adopted by the House, the second

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58. See text accompanying note 54 supra.


A further adjustment required in determining "adjusted ordinary gross income" is the exclusion from "ordinary gross income" of certain items of interest income, including interest received on a direct obligation of the United States held for sale to customers in the ordinary course of business by a regular dealer who is making a primary market in such obligations, and interest received on a condemnation award, a judgment, or a tax refund. Int. Rev. Code of 1954, § 542(b)(2)(C), as amended, 78 Stat. 81 (1964). Such interest items, which are considered as not being truly passive in nature, thus will not constitute "personal holding company income." Int. Rev. Code of 1954, § 542(a), as amended, 78 Stat. 81 (1964). See S. Rep. No. 830, 88th Cong., 2d Sess. 106 (1964).
test provided that rents would be treated as personal holding company income even though they satisfied the fifty per cent of adjusted ordinary gross income test if the corporation had other personal holding company income in excess of ten per cent of its "ordinary gross income." In other words, under no circumstances could rents escape personal holding company treatment if they sheltered other personal holding company income that exceeded ten per cent of ordinary gross income.

The House version of the bill went even further than the Treasury recommended, by extending this so-called "ten per cent test" to mineral, oil, and gas royalties as well. However, the Senate amended the "ten per cent test" with respect to rents by providing that rental income will not be deemed personal holding company income merely because the corporation had other personal holding company income in excess of ten per cent of ordinary gross income, provided that the excess over ten per cent is paid out to stockholders as dividends or else is treated by them as having been paid out in the form of consent dividends. It is important to note that, even as amended by the Senate, the ten per cent test does not permit the use of rents to shelter more than ten per cent of ordinary gross income. It merely provides an escape from personal holding company treatment in those cases in which that portion of the corporation's other personal holding company income that exceeds ten per cent of ordinary gross income is paid out as dividends.

For reasons that were not explained, the Senate did not extend the same benefits to corporations earning mineral, oil, or gas royalties. Consequently, the mere realization of other personal holding company income in excess of ten per cent of ordinary gross income is enough to treat such royalties as personal holding company income, without regard to the amount of dividends paid out by the corporation. The treatment of mineral, oil, or gas royalties thus is similar in this regard to the treatment of copyright royalties.

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63. INT. REV. CODE OF 1954, § 543(a)(2), as amended, 78 Stat. 81 (1964). See S. REP. No. 830, 88th Cong., 2d Sess. 107 (1964). For purposes of applying the ten per cent test with respect to rental income, other personal holding company income does not include amounts received as compensation from a twenty-five per cent stockholder for the use of property owned by the corporation, even though such amounts may otherwise qualify as personal holding company income.
C. Certain Types of Purely Passive Income

It has already been noted that the Treasury was disturbed by a discovery that corporations that were being used for the sole purpose of purchasing a motion picture negative and distributing it to exhibitors throughout the country were not subject to the personal holding company rules. Since the income from such distribution had been considered "rental income" and since such income was the only income derived by the corporation, personal holding company status would be avoided even though the income earned was purely passive in character.

To remedy this defect, the Treasury recommended that income derived in this manner should be treated as copyright royalties, rather than as rental income. The effect of this treatment in the film exhibition setting would be to classify such income as personal holding company income unless the corporation had trade or business deductions sufficient to satisfy the fifty per cent business expense test that is applied to copyright royalties. However, in view of the proposed expansion of the copyright royalty definition, the Treasury further recommended that Congress consider reducing the business expense requirement for such royalties from fifty to twenty per cent of ordinary gross income.65

Congress responded by placing passive film rents under the copyright royalty provisions and by reducing the business expense requirement to twenty-five per cent of ordinary gross income in order for copyright royalties to be assured of avoiding personal holding company treatment.66 An exception was created, however, for "produced film rents," i.e., rents derived from an interest in a film that was acquired before production of the film was substantially complete.67 In view of the activity needed to complete production and to distribute the film in such a case, it was felt that the income ulti-
mately realized on distribution of the film should be treated as rental income rather than as copyright royalties and that such income should not be classified as personal holding company income if it equalled at least fifty per cent of ordinary gross income. 68 There is no additional ten per cent test to be satisfied in the case of "produced film rents," and such income thus enjoys more favorable treatment than other forms of rental income under the new provisions.

