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David Beausejour
Bryant University

Joseph Matoney
University of Rhode Island

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David Beausejour, J.D., CPA
Joseph P. Matoney, Ph.D., CPA*

The personal holding company (PHC) tax was originally enacted to discourage taxpayers from using the corporate form of doing business to shelter certain types of passive income from high individual tax rates. The PHC tax is a penalty tax which is levied, in addition to the regular corporate income tax on the PHC's undistributed personal holding company income (UPHCI). An oil and gas corporation satisfying the income test and the stock ownership test will be classified as a personal holding company under Section 542. Classification as a PHC may subject the corporation to the personal holding company tax. This article provides an analysis of the PHC tax and its potential effect on oil and gas corporations.

Prior to the Tax Reform Act of 1986, the top corporate rate was less than the top individual rate. At that time the idea of shifting PHC income from individuals to corporations was

* Professors Beausejour and Matoney are, respectively, Assistant Professor and Professor of Accounting at Bryant College and University of Rhode Island.

tempting as long as the corporations involved could then successfully avoid the PHC tax. Since 1987, the top corporate rate has been higher than the top individual rate and thus the appeal of using a corporation to generate PHC income has somewhat diminished.

Despite this diminished appeal of shifting income, the PHC provisions are still important under the current law for a number of reasons. Even though the top corporate rate is higher than the top individual rate, a taxpayer can still take advantage of the graduated rates of a corporation and attempt to shift income from the top individual rate of 33 percent to the lowest corporate rate of 15 percent on the first $50,000 of corporate taxable income. In addition, due to the dividends received deduction, corporate recipients of dividend income are taxed at lower rates than individual recipients. Finally, the PHC tax may be applied to any corporation meeting the definition of a PHC. Intent to avoid tax is not necessary. Thus, the PHC provisions are a potential trap for any corporation, including an oil and gas corporation inadvertently falling within the mechanical definition of a personal holding company.

A personal holding company is any corporation meeting the income test and stock ownership test under Section 542. The income test is met if the corporation's PHC income is at least 60 percent of its adjusted ordinary gross income for the taxable year.[1] The stock ownership test is met if more than 50 percent of the value of the corporation's stock is owned, directly or indirectly, by or for not more than five individuals at any time during the last half of the corporation's taxable year.[2] The attribution rules for determining stock ownership are found in Section 544. Certain corporations are excluded from the PHC definition. These include tax-exempt corporations, banks, life insurance companies, surety companies, and foreign personal holding companies.[3] Even if a

[1] § 542(a)(1).

[2] § 542(a)(2).

[3] § 542(c).

corporation is a PHC, liability for the PHC tax may be avoided through the use of certain dividend distributions discussed later in this article. Since an S corporation is deemed to distribute all earnings and profits currently,[4] S corporations are not subject to the PHC tax. Therefore, an S corporation election is a quick way of avoiding PHC status in future years.

As discussed previously, the income test is met if at least 60 percent of the corporation's adjusted ordinary gross income for the taxable year is PHC income.[5] Adjusted ordinary gross income is defined as ordinary gross income net of a series of adjustments.[6] Ordinary gross income is defined as gross income excluding capital gains and Section 1231 gains.[7] In addition, there is an exclusion for PHC income generated by a foreign corporation whose stock is all owned by nonresident aliens during the last half of the taxable year.[8] The adjustments from ordinary gross income to arrive at adjusted ordinary gross income are contained in Section 543 (b)(2). These adjustments include: certain expenses incurred in generating gross rental income; certain expenses in generating gross income from mineral, oil, and gas royalties and in generating gross income from working interests in oil or gas wells; interest on United States obligations held for sale to customers by dealers; and interest on a condemnation award, a judgement, and a tax refund.

Under Section 543(b)(2)(A), gross income from rents are adjusted/reduced by the allowable deductions for depreciation, amortization, property taxes, interest, and rent to the extent allocable to such gross income from rents. Similarly, under Section 543 (b)(2)(B), gross income from mineral, oil, and gas royalties and from working interests in an oil or gas

[4] § 1366.

