CHAPTER 45

PERSONAL HOLDING COMPANY

INTRODUCTION

A personal holding company is a corporation that meets two particular tests (and is not specifically excluded from such status).[[1]](#endnote-1) These two tests are: (1) a stock ownership test; and (2) an income test. Both tests must be met in the same taxable year so that it is possible for a corporation to attain personal holding company status in one year and not in the next.

The stock ownership test works like this: The corporation meets the stock ownership requirements if more than 50% in value of its outstanding stock is owned directly or indirectly by or for not more than five individuals at any time during the last half of the taxable year.[[2]](#endnote-2) The second test, the income test, is sometimes referred to as the 60% test. If the stock ownership test has been met and at least 60% or more of the corporation’s adjusted ordinary gross income is personal holding company income (generally, dividends, interest, certain royalties, rents, or amounts received in return for a certain type of personal services), the corporation will be classified as a personal holding company.[[3]](#endnote-3)

The personal holding company provisions impose a tax at the highest individual income tax rate, separate and in addition to the existing corporate tax on specifically defined undistributed income of personal holding companies. Under the Taxpayer Relief Act of 2012, the personal holding company tax is increased to 20%.[[4]](#endnote-4)

Care should be exercised in the use of personal holding companies based on the repeal of the *General Utilities* doctrine by the Tax Reform Act of 1986. If assets in the corporation appreciate, generally there will be two taxes created, one at the corporate level (upon a sale of the assets or liquidation of the corporation) and one at the shareholder level (upon a liquidation of the corporation or dividend distribution).

It is important to have a business purpose when establishing the personal holding company. This technique is subject to many of the same considerations associated with the use of family limited partnerships. Therefore, it is important to follow a similar analysis in determining the appropriateness of this planning device.

WHEN IS USE OF SUCH A DEVICE INDICATED?

1. Where an individual has a large estate consisting of highly appreciated and readily marketable securities and wants to reduce federal estate taxes attributable to those assets.

2. Where an individual would like to reduce the value of his estate through court approved methods for discounts.

3. Where it is desired to achieve gift and estate tax savings for appreciated assets while retaining economic control and flexibility in making economic decisions. However, the planner should give careful consideration to other entities that can achieve the same result without double tax problems. These include, the family partnership, discussed in Chapter 43, the limited liability company, discussed in Chapter 44, and the S corporation, discussed in Chapter 46. In the case of the S corporation, its assets may consist entirely of passive investments, such as marketable securities, without triggering a corporate level tax so long as it has no corporate earnings and profits. Generally, if an S corporation has earnings and profits it will be from when it was a C corporation.

WHAT ARE THE REQUIREMENTS?

A corporation is formed by an individual who owns a substantial amount of appreciated property. The individual transfers a portfolio of common stock of various companies to a newly formed closely held corporation in return for its stock. This transfer can be accomplished without recognition of any gain. The transfer of assets to a corporation in exchange for its stock will not be a taxable event if the transferor controls 80% of the voting power and 80% of each class of stock immediately after the transfer.[[5]](#endnote-5)

The individual transferring this stock will have a basis (cost for purposes of determining gain or loss) in the new stock equal to the basis in the property transferred to the corporation.[[6]](#endnote-6) Likewise, the corporation will receive the stock transferred to it with the same basis this property had in the individual’s hands.[[7]](#endnote-7)

HOW IT IS DONE – EXAMPLES

Denise Lopez, a wealthy investor, purchased shares of Gro-Quick, a closely held corporation, many years ago. These shares are now worth 10 times what she paid for them and are continuing to appreciate rapidly. If Denise retains the stock, the shares will be includable in her estate. If she gives them away, she will incur a sizable gift tax. (The taxable portion of any gifts will be considered adjusted taxable gifts and therefore increase the rate at which the taxable estate will be taxed.) Furthermore, some of her beneficiaries are minor children and she does not want to make outright gifts. However, she does not want to use a trust because of certain administrative problems associated with a trust.

