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## The Liquidation of a Personal Holding Company Under the Revenue Act of 1964

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## THE LIQUIDATION OF A PERSONAL HOLDING COMPANY UNDER THE REVENUE ACT OF 1964

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### I. INTRODUCTION

The purpose of this article is to attempt to explain the changes made by the Revenue Act of 1964 and their two-fold affect on Personal Holding Company liquidations. One change relates to the Personal Holding Company's (hereinafter abbreviated as PHC) Undistributed Personal Holding Company Income (hereinafter abbreviated as UPHCI) in the year of liquidation, the other, to three new preferential methods of liquidation now available to the PHC. While the greater part of this paper will be devoted to an analysis of the preferential methods of liquidation, through a problem approach, a complete understanding of the area cannot be gained without first acquiring a knowledge of the treatment of the PHC's UPHCI in the year of liquidation.

Many other changes, not the subject of this article, have been made in the PHC area, change which will cause many corporations to become PHC's for the first time. These corporations will be desirous of using the new liquidation provisions in order to liquidate without incurring substantial tax costs. Since the Internal Revenue Service has not as yet issued any regulation or ruling on this subject, this paper has been written

to serve as a guide to those corporations who may choose to take advantage of the new statutory provisions.

### A. *The Opulent Avoider*

The PHC is a device used by a taxpayer in a high tax bracket who has substantial investment assets.<sup>1</sup> A transfer of these assets is made to a newly formed corporation, the taxpayer receiving the corporation's capital stock in exchange for his assets.<sup>2</sup> The corporation proceeds to hold these assets, receiving and collecting the dividends, interest, rents, etc., reporting the income received, and paying the required token tax.<sup>3</sup> This process continues for a number of years with no distributions to the taxpayer. In the year of liquidation the corporation distributes all the accumulated earnings and profits together with the corporate assets to the taxpayer in exchange for his capital stock. Any recognized gain is taxed at capital gains rates rather than ordinary rates.<sup>4</sup>

Through the use of a PHC the taxpayer avoids a high bracket tax treatment on his investment income. Without the corporate conduit the taxpayer would personally receive the interest, dividends, rents, etc., and be required to include these forms of income in his gross income.<sup>5</sup> In that case the rate of tax could be as high as seventy percent while the corporate rate would only be twenty-two percent.<sup>6</sup>

### B. *Opulence Restored*

Congress recognized the PHC as a device to avoid taxes and in order to limit the PHC's usefulness imposed upon all PHC's a high penalty tax, in addition to the regular corporate normal and sur tax.<sup>7</sup> However,

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1. Investment assets generally include stocks, bonds, savings accounts, and rental properties. These assets produce, what is commonly called, passive income.

2. This transfer is considered a tax free exchange to the taxpayer under INT. REV. CODE of 1954, § 351. It is a tax free exchange to the corporation by virtue of INT. REV. CODE of 1954, § 1032.

3. If the corporation's taxable income is under \$25,000 it will be taxed at a rate of twenty-two percent for those taxable years ending after December 31, 1963. INT. REV. CODE of 1954, § 11(b)(2). Should its taxable income exceed \$25,000 the corporation will be taxed at a rate of forty-eight percent on the excess over and above \$25,000. This rate is effective for taxable years ending after December 31, 1964. INT. REV. CODE of 1954, § 11(c)(3).

4. The difference between the taxpayer's adjusted basis in the capital stock of the corporation and amount distributed to him in liquidation will reflect the recognized gain. If the corporation liquidated under § 331 the amount distributed to the taxpayer would be considered as in full payment in *exchange* for his stock. Since this is treated as an exchange the taxpayer would reflect his gain as capital in nature rather than ordinary, and therefore would be subject to capital gains rates rather than ordinary rates.

5. INT. REV. CODE of 1954, § 61.

6. Effective for taxable years ending after December 31, 1964, the highest individual rate of tax is seventy percent. INT. REV. CODE of 1954, § 1(a)(2).