For one reason or another, no other forms of purely passive income were dealt with in as direct a manner as were film rents.

D. Liquidating Distributions

Another problem that required attention concerned the proper treatment of distributions made by a personal holding company at the time of its liquidation. As has been shown, the dividends-paid deduction allowed to personal holding companies in computing their "undistributed personal holding company income" has, since 1936, included amounts distributed in liquidation even though individual stockholders have been permitted to treat their distributions as payments received in exchange for their stock rather than as ordinary dividend distributions. 69 Thus, while the very purpose of the personal holding company provisions was to force a distribution of passive investment income into the hands of individual stockholders where it would be appropriately subjected to an individual income tax, the treatment of liquidating distributions seriously thwarted this purpose. Although never clearly articulated, the original reason for this statutorily conferred benefit apparently was to encourage the liquidation of personal holding companies. 70

By 1964, however, it was evidently felt that elimination of the capital gain windfall comported more with the underlying purposes of the personal holding company provisions than did continued encouragement of the liquidation of such companies. To remedy the statutory deficiency, therefore, it was decided to permit a dividends-paid deduction for post-1963 distributions in complete liquidation made to individual stockholders only if such amounts are formally designated as "dividends" by the corporation and are correspondingly treated as such by the recipient shareholders. 71 In that way, a

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69. See text accompanying note 13 supra.
70. See note 43 supra.
 corporation will be able to eliminate its undistributed personal holding company income during the period of complete liquidation, but the amount distributed will be taxed as ordinary dividend income in the hands of the individual stockholders just as if a regular dividend distribution had been made.  

The benefit of the dividends-paid deduction that may be obtained in this way is limited to each individual shareholder’s allocable share of undistributed personal holding company income for the year of distribution (before taking into account amounts distributed in liquidation that will qualify for the dividends-paid deduction). Moreover, since this new treatment is extended only to distributions in complete liquidation that occur within twenty-four months of adoption of the plan of liquidation, distributions in partial liquidation and distributions in complete liquidation that occur beyond the twenty-four month period will no longer qualify for the dividends-paid deduction under any circumstances.  

In those cases in which the stock of a personal holding company is held directly by another personal holding company and only indirectly by individual shareholders, a further defect in the statute was


74. This is true because § 582(b), which originally extended the benefits of the dividends-paid deduction to all types of liquidating distributions made by personal holding companies, has now been limited in its application to distributions made to corporate stockholders in cases of complete liquidation of a personal holding company occurring within twenty-four months after adoption of a plan of liquidation. Int. Rev. Code of 1954, § 582(b), as amended, 78 Stat. 88 (1964). Accordingly, the only provision that extends the benefits of the dividends-paid deduction to distributions in liquidation made to individual stockholders is new § 316(b)(2)(B), which, as indicated, limits the benefits thus extended to amounts distributed in complete liquidation within twenty-four months after adoption of a plan of liquidation. (Section 316(b)(2) must, of course, be read in conjunction with § 582(a) in this connection.) While it is true that § 316(b)(2) does not expressly exclude from its scope distributions in partial liquidation or distributions in complete liquidation occurring after the twenty-four month period, it is clear from the history of the section as originally enacted in 1942 and as amended in 1964 that such distributions are not intended to be within its scope. See S. Rep. No. 1611, 77th Cong., 2d Sess. 176-77 (1942), and H.R. Rep. No. 749, 88th Cong., 1st Sess. A104-07 (1963). See also St. Louis Co. v. United States, 237 F.2d 151 (3d Cir. 1956).
uncovered. If a corporation's earnings and profits for a taxable year exceed its undistributed personal holding company income before the payment of dividends (as in the case where the corporation realizes net long-term capital gains), any distribution out of earnings and profits that exceeds undistributed personal holding company income would be of no benefit to the distributing corporation in that year so far as its personal holding company status is concerned. For that reason, a dividend carryover for two succeeding years is allowed, with the excess distribution in a given year qualifying for the dividends-paid deduction in the subsequent years. Moreover, under the provisions of section 381, if an eighty per cent owned subsidiary with a dividend carryover were to be liquidated under section 332, its parent would succeed to the dividend carryover and would be in a position to enjoy the carryover itself.