Denise forms a corporation and retains 100% of its stock. The stock she transfers to the corporation has a fair market value of $1,000,000. The corporation is capitalized as follows: $800,000 (fair market value) of non-voting common stock is issued to Denise. In addition, she receives $200,000 worth of voting common stock. (The breakdown is arbitrary and can be varied according to the particular situation.)

Since one of Denise’s main objectives is to maintain control while making gifts to limit future appreciation in the value of her estate, she retains the voting stock and begins a gift program with the non-voting common. She gives, over a period of years, the $800,000 worth of non-voting common stock to family members. This enables her to continue to direct and control the investment program. Because of the gift tax applicable exemption ($5,430,000 in 2015) and the annual exclusions ($14,000 in 2015) the transfer can be made with no out of pocket gift tax cost. Because the non-voting common stock represents most of the right to the financial growth of the business (80%), substantial future appreciation is removed from Denise’s estate. For example, if the underlying assets double in value after the gift of the common stock, 80% of that appreciation is realized in the hands of the donees rather than in Denise’s hands.

This technique can also be considered when trying to gift assets that are not readily divisible, such as artwork. By gifting a percentage of the stock, a fractional interest in the asset can be transferred and control can still be retained.

Beware: In the case of family corporations, the use of common and preferred stock in either capitalizing or recapitalizing the entity, followed by a transfer of shares to other family members by gift or sale, may and probably will create a gift tax valuation problem under IRC section 2701 or a gift, estate, or generation-skipping transfer tax problem if restrictions on certain classes of stock lapse under IRC section 2704. These issues are covered in detail in Chapter 22. However, this problem will not occur in the case of an unmarried couple or a transfer between two unrelated friends since it would fall outside the scope of IRC Section 2701.

An additional benefit of using a corporation to hold significant assets is the fact that the corporate stock may be worth less than the value of the assets in the corporation. Courts have consistently allowed discounts of 10% and more (in one case as much as 55%) on the theory that stock of a personal holding company is less attractive to an investor than a direct ownership in similar stock listed on an exchange with ready access to the investing public.

*Example*: A gift of 100 shares of AT&T is worth more than a gift of shares representing a 10% interest in a personal holding company whose only assets are 1,000 shares of AT&T. It is this fact – that an investment in a personal holding company is less desirable than in the underlying shares because the underlying assets can be easily traded in the market while shares in the personal holding company cannot – that is the primary reason for the discount from the net asset value of the underlying shares. (See Figure 45.1, which illustrates the percentage, discounts allowed in a number of personal holding company cases.) Thus, in the example above, Denise’s $1,000,000 portfolio may be valued for estate purposes at considerably less than the $1,000,000 that the underlying assets are worth. (The value of a gift of less than a controlling interest would be further reduced because of the lack of voting control.)

TAX IMPLICATIONS

1. As mentioned above, substantial estate and gift tax savings may be possible through discounts in the valuation process. (See list of cases in Figure 45.1.) However, these discounts are subject to IRS scrutiny. In order to maintain these discounts, it is important that the business have a purpose and the formalities in operating the business are properly followed.