[5] § 542(a)(1).

[6] § 543(b)(2).

[7] § 543(b)(1).

[8] § 543(b)(1)(c).

well is adjusted/reduced by allowable deductions for depreciation, amortization, depletion, property and severance taxes, interest and rent allocable to such gross income. The above adjustments shall not exceed the gross income from the rents, the mineral, oil, and gas royalties, or the working interests in an oil or gas well respectively.

Under Section 543(a), certain types of income included in a corporation's adjusted ordinary gross income are personal holding company (PHC) income. PHC income includes dividends, interest, royalties (other than copyright royalties or mineral, oil or gas royalties), annuities, adjusted income from rents, adjusted income from mineral, oil, and gas royalties, copyright royalties, computer software royalties, distributions from estates or trusts, and income from personal service contracts involving a 25-percent-or-more shareholder.

As discussed previously, mineral, oil, and gas royalties are adjusted before being included in adjusted ordinary gross income. The adjusted amount, adjusted income from mineral, oil, and gas royalties is included in PHC income unless all of the following conditions are met:

(A) it constitutes 50% or more of adjusted ordinary gross income,

(B) other PHC income (other than from mineral, oil, and gas royalties) is not more than 10% of ordinary gross income, and

(C) the total Section 162 business expense deductions other than those for compensation for personal services rendered by shareholders and those specifically allowable under sections other than Section 162, must equal or exceed 15% of adjusted ordinary gross income.[9]

Thus, if an oil and gas company can satisfy the 50-percent test, the 10-percent test, and the 15-percent test, the royalties will not be included in PHC income.

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[9] § 543(a)(3).

The following example illustrates the 50-percent test:

Example 1:

> X Corporation has gross income consisting of $4,000 of manufacturing profit, $1,000 of dividends and $40,000 of gross income from oil and gas royalties. The allowable deductions allocable to the royalties for depreciation, amortization, depletion, property and severance taxes, interest and rent are $25,000. The adjusted income from the oil and gas royalties is $15,000 ($40,000 less $25,000) and the adjusted ordinary gross income is $20,000 ($4,000 + $1,000 + $40,000 - $25,000). Since $15,000 is at least 50% of $20,000, X Corporation has passed the first condition for excluding its oil and gas royalties from PHC income.

Although X Corporation has met the 50-percent test, it must still pass the two remaining tests in order to prevent its oil and gas royalties from becoming PHC income. In applying the 10-percent test, PHC income does not include mineral, oil and gas royalties.

Example 2:

> Assuming the same facts as in Example 1, since the dividends of $1,000 do not exceed 10% of the ordinary gross income of $45,000 ($4,000 + $1,000 + $40,000), X Corporation has passed the second condition for excluding its oil and gas royalties from PHC income.

Under Section 543(a)(2) for rents and Section 543(a)(4) for copyright royalties, there are tests similar to those for mineral, oil, and gas royalties used to exclude the adjusted income from rents or copyright royalties from PHC income. However, in applying the 10-percent test, PHC income specifically includes copyright royalties and adjusted income from rents whether or not such income would otherwise be treated as PHC income.[10]

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[10] § 543(a)(3)(B).

Although X Corporation has met the 50-percent test and the 10-percent test, the adjusted income from the oil and gas royalties will be PHC income unless the Section 162 business expense deductions, excluding items deductible under sections other than Section 162 and items deductible as compensation for personal services rendered by shareholders, are at least 15 percent of adjusted ordinary gross income.

Example 3:

> Assume the same facts as in Example 1 and, in addition, assume the Section 162 deductions are $3,500. Since the business deductions of $3,500 are at least 15 percent of adjusted ordinary gross income of $20,000, X Corporation has passed the third condition for excluding its oil and gas royalties from PHC income.

