

# Avoiding the Personal Holding Company Tax

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The personal holding company (PHC) tax is a federal 20 percent penalty tax assessed on certain types of undistributed passive income, including interest and dividend income, earned by a closely held C-corporation. Although the disparity between individual and corporate tax rates that prompted the enactment of the PHC tax largely has been eliminated, the tax remains a trap for unwary corporations and can result in a substantial tax liability. Special care and planning are necessary to avoid structures that expose a corporation to the PHC tax and, once exposed, to operate the corporation in a manner that eliminates the PHC tax liability. This is especially true for banking organizations, as special PHC rules apply to banks and certain other lenders.



## Applicability of the PHC Tax

The PHC tax is a concern for a C-corporation when three conditions are satisfied:

1. More than 50 percent of the value of the corporation's stock is owned by five or fewer individuals at any time during the last half of the corporation's tax year
2. At least 60 percent of the corporation's gross income is from certain identified passive sources
3. Corporate distributions to shareholders for the year are insufficient to eliminate the PHC tax

Special attribution rules apply for purposes of determining stock ownership. The primary sources of passive income include interest, dividends, rents, and royalties. For purposes of measuring the 60 percent threshold, gross income is modified by removing U.S. government interest and certain expenses directly associated with the production of rental income.

If the first two conditions are satisfied, the corporation is required to attach Schedule PH, "U.S. Personal Holding Company (PHC) Tax," to its federal income tax return unless it is an exempt corporation (defined later). This form indicates to the IRS that the PHC conditions have been satisfied for the year and subjects the corporation to a distribution test to determine the extent of its PHC tax liability.

## PHC Tax Liability

A PHC tax liability will result only when the corporation has positive undistributed PHC income for the taxable year.

To determine PHC income, federal taxable income is modified by:

- Adding back the dividends-received deduction
- Limiting the net-operating-loss deduction to the loss generated in the immediately preceding tax year
- Removing net capital gains, net of the federal tax liability on these gains
- Deducting the federal tax liability due on the taxable income after applying the modifications discussed earlier
- Deducting the amount of shareholder distributions paid (or deemed paid) during the year

The resulting figure is the corporation's undistributed PHC income subject to the 20 percent PHC tax. This tax is reported on Form 1120, "U.S. Corporation Income Tax Return," and factors into the corporation's overall federal tax liability.

## Risks for Bank Consolidated Groups

The PHC tax generally is determined and applied on a consolidated basis. However, if any affiliate in the consolidated group is an exempt corporation, the PHC rules are applied individually to each corporation in the group. Exempt corporations include banks, thrifts, and nonbank finance companies that meet certain lending tests. Thus, for a consolidated banking group, each of these tests is determined at the affiliate level for each member of the group. This poses particular planning challenges for certain nonbank affiliates within the group, to the extent they are profitable and earn investment income.

For example, a bank-owned investment subsidiary that houses the bank's investment portfolio and generates net investment income will generate a PHC tax liability if the distribution rules are not properly addressed. Likewise, a bank-owned finance company that does not meet the particular lending tests for PHC exemption also could generate a PHC liability if proper planning is not undertaken. Furthermore, a bank holding company that maintains its own investment portfolio and is profitable on a stand-alone basis could generate a PHC tax liability.

## Planning Considerations

The PHC planning for bank consolidated groups centers on several IRS rulings addressing the PHC treatment of intercompany distributions when the group contains an exempt member. These rulings provide two fundamental concepts: 1) Dividends received from an exempt member are ignored by the recipient corporation for all PHC purposes; and 2) Dividends received from a nonexempt member are PHC income to a nonexempt recipient member to the extent the distributing member availed itself of a distribution deduction. Applied properly, these rules can offer an escape from the PHC tax for affiliates within a bank consolidated group.

For bank-owned subsidiaries, PHC planning can be structural or operational in nature. From a structural standpoint, closely held banks should be cautious about setting up profitable subsidiaries that will generate the passive sources of income potentially subject to the PHC tax. For example, establishing an investment subsidiary underneath the bank might expose the income of that subsidiary to the PHC tax. If the bank subsidiary is established, the only way to avoid the PHC tax is operational planning.

This involves paying sufficient dividends (or making an election for deemed dividend distributions) annually to the bank parent, eliminating the PHC tax liability of the subsidiary and moving this income into the bank, which is exempt from the PHC tax. If the bank has two or more tiers of subsidiaries, the PHC income must be distributed by each subsidiary until it either reaches the bank or is received by an affiliate with sufficient losses to offset the PHC income distribution received.

Closely held banks might want to avoid establishing a holding company for PHC exposure reasons. If a holding company is established, careful annual planning is necessary to avoid the PHC tax. The holding company must verify that either its PHC income is negative (bank dividends are excluded from this determination) or sufficient dividends are paid to shareholders so the PHC tax is avoided. Establishing an investment portfolio within the bank holding company could be an issue, unless the holding company intends to pay annual shareholder dividends in an amount sufficient to eliminate any PHC tax concerns.

## Protect Yourself From the PHC Tax

Neglecting to identify and properly plan for a PHC tax exposure can be an expensive mistake. Although banks are exempt from the PHC tax, many of the affiliates that are commonly established within banking groups are not. For closely held banks, the opportunities for using these other affiliate structures could be limited or require constant and careful planning to navigate through the PHC tax exposure.



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