**Figure 45.1**

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| --- | --- | --- | --- | --- |
| **PERSONAL HOLDING COMPANY CASES INVOLVING ESTATE TAX DISCOUNTS** | | | | |
|
| **Case** | **Company & Holdings** | **Shs. to be Valued** | **Total Shares** | **Discount Allowed** |
| *Celia Waterman* 20 TCM 281 (1960) | *Maxcell Corp.* (Apt bldgs) | 299 | 571 | 30.8% |
| *Lida E. Tompkins Est.* 20 TCM 1763 (1961) | *H Street Building Corp.* (Gen’l real estate business, building, contracting and construction) | 186 | 650 | 32.8% |
| *Drybrough v. U.S.* 60 TCM 645 (W.D. Ky 1962) | (5 separate real estate holding companies) |  |  | 35.0% |
| *Harry S. Leyman* 40 TC 100 (1963) | *Leyman Corp.* (Real estate, 2 Buick agencies, parking garages) | 2,309 | 9,400 | 36.7% |
| *Hamm v. Comm.* 325 F.2d 934 (8th Cir. 1963) | *United Properties, Inc.* (Commercial real estate and 10 closely held subsidiaries) | 263N | 1,000 | 27.2% |
| *Gregg Maxcy Est.* 28 TCM 783 (1969) Rev’d on appeal, 441 F.2d 192 (5th Cir. 1971) | *Maxcy Securities, Inc.* (Citrus grove, restaurant, mortgages (1) and accounts receivable (2)) | 164 | 174 | 15.0% |
| 86 | 174 | 25.0% |
| *Heckscher v. Comm.* 63 TC 485 (1975) | *Anaheim Realty Co.* (Undeveloped Florida real estate and securities) | 2,500 | 108,675 | 48.3% |
| *Lloyd R. Smith Est.* 9 TCM 907 (1950) | *Smith Investment Co.* (Stock of A O Smith Corp) | 408 | 1,860 | 22.1% |
| *Bishop Tr. Co. Ltd. v. U.S.* 501 USTC ¶10,764 (DC Hawaii 1950) | *Henry P. Baldwin Ltd.* (Stock listed on Honolulu Exchange) | 1,861 | 15,000 | 32.8% |
| *Goss v. Fitzpatrick* 97 F. Supp. 765 (D.C. Conn. 1951) | *Alden M. Young Co.* (Marketable securities; some real estate) | 1,900 | 13,518 | 42.9% |
| *Clarence J. Grootematt, Est.* 79,049 (P-H) | *Greendale Land Co.* (development and sale of real estate) | 40 | 400 | 25.0% |
| *Ernest A. Oberting Est.* TC Memo 1984-407 | *Warrior Oil Co.* (percent interest in Indonesian oil contracts) | 45 | 225 | 65.0% |
| *Estate of Cotchett* TC Memo 1974-31 | *Eddy Investment Co.* (cash and marketable securities) | 20,692 | 103,621 | 34.0% |
| *Estate of Hayes* TC Memo 1973-236 | *DuQuoin Coca Cola* (farm land, dairy business, soft drink bottling business) | 930 | 5,952 | 25.0% |

2. The individual forming the personal holding company can perform bona fide services for it and receive a salary. Assuming the salary paid is reasonable, the individual will be taxed at a maximum rate of 39.6% on compensation and that amount will be fully deductible by the corporation. Any excess compensation (compensation deemed unreasonable) would be subject to tax at the corporate level (nondeductible) and then taxed at the individual level. Operating expenses may even generate a net operating loss. (Local and state franchise taxes should be considered.)

3. The taxable income of the corporation can be lowered further by providing a working stockholder and working members of his family with various fringe benefits. These include a qualified pension or profit-sharing plan. Furthermore, some medical expenses may be deductible. These expenses must be reasonable in view of the services performed by the employee shareholder.

4. A capital loss of a corporation can be carried back up to three years to offset prior capital gain income while individuals are not allowed a carry-back of losses.

5. There is, of course, a substantial disadvantage if a personal holding company is not properly handled. As in any corporation, there is the potential for double taxation (the first incident when the corporation sells securities and again when the shareholder receives the proceeds or other property as a dividend or on the liquidation of the corporation). However, the potential for double taxation can be minimized or eliminated by carefully controlling the type of investments and expenses incurred.

The other problem is the imposition of state capital stock or franchise tax on the value of the personal holding company stock or on the net income remaining in the corporation each year.

HOW CAN LIFE INSURANCE ENHANCE THIS TOOL?

It is possible to transfer to a personal holding company, in addition to other assets, life insurance policies. For instance, an individual would transfer existing life insurance policies (term or whole life) having little present value as compared with their face amounts to the personal holding company in exchange for voting common stock. (Alternatively, the personal holding company could purchase insurance on the life of the holder of the voting stock.) By then giving non-voting common stock in the holding company to the donee-family members (alternatively, the corporation could sell those family members stock for cash or other property), most of the eventual appreciation due to the death value of the life insurance can be transferred out of the donor-owner’s estate.

Because the decedent’s executor will have voting control over the personal holding company by virtue of his ownership of the personal holding company voting common stock, that individual could direct the corporation to make a Section 303 stock redemption, thus providing estate liquidity.