To prevent such a windfall from accruing to the astute parent corporation that chooses to liquidate its eighty per cent subsidiary in a year when the subsidiary's earnings and profits exceed its undistributed taxable income, the Treasury and the Congress agreed that with respect to post-1963 distributions in complete liquidation made to corporate stockholders within twenty-four months of the adoption of a plan of complete liquidation, the dividends-paid deduction should be limited to each corporate stockholder's allocable share of undistributed personal holding company income (before taking into account amounts distributed in liquidation that will qualify for the dividends-paid deduction), rather than to its allocable share of earnings and profits for the period. Since this limitation correlates with the limitation now imposed on distributions in complete liquidation made to individual shareholders, it will no longer be possible for the dividends-paid deduction of any corporation to exceed the amount of its undistributed personal holding company income in

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75. See INT. REV. CODE OF 1954, § 545(b)(5).
76. This is so because, once the distributions out of earnings and profits equal the corporation's undistributed personal holding company income, there is no basis on which to impose a personal holding company tax. Any excess distributions out of earnings and profits thus are of no additional benefit to the corporation in the year of distribution as far as the personal holding company rules are concerned.
77. INT. REV. CODE OF 1954, § 564.
78. INT. REV. CODE OF 1954, § 381(c)(14) lists as one item to which a parent corporation will succeed, on the liquidation of a subsidiary under § 332, "the dividend carryover (described in section 564)."
any year in which distributions in complete liquidation are made. In this way, there will be no basis on which a corporation might be entitled to a dividend carryover in the year of its liquidation, and a parent corporation will not fall heir to such a carryover merely by liquidating its eighty per cent owned subsidiary in a year when the subsidiary’s earnings and profits happen to exceed its undistributed taxable income.

E. Devices To Cushion the Impact

While some of the changes that have been made in the personal holding company area are rather limited in scope, Congress fully recognized that others are of a very sweeping nature. For this reason, it sought ways to soften the impact of the new provisions on the untold number of corporations that now are certain to be confronted with personal holding company problems.

1. Deduction for Qualified Indebtedness

Turning first to a device previously used in connection with passage of the first personal holding company provisions in 1934, Congress decided upon a relief provision that would permit a corporation, in computing undistributed personal holding company income, to take a deduction for amounts used or set aside to pay or retire “qualified indebtedness” incurred before the new amendments became effective. The deduction applies to indebtedness incurred after 1933 and before 1964 and extends to any corporation that was not a personal holding company in one of its two most recent taxable years ending prior to January 1, 1964, but would have been a personal holding company if the 1964 amendments had been in force in those years.

The theory behind the debt-retirement deduction, of course, is that a corporation ought not be penalized when its failure to dis-

82. Int. Rev. Code of 1954, § 545(c)(3), added by 78 Stat. 90 (1964). The deduction also applies with respect to indebtedness incurred in 1964 and later years that is used to retire pre-existing “qualified indebtedness,” provided the corporation elects not to deduct the amount thus used to pay the prior indebtedness. See Int. Rev. Code of 1954, § 545(c)(3)(A), (c)(4), added by 78 Stat. 90 (1964).
83. Int. Rev. Code of 1954, § 545(c)(2)(A), added by 78 Stat. 90 (1964). A corporation that was a personal holding company under pre-1964 law in one of its two most recent taxable years ending prior to January 1, 1964, may qualify for the deduction if it was not a personal holding company in the other year but would have been such if the new rules had been in effect then. The deduction also extends to a corporation that acquires a qualified corporation and thereby succeeds to the deduction under § 545(c)(15), as amended, 78 Stat. 92 (1964). See Int. Rev. Code of 1954, § 545(c)(2)(B), added by 78 Stat. 90 (1964).
tribute dividends is tied to its need for funds to retire pre-existing indebtedness. To prevent the allowance of an unintended benefit, however, the deduction for amounts used or set aside for debt retirement must be reduced by the amount of any deduction that the corporation was previously allowed, in computing undistributed personal holding company income, for such non-cash items as depreciation, amortization, depletion, or net long-term capital gains. But for this requirement, a corporation would enjoy the effect of a double deduction with respect to these items. Their prior allowance, while reducing undistributed personal holding company income, also would free a corresponding amount of cash for use in retiring indebtedness. Allowing another deduction at the time those funds were actually so used or set aside would clearly duplicate the benefits to be derived from such items.