7. INT. REV. CODE of 1954, § 541. The penalty tax, under the new law, is seventy percent of the PHC's UPHCI. Before the Revenue Act of 1964 the penalty tax was seventy-five percent of the UPHCI not in excess of \$2,000 and eighty-five percent of the UPHCI in excess of \$2,000.

the penalty tax was a deterrent to the formation of PHC's only when the corporation could not avoid being classified as a PHC. Since a corporation had to meet certain statutory requirements before it would be considered a PHC,<sup>8</sup> through proper organization and/or operation the corporation could avoid PHC classification and therefore avoid the high PHC penalty tax. Thus, prior to the Revenue Act of 1964 many corporations, which for all practical purposes were PHC's, avoided the penalty tax by developing devices to circumvent the definitional requirements of the statute.<sup>9</sup>

Having become aware of the devices which were being employed to avoid the PHC definition, Congress took steps to put an end to these abuses.<sup>10</sup> The PHC provisions were drastically amended to plug the classification loopholes and to include within the PHC category corporations which had previously been outside its realm.

### C. *From Frying Pan to Fire*

Although the purpose of curbing abuses was achieved through statutory changes, a new problem was created. Corporations which had previously remained outside the PHC definition by adhering to the strict letter of the statutory language now found themselves in a precarious situation. By continuing operations the corporation would subject itself to the PHC penalty tax, while a liquidation under existing law would also present an extreme hardship.<sup>11</sup>

The problem created by the definitional changes was alleviated in the Revenue Act of 1964 by the implementation of three preferred methods of liquidation. Two of these provisions for liquidation are now found in Section 333 of the Internal Revenue Code of 1954,<sup>12</sup> while the third, due to an early expiration date, has been retained in the Revenue Act of 1964.<sup>12a</sup> These special liquidation provisions are available to those

8. INT. REV. CODE of 1954, § 542.

9. Some of these devices were:

- A. Use of rental income to shelter investment income.
- B. Use of income from mineral operations to shelter other investment income.
- C. Timing capital gains which were not PHC income (e.g., from the sale of business assets) to avoid PHC status.
- D. Switching capital gains from the sale of securities to other years to avoid the PHC gross income test.

10. The abuses were curbed by amending the INT. REV. CODE of 1954, §§ 541-545. Through these revisions the PHC definition was broadened to include many corporations which had previously been able to avoid PHC classification.

11. A liquidation under § 331 would require the taxpayer to pay capital gains rates on the accumulated earnings and profits and the appreciation in value of the assets of the firm. A corporation would not liquidate under § 333 since the accumulated earnings and profits would be taxed as a dividend at ordinary rates. This is the very thing the taxpayer was trying to avoid when he set up the corporation. A liquidation through the use of § 332 or § 337 would generally be inapplicable.

12. INT. REV. CODE of 1954, §§ 333(g)(1), 333(g)(2).

12a. Pub. L. No. 272, 88th Cong., 2d Sess., § 225(h) (Feb. 26, 1964).

corporations which now find themselves classified as PHC's and which *would have been* considered PHC's in either 1962 or 1963 or both if the new law had been applicable in those years.

## II. THE LIQUIDATING DIVIDEND

This section of the article will be devoted to a consideration of the changes which have taken place with respect to distributions in liquidation by a PHC. The intention is to provide a background for the discussion of the new preferential methods of liquidation now available to certain PHC's.

### A. Background

Prior to the Revenue Act of 1964 the PHC was required to pay the PHC penalty tax based upon its UPHCI.<sup>13</sup> In arriving at its UPHCI the PHC was permitted to deduct distributions in liquidation to the extent of its accumulated earnings and profits.<sup>14</sup> As a general result the PHC would not have any UPHCI in the *year of liquidation* to which the penalty tax could apply. For example:

The X corporation has UPHCI in the year of liquidation of \$100,000. All of the firm's assets, including \$200,000 of accumulated earnings and profits, are distributed to the stockholders. Prior to the 1964 amendments the PHC would receive a dividends paid deduction of \$100,000, the extent of its accumulated earnings and profits, and would therefore eliminate its UPHCI and any penalty tax.

This loophole in the law was recognized by the Committee on Ways and Means. At a meeting on the Revenue Act of 1964 the Committee stated:

Under present law, [the penalty tax] on personal holding companies applies only to the undistributed personal holding company income. Thus, this tax is applied after dividend distributions are taken into account. Included among the amounts treated as dividends eligible for the dividends paid deduction are distributions in liquidation to the extent of the accumulated earnings and profits. As a result, in the year of liquidation of a personal holding company there is no income subject to personal holding company tax for that year.<sup>15</sup>

The House Ways and Means Committee also recognized the advantage gained by the PHC stockholders upon receiving the liquidating distribution.

These provisions permit a company which is a personal holding

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13. INT. REV. CODE of 1954, § 545, provides the definition of Undistributed Personal Holding Company Income.