IMPLICATIONS AND ISSUES IN COMMUNITY PROPERTY STATES

The particular form of property ownership between spouses holding an interest in a corporation classified as a personal holding company has no particular bearing on meeting the stock ownership test, by virtue of the family attribution rules.[[8]](#endnote-8) That is, the ownership interest of one’s spouse will be attributed back, regardless of whether the spouse’s interest is community or separate property.

However, for estate planning purposes, a community property form of ownership is advantageous, as compared to joint tenancy or tenancy in common, because of the step-up in the tax basis of both halves of the community property on the death of one spouse.

Under IRC Section 542, a personal holding company is a corporation where (1) at least 60% of the adjusted ordinary gross income of which is personal holding company income (i.e., dividends, interest, royalties, and certain rents), and (2) more than 50% of the stock of which is owned by five or fewer individuals.

Of particular importance to estate planners when dealing with a personal holding company is the classification of the income produced by the enterprise, because, in order to meet the 60% test, a significant amount of the income must be classified as personal holding company income.

If the stock ownership is community property, then, absent an agreement to the contrary, the income will also be community property. However, as noted in Chapter 43 on Family Limited Partnerships, in some community property states, if the stock ownership is separate property, this does not necessarily mean that the income produced, or any accretion in value, will also be separate property.

As previously discussed in Chapter 40, if an increase in the value of separate property is attributable to the ability or activity of either spouse, for which the community has not been sufficiently rewarded (e.g., by an appropriate salary), at least a portion of that increase may well be determined to be community property (thereby reducing the gross estate of the original owner-spouse).

In addition, the income produced may be classified as both community and separate property. If one of the spouses invests separate property in a business and conducts that business during marriage, without adequate reward to the community for the spouse’s efforts, the resulting profits may be community and separate property in proportion to the amounts attributable to the personal efforts and to capital investment, respectively.

In such circumstance, depending on which spouse dies first, it may be important to be able to show that the profits from, and appreciation in value of, the business are from one (or both) spouse’s efforts, rather than merely a natural enhancement in value, in order to spread the increased value between the two estates, and to provide a step-up in basis for both halves of the community property at the first death. If the spouse who originally owned the business dies first, then the entire business will receive a “stepped-up” basis regardless of the amount of community property effort.

FREQUENTLY ASKED QUESTIONS

**Question** – How can stock be shifted to children and grandchildren without incurring gift tax costs if the children do not have cash or other property to purchase the stock?

*Answer* – The parent of a child can lend money directly to his children or their custodian or to an irrevocable trust established for their benefit, or guarantee a loan between the child and a third party, such as a bank.[[9]](#endnote-9) The child (or trust) can then purchase stock directly from the corporation for cash. The child could obtain cash to pay back the loan if the personal holding company declares dividends on the common stock. Income shifting from parent to child – and therefore income tax savings – assuming the Kiddie Tax rules can be avoided.

**Question** – Assuming that personal holding company status is – at some date – considered onerous, how can such classification be avoided?

*Answer* – As mentioned above, there are two tests – both of which must be met – before a corporation will be classified as a personal holding company. The first requires that five or fewer shareholders own more than 50% of the value of the stock at some time during the last six months of the taxable year. This test can be sidestepped by distributing ownership of shares to a sufficient number of unrelated parties or by issuing a second class of stock to a sufficient number of unrelated parties to fall outside the five or fewer shareholders test or to dilute ownership value to fall below the 50% of ownership threshold.

The second test requires that personal holding company income be greater than or equal to 60% of adjusted ordinary gross income. To avoid this test, property that produces personal holding company income, such as rental property, can be transferred out of the corporation (with potential tax consequences). Conversely, by producing more active as opposed to passive income within the corporation, the 60% test can be avoided.

Furthermore, expenses related to adjusted ordinary gross income can be deferred into future periods or a depreciation method can be selected to maximize adjusted ordinary gross income.