2. Favorable Liquidation Treatment

Even more significant relief provisions contained in the 1964 Act make it possible for many corporations to liquidate completely at a minimum current tax cost to their shareholders if such a course proves desirable in light of the new amendments. Interestingly enough, these provisions represent a limited revival of the policy of encouraging the liquidation of personal holding companies through the extension of favorable tax treatment.

As is true for the debt-retirement deduction provision, the special liquidation benefits are available to all so-called “would have been” corporations, those corporations that were not personal holding companies in one of their two most recent taxable years ending prior to the effective date of the 1964 Act but that “would have been” personal holding companies if the new amendments had then been in effect. Since many such corporations may hold assets that have substantially appreciated in value, Congress has applied the principles, and enlarged upon the benefits, of section 333 in favor of those “would have been” corporations that choose to liquidate in relatively short order.

84. Int. Rev. Code of 1954, § 545(c)(5), added by 78 Stat. 90 (1964). Special rules are provided for those cases in which property subject to a depreciation allowance is disposed of by the corporation, if such disposition has the effect of relieving the corporation of “qualified indebtedness.” Int. Rev. Code of 1954, § 545(c)(6), added by 78 Stat. 90 (1964).


86. The special liquidation provisions are contained in Int. Rev. Code of 1954, § 333(g), added by 78 Stat. 89 (1964). Shareholders of corporations that qualify for special liquidation treatment must make the appropriate elections under § 333(e) or (f).
Three separate sets of rules have been established, each geared to a specific period of time during which liquidation must take place.

(a) **Corporations That Liquidate Before 1966.** If a corporation that otherwise qualifies for the special liquidation benefits chooses to liquidate before 1966 and if the liquidation is completed within one calendar month, each shareholder of the corporation who has held his stock over six months will be taxed at long-term capital gain rates on that portion of his gain that does not exceed his ratable share of the corporation's accumulated earnings and profits, with any remaining gain to him recognized (and taxed as a long-term capital gain) only to the extent that the value of any property distributed to him that consists of money or of stock or securities acquired by the corporation after 1962 exceeds his ratable share of earnings and profits. The balance of the shareholder's gain on liquidation will be tax-deferred.

Also, and of considerable importance, qualifying corporations that choose to liquidate before 1966 are afforded complete immunity from the new personal holding company provisions, except those relating to computation of the dividends-paid deduction.

(b) **Corporations That Liquidate During 1966.** Shareholders of those eligible corporations that choose to liquidate during 1966 will also enjoy the favorable tax benefits outlined above if their liquidation is completed within one calendar month. Such corporations, however, will not enjoy immunity from any of the new personal holding company rules during the taxable years they remain in existence.

(c) **Certain Corporations That Liquidate After 1966.** A corpora-

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87. **INT. REV. CODE OF 1954, § 333(g)(l), added by 78 Stat. 89 (1964).**

88. **Revenue Act of 1964, § 225(b)(l), 78 Stat. 90.** Such corporations continue to be subject to the pre-1964 personal holding company rules, of course. A corporation that pays a personal holding company tax under the new provisions and then liquidates before 1966 may file a claim for refund of the tax thus paid. See H.R. REP. No. 749, 88th Cong., 1st Sess. A113 (1963). Immunity from the new provisions is not extended to liquidations under § 332 unless the parent corporation is also liquidated in a non-§ 332 liquidation and all distributions in such liquidation are made before the ninety-first day after the last distribution in the § 332 liquidation of the subsidiary and before 1966. Revenue Act of 1964, § 225(b)(2), 78 Stat. 90.

89. **INT. REV. CODE OF 1954, § 333(g)(l), added by 78 Stat. 89 (1964).**
tion otherwise eligible for favorable liquidation treatment, but which at the beginning of 1964 was carrying "qualified indebtedness" that it had incurred between 1933 and 1964, may enjoy somewhat more limited tax benefits if it defers liquidation until the year in which it retires its indebtedness or the year in which it could have done so had it devoted to that purpose all of its post-1963 earnings and profits and funds freed by depreciation and amortization deductions. If a corporation thus situated gives appropriate notice before January 1, 1968, that it may liquidate in accordance with the above-stated time-table, its shareholders will enjoy the same tax treatment on liquidation they would have enjoyed if the liquidation had occurred before the end of 1966, with one exception.