14. INT. REV. CODE of 1954, § 545(a) and § 562(b).

15. U.S. CODE CONG. & AD. NEWS 1390 (1964).

company to avoid both the personal holding company tax and the individual rates with respect to its owner in the year in which it chooses to liquidate. A corporation which is formed to hold assets producing personal holding company income can avoid personal holding company tax if it is liquidated before the end of the first year, since its undistributed personal holding company income is reduced to zero by the liquidation distribution. The stockholders are taxed at only capital gains rates on the liquidation distribution.<sup>16</sup>

It can be seen that although the PHC receives a dividends paid deduction which it may use to offset its UPHCI and therefore avoid the PHC tax, the liquidation distribution is not treated as a dividend to the stockholders, taxable at ordinary rates. Through the use of a section 331 liquidation the stockholders treat all distributions as being in exchange for their stock in the PHC and report their gain upon liquidation as capital in nature. The amount treated as a dividend deduction to the PHC is, in essence, reflected as a capital gain by the stockholders. For example:

In the previous example \$200,000 of accumulated earnings and profits, along with other firm assets, was distributed to the stockholders. Assume that the total value of all the assets and the accumulated earnings and profits is \$1,200,000 and that the stockholder's basis in the PHC's capital stock is \$1,000,000. Under these circumstances the stockholders will reflect a \$200,000 capital gain if the corporation liquidated under section 331. Of this \$200,000 the PHC had used \$100,000 as a dividend paid deduction to reduce its UPHCI to zero.

#### B. *Loopholes Closed—The Revenue Act of 1964*

In order to prevent the UPHCI of the PHC from escaping the penalty tax in the year of liquidation, and to prevent the non-corporate stockholder of the PHC from receiving a capital gain on the UPHCI which is distributed to him in the year of liquidation, Congress amended Code sections 316, 562, and 331. The effect of the amendment to section 316 is to deny the PHC a dividends paid deduction (which it can use to reduce its UPHCI to zero and avoid the PHC penalty tax) unless it designates the non-corporate shareholders' allocable share of the UPHCI as a *dividend* to him. The amendment to section 562 permits the PHC to reduce its UPHCI in an amount not in excess of any corporate distributee's allocable share of the UPHCI. However, this distribution is not treated as a *dividend* to the corporate shareholder, but rather as a capital gain under section 331. Section 331 has been amended to provide

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16. Hearings before the Committee on Ways and Means on the Technical Implementation of the President's Recommendations contained in his message on taxation, H. Rep. No. 749, 88th Cong., 1st Sess., pt. 1, at 121 (1963).

that the dividend designated by the PHC can not be treated as a capital gain to the non-corporate distributee.

#### 1. SECTION 316—THE NON-CORPORATE DISTRIBUTEE

A PHC can avail itself of the dividends paid deduction only after it determines that its liquidating distributions qualify as *dividends*. Section 562(a) provides the general rule, that a dividends paid deduction is only allowed when the definition of a dividend as set forth in section 316 is met. Section 316(b)(2)(A) declares that the term dividend means any *distribution of property* made by the PHC to its shareholders, to the extent of its UPHCI for such year.

At this point the new sub-paragraph (B) of section 316(b)(2) comes into play. It qualifies sub-paragraph (A) by providing that the term *distribution of property* includes a distribution in complete liquidation occurring within 24 months after the adoption of a plan of liquidation, but only to the extent of the amounts distributed to distributees *other* than corporate shareholders,<sup>17</sup> and only to the extent that the PHC designates such amounts as a dividend distribution and duly notifies such distributees of such designation.<sup>18</sup> The amount designated cannot exceed the sum of such distributees' allocable share of the UPHCI for such year.<sup>19</sup>

The effect of section 316(b)(2)(B) is to deny the PHC a dividends paid deduction in the year of liquidation unless it designates that portion of its UPHCI which is attributable to its non-corporate stockholders as a dividend. Once the designation is made the PHC will have a dividends paid deduction which it can use to offset its UPHCI in the year of liquidation. The non-corporate stockholder must pick up these designated amounts as dividend income in the year of distribution. If a designation is not made the PHC will not have a dividends paid deduction and will therefore have to pay the PHC tax on its UPHCI. If the PHC tax is paid the stockholder will not be required to pick up any dividend income in the year of distribution. As a practical matter it is very doubtful that a PHC will elect to pay the PHC tax rather than direct that its UPHCI be designated as dividends to its non-corporate stockholders.