Finally, if there is a potential personal holding company liability, cash dividends can be paid out during the tax year, post year-end dividends can be paid, consent dividend procedures can be used, deficiency dividend procedures can be used and, as a final last-ditch alternative, the corporation can be liquidated. However, the lack of a capital gains deduction upon a sale or exchange or liquidation makes the liquidation alternative more expensive. In addition, gain from appreciated property that the corporation distributes will be taxed at the corporate level. If the corporation does not have any earnings and profits (or declares a dividend to eliminate any), it can elect S corporation status and avoid any personal holding company tax regardless of the level of passive income. This is because S corporations are not subject to tax under Chapter 1 of the Internal Revenue Code.[[10]](#endnote-10) Such an election may bring into play the built-in gain rules.[[11]](#endnote-11)

**Question** – Is the personal holding company technique a sure fire way to obtain an estate or gift tax valuation discount?

*Answer* – Not every personal holding company will result in an estate or gift tax valuation discount. In one case, the value of stock in two personal holding companies that were owned by the decedent was not reduced by a lack of marketability discount.[[12]](#endnote-12) The court held that the proper estate tax value was the net asset value of the companies less the cost involved in liquidating them. Note that the result occurred because the decedent owned 100% of both companies and therefore had the unqualified right to liquidate them at any time. Note also that all the assets in both companies were cash or marketable securities, and that neither corporation had any significant liabilities. Planners should use this case as a “how not to do it” guideline. Another area where a discount may be available relates to a discount in the value of the stock in order to recognize the built-in capital gains tax associated with liquidation of the corporation.[[13]](#endnote-13)

CHAPTER ENDNOTES

1. . IRC Sec. 542(c) contains 10 types of business entities that are specifically excluded from personal holding company status, such as tax-exempt corporations, banks, and life insurance companies. [↑](#endnote-ref-1)
2. . IRC Sec. 542(a)(2). The ownership test pertains to value and not to the number of outstanding shares. Under constructive ownership rules an individual is deemed to own all the stock directly or indirectly owned by or for his brothers and sisters, spouse, ancestors, and lineal descendants. Likewise, stock owned directly or indirectly by or for a corporation, partnership, estate, or trust is considered as being owned proportionately by its shareholders, partners, or beneficiaries. IRC Sec. 544(a). [↑](#endnote-ref-2)
3. . IRC Sec. 542(a)(1). “Adjusted ordinary gross income” is essentially gross income less gains from sales or other dispositions of capital assets and IRC section 1231 property, and further reduced by depreciation, certain taxes, interest, and rents attributable to income from certain rents and royalties. IRC Sec. 543(b). [↑](#endnote-ref-3)
4. . Taxpayer Relief Act of 2012 Section 102(c)(1). [↑](#endnote-ref-4)
5. . IRC Secs. 351, 368(c); Treas. Reg. §1.351-1(a). [↑](#endnote-ref-5)
6. . IRC Sec. 358(a). [↑](#endnote-ref-6)
7. . IRC Sec. 362(a). [↑](#endnote-ref-7)
8. . IRC Sec. 544(a)(2). [↑](#endnote-ref-8)
9. . TRA ’84 severely limited the utility of interest-free loans. See IRC section 7872 and Chapter 37 of this book. Also, note the IRS position in PLR 9113009 that a guarantee, for less than full and adequate consideration, is a completed gift for gift tax purpose. (This ruling was withdrawn by the IRS in PLR 9409018 without comment on the taxable gift issue.) [↑](#endnote-ref-9)
10. . IRC Sec. 1363. [↑](#endnote-ref-10)
11. . IRC Sec. 1374. [↑](#endnote-ref-11)
12. . *Est. of Jephson v. Comm*., 87 TC 297 (1986). [↑](#endnote-ref-12)
13. . Eisenberg v. Comm., 82 AFTR 2d 98-5757 (155 F. 3d 50); AOD 1999-001, 2/01/1999 in which the IRS acquiesced in the concept that a discount for built in capital gains may be appropriate. The IRS concluded that there was no legal prohibition against such a discount and the amount and circumstances of such discount will depend upon the facts of each case. [↑](#endnote-ref-13)