Unlike mineral, oil, and gas royalties, income from a working interest in an oil and gas well is never PHC income. However, the income from working interests in oil and gas wells must be reduced by expenses related to such income under Section 543 (b) (2) (B) to arrive at adjusted ordinary gross income. As a result, when applying the 60 percent income test to determine whether or not the oil and gas company is a PHC, the adjustments for working interests make it more difficult for a corporation with working interest income to escape PHC status. The detrimental effect of these adjustments is illustrated in Example 4.

Example 4

> X Corporation has oil and gas royalties of $40,000 and allowable deductions allocable to the royalties of $10,000. The Corporation also has income from working interests in the amount of $120,000 and allowable deductions allocable to the working interests in the amount of $100,000. X Corporation has dividend income in the amount of $20,000. X Corporation's adjusted ordinary gross income is $70,000.

($40,000−$10,000)+($120,000−$100,000)+$20,000=$70,000

The $30,000 in adjusted income from the oil and gas royalties is PHC income. The 50-percent test is not met since adjusted ordinary gross income from the royalties of $30,000 is not at least 50 percent of the adjusted ordinary gross income of $70,000. The 10-percent test is not met since the other PHC income, dividends in the amount of $20,000 is more than 10 percent of the corporations ordinary gross income of $180,000. Assuming that the corporation satisfies the stock ownership test, the corporation is a PHC since at least 60 percent of the corporations adjusted ordinary gross income is PHC income. The PHC income $50,000 ($30,000 in adjusted ordinary gross income from royalties plus $20,000 in dividends) is 71 percent of the adjusted ordinary gross income of $70,000.

It should be noted in the above example that the Section 543(b)(2)(B) adjustments for the working interests in the oil and gas wells were required to calculate adjusted ordinary gross income. If this were not the case, X Corporation's adjusted ordinary gross income would be $170,000 and the corporation would not be a PHC since the PHC income of $50,000 would not be at least 60 percent of $170,000.

Since the PHC tax is imposed only on personal holding companies, if an oil and gas corporation can avoid PHC status, there would be no reason to worry about the PHC tax. An oil and gas corporation might change its stock ownership so as to avoid having five or fewer shareholders owning more than 50 percent in value at any time during the last half of the tax year. This could be accomplished through a sale of stock to unrelated parties so as to avoid the Section 544 attribution rules. The stock sold could be preferred stock or common stock. A sale of nonvoting preferred stock to unrelated parties would permit the common shareholders to retain control of the corporation while spreading the corporation's equity value among a larger number of shareholders.

Oil and gas corporations could possibly change the amount and type of income earned by the corporation so as to fail the 60-percent test. The 60-percent test could be algebraically stated as follows:

$$\frac{\text{PHC income}}{\text{adjusted ordinary gross income (AOGI)}} = 60\% \text{ or more.}$$

Decreasing the numerator (PHC income) or increasing the denominator (AOGI) will reduce the resulting percentage. Of course, if the percentage can be kept below 60 percent, the corporation will not be classified as a PHC. Methods to reduce the resulting percentage include:

1. Invest in low yield, growth securities rather than those generating heavy interest or dividend income.
2. Invest in tax-exempt securities; the income from these securities has no effect in applying the income test.
3. Add additional operating activities to the corporation thereby making the PHC income a smaller portion of the AOGI.
4. Invest in partnerships generating gross income that is not PHC income thereby making the PHC income a smaller portion of the AOGI.
5. Sell securities generating PHC income; the capital gains are not PHC income and are not included in AOGI; therefore, the resulting percentage when applying the 60% income test would naturally be reduced.