It should be noted that although a PHC cannot designate a dividend in excess of its non-corporate shareholders allocable share of the UPHCI, it could designate less than his share as a dividend. For example:

The X corporation has an UPHCI of \$100,000 in the year that it liquidates. Individuals A and B each own fifty percent of the X corporation stock. Each stockholder's allocable share of the UPHCI is \$50,000.

17. INT. REV. CODE of 1954, § 316(b)(2)(B)(i).

18. INT. REV. CODE of 1954, § 316(b)(2)(B)(ii).

19. INT. REV. CODE of 1954, § 316(b)(2)(B)(iii).

X could designate \$40,000 to A, or the entire \$50,000, but it could not designate more than \$50,000.

Assuming a PHC has made the proper designation it will be permitted the dividends paid deduction for its non-corporate stockholders. Since the definition of a dividend has been met, section 561(a)(1) permits the deduction.

## 2. SECTION 562—THE CORPORATE DISTRIBUTE

Section 562(b)(2) provides that for the *purposes of computing the dividends paid deduction* any distribution to a corporate shareholder of a PHC within twenty-four months after the adoption of a plan of liquidation shall be treated as a *dividend*. However, the deduction will only be allowed to the extent of the corporate shareholders allocable share of the UPHCI for the taxable year of the distribution.

It is important to understand that the distribution will only be considered as a dividend *for the purpose of computing the dividends paid deduction*. This has no bearing on the reflection of this distribution by the corporate shareholder in his tax return. The corporate shareholder may not treat this distribution as a dividend and then avail himself of the eighty-five percent dividend credit of section 243. Since section 316(b)(2)(B) talks only in terms of a non-corporate shareholder, the corporate shareholder cannot report the income as a dividend under that code authority. If section 316 cannot help the corporate shareholder to report his distribution as a dividend, then there can be no relief in any other code provision, for section 316 delineates what shall or shall not be classified as a dividend. Although the corporate distributee cannot treat the distribution as a dividend, he will be entitled to a capital gain under section 331.

The effect of section 562(b)(2) is to permit the PHC to reduce its UPHCI by the amount which it distributes to its corporate shareholder, but not in excess of such corporate shareholder's allocable share of the UPHCI for the liquidation year.

## 3. SECTION 331—THE RESTORATION OF SECTION 301 DIVIDEND TREATMENT

The general rule of section 331 is that liquidating distributions received by a shareholder are to be treated as full payment in *exchange for his stock*. Section 331(b) calls for the non-application of section 301.<sup>20</sup> If the provisions of 331(b) were still to obtain the non-corporate

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20. Section 301 generally provides that any distribution of property made by a corporation to its stockholder which qualifies as a dividend under § 316 shall be treated as a dividend to the shareholder. Section 331(b) provides that § 301 will be inapplicable, therefore permitting the distribution to be taxed as a capital gain rather than a dividend at ordinary rates.



shareholder of a PHC would not have to recognize dividend income on the amounts designated as dividends under section 316(b)(2)(B). For this reason section 331(b) has been amended to provide that section 301 will not be applicable except where there has been a distribution under 316(b)(2)(B).

The effect of the amendment to section 331(b) is that amounts which are distributed to non-corporate shareholders by a PHC, and which meet all the requirements of section 316(b)(2)(B), are not treated as in payment in exchange for stock of the distributing corporation under section 331(a). The corporate shareholder will still recognize capital gains treatment as to his distributions.

The following example will serve to illustrate the application of sections 316(b)(2)(B), 562(b)(2), and 331(b), and the resulting effect upon corporate and non-corporate distributees:

L is a PHC. Its UPHCI for 1964 is \$303,000. On 12/31/64, pursuant to a plan of liquidation, it distributes all of its assets (consisting of stocks with a fair market value of \$9,000,000 and \$603,000 in cash, including \$300,000 accumulated from prior years' earnings) equally to its three shareholders, individuals A and B and corporation C. A and B each receive a liquidating distribution of \$3,201,000 (one-third of \$9,603,000). A and B each have an adjusted basis of \$2,900,000 for their stock in corporation L. A and B could now report a \$301,000 capital gain under section 331, but L corporation would not get a dividends paid deduction to be applied against their UPHCI. Thus, L corporation would have to pay the PHC tax on its UPHCI. However, L corporation designates \$202,000 (two-thirds of the UPHCI of \$303,000) of the distributions in liquidation to A and B as a dividend and so notifies them of such designation.