The special capital gain treatment for earnings and profits in such a liquidation is limited to that portion of each shareholder's gain that is attributable to earnings and profits realized before 1967. That portion of the gain attributable to post-1966 earnings and profits will be taxed as an ordinary dividend. Any excess gain will be recognized and taxed as capital gain only to the extent that the value of any property distributed to the shareholder that consists of money or of stock or securities acquired after December 31, 1962, exceeds his ratable share of the corporation's earnings and profits.

Corporations falling into this category are also subject to all of the new personal holding company rules during the years they remain in existence.

F. Other Amendments Contained in the 1964 Act

Other significant changes made in the personal holding company provisions include the introduction of a single new rule to govern the exclusion from personal holding company treatment afforded certain lending and finance companies and the introduction of a retroactive exemption from personal holding company treatment for domestic building and loan associations, domestic savings and loan associations, domestic savings and loan companies, and corporations primarily engaged in the business of making personal property loans to individuals.

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92. INT. REV. CODE OF 1954, § 333(g)(2)(B)(ii), added by 78 Stat. 89 (1964). Such notification is to be given in accordance with applicable regulations.
94. INT. REV. CODE OF 1954, § 542(c)(6), as amended, 78 Stat. 79 (1964). Under pre-1964 law, four separate categories of lending and finance companies had been excluded from personal holding company treatment, and, in some instances, limitations were placed on the type of loans that could be made if the exclusion was to be obtained. The new rule leaves the regulation of loans to state and local law and focuses only on the source and extent of the income derived by a lending or finance company. See generally S. REP. No. 830, 88th Cong., 2d Sess. 109-11 (1964).
associations, and federal savings and loan associations, regardless of whether they satisfy certain real estate investment tests.95

Finally, the personal holding company tax itself has been reduced to a flat seventy per cent of all undistributed personal holding company income.96

V. COMMENTARY AND CONCLUSIONS

Legislation of the complexity of the new personal holding company amendments typically requires some time in operation before a true appraisal of its overall significance can fairly be made. For that reason, no attempt will here be undertaken to comment on each of the personal holding company provisions contained in the 1964 Act. Some observations are appropriate, however, even at this relatively early date.

A. Rents and Mineral Royalty Income

Initially, it seems clear that the practice targeted as the principal evil—the use of certain types of income to shelter purely passive investment income—has been severely restricted, and, in some instances, most assuredly eliminated. It is difficult, for example, to imagine many individuals relying upon rental or mineral royalty income to shelter dividends or interest now that the sheltering umbrella can at best encompass only ten per cent of income earned. Such an effort, it would seem, is hardly worth the candle.

Yet, despite the unquestioned success that the new provisions are certain to have in this regard, one cannot but wonder whether the manner employed to achieve that success did not somehow get out of control. Was it, for example, absolutely necessary to an accomplishment of the objective to require that numerous computations and adjustments be made and that two separate tests be satisfied before rental income can avoid personal holding company classification?

To be sure, the old fifty per cent or more test for rental income had proved deficient on three counts. First, it did not provide a true test of whether the rents were derived from the active conduct of a rental operation or from a mere passive investment in rental-producing property.97 Second, affording immunity to rental income that

97. Can it possibly be said, without more, that a corporation that derives its entire income from one piece of rental producing property is any more engaged in the active
satisfied the fifty per cent test, without more, unquestionably made rents an attractive sheltering device for sizeable amounts of personal holding company income. Third, because the fifty per cent test was based on gross rental income, the amount that had to be invested in rental-producing property in order to satisfy the test was generally far less than the amount that had to be invested in securities producing an equivalent gross yield; the use of rents as a sheltering device was thus not only attractive but relatively inexpensive.

Instead of requesting complete elimination of the fifty per cent test as a basis for characterizing rental income, however, the Treasury chose to preserve the basic framework of that test, perhaps because the long-continued existence of the test had lent a certain sanctity to the notion that income from rents (however calculated) should not be treated as personal holding company income when it constituted at least half of the corporation's total income. In thus choosing to retain this concept, the Treasury automatically restricted its ability to deal directly with the deficiencies observed under the old fifty per cent test to the disparity in investment requirements produced by a test based upon gross rental income.