Once it is established that a corporation is a PHC, the PHC tax of 28 percent is applied on the undistributed personal holding company income (UPHCI).[11] UPHCI is defined in Section 545 as taxable income as adjusted. Positive adjustments include the following:

(1) The dividends received deduction.[12]

(2) The net operating loss deduction for years other than the preceding year.[13]

Negative adjustments include the following:

(1) Charitable contribution adjustment.[14]

(2) Federal income taxes and foreign income taxes.[15]

(3) Net capital gain minus the income taxes attributable to such gain.[16]

(4) Amounts irrevocably set aside to pay or retire qualified indebtedness.[17]

(5) Dividends paid deduction.[18]

As a result of the dividends paid deduction, a corporation may avoid the PHC tax by making sufficient dividend distributions to eliminate UPHCI. The dividends paid deduction adjustment includes the dividends paid during the taxable year, the consent dividends for the taxable year determined under Section 565, and the dividend carryover described in Section 564. With respect to the dividends paid during the taxable year, a "dividend" includes only distributions described in Section 316. Thus, in order to qualify for the dividends paid deduction, the distribution must be made out of the corporation's current or accumulated earnings and profits. As a general rule, a dividend is considered paid when

[11] § 541.

[12] § 545(b)(3).

[13] § 545(b)(4).

[14] § 545(b)(2).

[15] § 545(b)(1).

[16] § 545(b)(5).

[17] § 545(c).

[18] § 561.

received by the shareholder;[19] therefore, a deduction for the dividends paid during a taxable year is not allowed unless the shareholder receives the dividend during the year the deduction is being claimed. However, Section 563(b) provides an exception to this general rule.

Under Section 563(b), a dividend paid on or before the 15th day of the third month following the close of the taxable year shall be considered as paid during the taxable year. The corporation must elect this treatment. The election is made by simply including the so called "throwback dividend" in computing its dividends paid deduction for the preceding year on the return filed for such year.[20] The throwback dividend is limited to the lesser of: (1) the undistributed personal holding company income of the corporation for the taxable year before considering the throwback dividend,[21] or (2) 20 percent of the sum of the dividends paid during the taxable year.[22] This limited exception is allowed since a corporation may not know exactly how much it must distribute to avoid the PHC tax until after year end. By allowing a deduction for the throwback dividend, a corporation can avoid the PHC tax by eliminating UPHCI.

A corporation with insufficient funds to actually pay a dividend to reduce UPHCI to zero might be faced with a choice between borrowing to pay a dividend or paying the PHC tax. This is fortunately not the case, however thanks to the consent dividend provision permitted under Section 565. A consent dividend is a hypothetical dividend that shareholders agree to treat as a dividend even though they do not actually receive anything. The consent dividend procedure allows a corporation which has failed to pay sufficient dividends during the year and failed to pay sufficient throwback dividends to eliminate UPHCI and avoid the PHC Tax.

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[19] Regs. § 1.561-2.

[20] Regs. § 1.563-2.

[21] § 563(b)(1).

[22] § 563(b)(2).

Under the consent dividend provision, any person owning consent stock on the last day of the corporation's taxable year can file a consent with the corporation's tax return. Under the signed consent, the shareholder agrees to treat as a dividend the amount specified.[23] Consent stock is stock that is entitled, after the payment of preferred dividends, to a share in the distribution (other than in complete or partial liquidation) of all the remaining earnings and profits.[24] Generally speaking, this would be common stock. A shareholder's consent is made on Form 972, "Consent of Shareholder to Include Specific Amount in Gross Income."

Although the Form 972 is executed and signed by the shareholders, it is filed by the corporation with its income tax return for the year the consent dividend is being claimed. The shareholder agrees to include in his or her gross income for the taxable year in which the corporation's taxable year ends a specific amount as a taxable dividend.[25] The effect of the consent is that the specified amount is included in the shareholder's income as a dividend received on the last day of the corporation's taxable year.[26] If the Commissioner later determines that the corporation is not a PHC, the shareholder will not be charged with a taxable dividend.[27]

As previously mentioned, the dividends paid deduction includes the dividend carryover described in Section 564. Under this provision, "excess" dividends paid in the preceding two years may be used as a dividend carryover to reduce the corporation's UPHCI. Section 564 allows a PHC to deduct the excess of its dividend distributions eligible for the dividends paid deduction for the preceding two years over the taxable income (as adjusted under Section 545) for those

[23] § 565(a).