The adjustments to gross income that now produce the figure "adjusted income from rents" are, of course, designed to correct this third deficiency in the fifty per cent test. These adjustments (for depreciation, property taxes, interest, and rents paid) are all related, in one sense or another, to the corporation's actual investment in rental-producing property. The purpose served by these adjustments is to limit application of the fifty per cent test to an amount that represents a more realistic yield from the rental investment, i.e., rental income after taking into account what might loosely be called certain fixed charges. In this way, it is possible to maintain the notion that rents should not be treated as personal holding company income when they represent at least half of the corporation's total income-producing activities, while at the same time requiring a substantially larger amount of such income to satisfy the fifty per cent test. To obtain this larger amount of rental income, of course, the investment in rental-producing property must be increased significantly, perhaps even to the level of the corporation's otherwise sheltered investment in income-producing securities.

But it was fully recognized by the Treasury that correction of the "disparity in investment" defect would not, of itself, assure elimina-

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conducted on a real estate business than is a corporation that derives its income in part from a similar piece of property and in part from other sources?
tion of the use of rents as a sheltering device.98 Something more was obviously needed, and this took the form of the new ten per cent limitation on the retention of other types of personal holding company income. In light of the adoption of a ten per cent test to curtail sharply the sheltering of dividend or interest income in all events, however, the need for rents to satisfy a modified fifty per cent test becomes even more open to question.

It is true that the adjustments required under the new fifty per cent test may in some instances drive below the ten per cent level that amount of dividend or interest income that may be retained under the sheltering umbrella.99 But, from the standpoint of ease of understanding and simplicity of administration, a powerful argument can be made in favor of enacting only the less complicated ten per cent test to deal with the problem, particularly since application of that test alone will produce the same general results in the great majority of cases.100 As things now stand, of course, both tests must be satisfied in order for rents to escape treatment as personal holding company income.

Interestingly, one apparently unintended effect of the ten per cent test as applied in the case of rental income has already come to light. Certain closely held corporations that engage in the manufacturing of tangible personal property under patent rights or other secret processes and that derive the bulk of their income from the leasing of such property after its manufacture frequently also derive royalty income from the use of their patents or other intangible property rights. If undistributed royalty income of this type were to exceed ten per cent of total ordinary gross income, then, unless the corporation made the appropriate dividend distributions, the corpo-

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98. See 1965 Ways and Means 122.
99. Thus, for example, assume a corporation with 180,000 dollars of gross rental income and twenty thousand dollars of dividend income. If the adjustments to rental income required under the fifty per cent test amount to 160,000 dollars or less, so that, the “adjusted income from rents” is twenty thousand dollars or more, the corporation will avoid personal holding company status, since the “adjusted income from rents” will satisfy the fifty per cent test (fifty per cent of “adjusted ordinary gross income”) and the twenty thousand dollars of dividend income satisfies the ten per cent test (ten per cent of “ordinary gross income”). If, however, the adjustments to rental income amounted to 170,000 dollars, the “adjusted income from rents” would equal ten thousand dollars and would not satisfy the fifty per cent test unless the corporation’s dividend income were only ten thousand dollars rather than twenty thousand dollars. Dividend income of only ten thousand dollars would, of course, then easily satisfy the ten per cent test.
100. No doubt, a number of examples can be presented in which the fifty per cent-tenten per cent tandem would achieve a more stringent result than would an application of the ten per cent test alone. But it is quite likely that introduction of the ten per cent test alone would just as effectively deter the continued use of rental income as a sheltering device as will the fifty per cent-tenten per cent combination.
ration's rental income would have constituted personal holding company income under the ten per cent test as originally adopted, and it was quite likely that the corporation would have become a personal holding company. To correct this unintended result, Congress has recently added an amendment to the new provisions that would exclude from the scope of the ten per cent test all royalties received for the use of, or for the privilege of using, patents, inventions, models, designs, secret formulas or processes, or other similar property rights when such property rights are also used by the corporation in the manufacture or production of tangible personal property held by it for lease to customers and the rental income from such leases equals fifty per cent or more of adjusted ordinary gross income.101 The effect of this amendment is to prevent the receipt of patent royalties or other similar royalties from possibly forcing a corporation into personal holding company status when the bulk of its income is derived from the leasing of property that it manufactures under such patents.