[24] § 565(f).

[25] Reg. § 1.565-1(c)(1).

[26] § 565(c).

[27] Regs. § 1.565-1(c)(2).

preceding two years.[28] Excess dividends could occur if the corporation's earnings and profits for either of the preceding two years must exceed taxable income (as adjusted under Section 545) and there is a distribution to the extent of earnings and profits or where the corporation makes a distribution out of accumulated earnings and profits as of the beginning of either of the preceding two years.

The legislative intent in enacting the PHC provisions was to compel the distribution of certain types of income by closely held corporations and thus subject such income to taxation at individual rates. This intent is evident in the deficiency dividend procedure allowed under Section 547. Under this provision, even if a corporation fails to distribute sufficient dividends or to timely elect a consent dividend to eliminate UPHCI, the corporation is allowed a last-chance to avoid the PHC tax by paying a deficiency dividend. This deficiency dividend is earmarked as a retroactive dividend deductible against UPHCI for the earlier year. In order to qualify as a deficiency dividend, the following requirements must be met under Section 547:

(1) a determination has been made establishing the amount of the PHC tax deficiency for a prior tax year.

(2) the dividend must be paid within 90 days after the determination.

(3) a claim for the deficiency dividend deduction must be filed within 120 days after the determination.

A determination includes:

(1) a decision by the Tax Court, or a judgment, decree, or other order by any court of competent jurisdiction, which has become final;

(2) a closing agreement under Section 7121;

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[28] § 564(b).

(3) an agreement signed by the Secretary and the corporation relating to the liability of the corporation for the PHC tax.[29]

It is important to know the date of the determination, since this date starts both the period within which the deficiency dividend must be paid and the period in which the claim for deduction must be filed. The Regulations provide guidance as to the exact date of determination.[30]

The claim for a deficiency dividend deduction is made on Form 976.[31] This form requires certain information including the amount of the deficiency for the PHC tax, the amount and date of payment of the deficiency dividend, the various classes of outstanding stock, the identity of each shareholder, the number of shares held by each shareholder, and a copy of the corporate resolution authorizing the payment of the deficiency dividend.[32]

Although planning to avoid the PHC tax should take second seat to that of planning to avoid the regular income tax under Section 11, oil and gas corporations should not ignore the potential hazard of the PHC tax. Unlike the accumulated earnings tax under Section 531, no element of intent is necessary to determine liability for the PHC tax. Therefore, any corporation may be liable for the tax, even oil and gas corporations that have inadvertently fallen within the definition of a PHC.

An oil and gas corporation that is not in jeopardy of being classified as a PHC need not be concerned about the tax. However, if an oil and gas corporation's PHC income approaches 60 percent of its adjusted ordinary gross income, the corporation should consider the methods discussed earlier in this article to avoid being classified as a PHC. In

[29] § 547(c).

[30] Regs. § 1.547-2(b)(1).

[31] Regs. § 1.547-2(b)(2).

[32] *Id.*

the event that the corporation does not deem it advisable to issue additional stock so as to fail the stock ownership test, and if the corporation is not in a position to significantly reduce its PHC income or increase its adjusted ordinary gross income so as to fail the 60 percent income test, the corporation can still attempt to eliminate undistributed personal holding company income (UPHCI). This can be done through the various types of dividends discussed, including as a last resort, the deficiency dividend procedure. Oil and gas corporations who have achieved the unfortunate status as a PHC could possibly consider an election under Subchapter S. An S Corporation election will however only provide protection from the tax in the future. It will not provide retroactive protection to the corporation in years during which the corporation was a regular corporation.

Planning in the personal holding company tax area can prevent an oil and gas corporation from inadvertently falling within its provisions. A corporation close to passing the 60-percent test should take steps to avoid being classified as a PHC. These steps could prevent the corporation from being forced into a situation of either paying the PHC tax or paying a throwback dividend, electing a consent dividend, or electing a deficiency dividend.