Finally, with respect to rents, nothing contained in the new provisions effectively deals with the problem of determining when rental income is in fact derived from bona fide operating activity rather than from mere investment. It is, therefore, still possible for a corporation that derives its only income from passive rental activity to escape personal holding company treatment. Until this problem is squarely dealt with, the personal holding company provisions will continue to contain at least one glaring deficiency.

B. Overall Gross Income Test

Of all the changes made in the personal holding company area by the Revenue Act of 1964, the one that in the long run may well prove to be the most significant is the reduction to sixty per cent of the proportion of passive income that will subject a closely held corporation to personal holding company treatment. By now affording immunity, in general, only to those corporations that derive over forty per cent of their total adjusted ordinary gross income from operating sources, the new gross income test extends the reach of the personal holding company provisions to many corporations that may well be engaged in relatively extensive, though nonetheless insuffi-

101. 78 Stat. 596 (1964). INT. REv. CODE OF 1954, § 54(2)(a), as amended, Revenue Act of 1964, 78 Stat. 81. The amendment treats such royalties as additional “rent” for purposes of making all necessary computations with respect to rental income. Thus, such royalties will not constitute other personal holding company income for purposes of applying the ten per cent test. The amendment applies to taxable years beginning after December 31, 1963.
dent, operating activity. In so doing, of course, the new test will be serving even more directly as a replacement of, rather than as a supplement to, the accumulated earnings provisions; and, the problem of designing appropriate legislation to combat abuses of the corporate form is brought more sharply into focus.

The amount of income that a particular closely held corporation should be permitted to accumulate without the threat of a penalty tax is certainly a question defying simple answers. Past experience convincingly reveals that, in many instances, the nature of the income earned fairly compelled the conclusion that the corporation was being used solely as a device for avoiding the individual income tax on amounts that should properly have been earned by the stockholders themselves. But, as the income earned consists more and more of a business and investment mix, so that the same conclusion cannot always be so easily reached, the problem becomes a little more difficult. It is at this point, where conclusions are no longer so compelling, that there ought to be room for a justification of the accumulation, if one exists, in order to avoid the purely arbitrary assertion of a penalty tax. The accumulated earnings provision, despite all its shortcomings, does at least afford the opportunity for a fair hearing before a determination is finally made regarding the purpose for which earnings have been accumulated. Yet the new sixty per cent test for determining personal holding company status affords no such opportunity for corporations that derive up to forty per cent of their income from bona fide operating activity. Indeed, unless a corporation is assured that over forty per cent of its income will be derived from operating sources each year, in many instances it might be better off with no operating income. The distributions that it will now be required to make to avoid the personal holding company tax may well make it difficult for such a corporation to sustain its operating activity in succeeding years.

No doubt there were numerous corporations that proudly skirted the old personal holding company rules by engaging in just enough operating activity to derive twenty-one per cent of their gross income from nonpassive sources. Perhaps it was necessary to curtail severely the sheltering benefits thus achieved. But, with the introduction of the new sixty per cent test, it does not seem too difficult to imagine many bona fide non-shelter corporations that, due to a combination of economic and other nontax considerations, will now find themselves confronted with the imposition of a personal hold-
ing company tax unless they distribute earnings that they should rightfully be entitled to accumulate for expansion when conditions become more favorable.

It may be that closely held corporations that derive only forty per cent of their income from nonpassive sources should be subjected to special tax treatment unless they make distributions to their shareholders. But are they properly characterized as "personal holding companies"? Are they not, by their very nature as mixed operating-investment companies, likely to have reasons for accumulating income that may well differ materially from the motivations behind their incorporated pocketbook predecessors? And if that is so, should they not—at least under some circumstances—be entitled to slightly less stringent treatment than their predecessors were accorded?

To raise these questions is not necessarily to answer them. The difficulties involved in policing the use of the corporate form as a means for avoiding individual income taxes have long made it apparent that no simple legislative solution exists. But it is difficult to argue that the meat-ax is to be preferred any more than the butter knife. What does seem clear is that future efforts at tax reform must include a more thorough reflection upon this problem as part of an overall review of the entire vast and imposing area of corporate-stockholder relationships.