In view of this designation A and B must treat \$101,000 as a dividend and report a gain on the liquidation of the corporation of \$200,000, computed as follows:

Distribution	\$3,201,000	
Less: Amount designated as a dividend by corporation L	101,000	
	<hr/>	\$3,100,000
Less: Basis in stock of corporation L		2,900,000
Gain on Liquidation		<hr/>
		<u>\$ 200,000</u>

The distributions under section 316(b)(2)(B), which are the dividends designated by L corporation, are, in accordance with the amended section 331(b), distributions of property to which section 301 applies.

These distributions are not treated as in payment in exchange for stock of the distributing corporation under 331(a). The \$200,000 gain in liquidation will be treated as payment in exchange for stock of the distributing corporation under 331(a), and will thus be afforded capital gains treatment.

Corporation C will treat the entire amount of its \$3,201,000 liquidating distribution as full payment in exchange for its stock. Section 316(b)(2)(B) and section 331(b) are not applicable. Therefore, corporation C, not having received a dividend, cannot take advantage of the eighty-five percent dividend credit of section 243. However, L corporation may still take a deduction for \$101,000 as a dividends paid deduction under section 562(b)(2). The \$101,000 represents corporation C's allocable share of the UPHCI for the taxable year. If dividends had not been designated to A and B, L corporation would still be limited to a dividends paid deduction of \$101,000, for this amount represents C's allocable share of the UPHCI for the liquidation year.

L corporation now has no UPHCI for 1964, computed as follows:

UPHCI		\$303,000
Less: Distributions to A and B designated as a dividend (Section 316(b)(2)(B))	\$202,000	
Distribution to Corporation C in liquidation (Section 562(b)(2))	101,000	303,000
		<u>0</u>
UPHCI		<u>0</u>

### III. PREFERENTIAL PERSONAL HOLDING COMPANY LIQUIDATIONS— THE NEED FOR SPECIAL HANDLING

Although Congress found it necessary to strengthen the PHC provisions in order to curb abuses, it did not intend to penalize those corporations which had previously avoided PHC classification by adhering to the strict letter of the statutory language. These corporations now found themselves subject to the PHC penalty tax since they were now within the PHC definition. Recognition of the hardship created by the new amendments and the manner in which the problem was resolved is found in the following statement by the House Ways and Means Committee.

While your committee believes that the tightening of the personal holding company provisions as indicated in the prior discussion is desirable, nevertheless, it believes that it would be unfortunate to apply these provisions without any alternatives being available, to companies which in the past have not been classified as personal holding companies but which as a result

of the new provision will for the first time find themselves subject to the personal holding company tax. Your committee believes that it would be unfair to require such companies to pay a personal holding company tax if they are willing to liquidate. Although it is understood that some of these companies are willing to liquidate, nevertheless, it would represent a hardship under existing law for them to do so. The hardship arises from the fact that if they liquidate under the provisions of section 331 of the code, not only would the earnings and profits of such corporations be taxed to the shareholders at capital gains rates but also any other appreciation which has occurred in the value of the assets would be so taxed to them. Such companies in the absence of the new personal holding company provisions would face no necessity of liquidating and therefore under these circumstances no tax would now be paid with respect to these unrealized increases in value. Your committee believed it was appropriate therefore to forego the tax at this time on unrealized appreciations in value but to collect the capital gains tax on the earnings and profits distributed.<sup>21</sup>

Pursuant to its desire to mitigate the effect of the new amendments and provide a method whereby liquidation would not create an undue heavy burden, Congress has provided for three special forms of liquidation applicable to PHC's. The first two methods of liquidation involve section 333, while the last involves a liquidation under section 333 or 331, depending upon the whim of the liquidating corporation. It is imperative to note that the amendments made to sections 316(b)(2)(B), 562(b)(2), and 331(b), are applicable to all of these special liquidations, except where it is specifically pointed out that they are inapplicable.

*A. Liquidations Before January 1, 1967—Section 333(g)(1)*

In order to avail itself of a section 333(g)(1) liquidation a PHC must first meet the requirements of section 333(g)(3). This is the "would have been" provision. Paragraph (3), of subsection (g), of section 333, declares that a corporation which was not a PHC for at least one of the two most recent taxable years ending before the date of enactment of this subsection, under section 542, but "would have been" a PHC for such taxable year if the new section 542 had been applicable, will be considered to meet the requirement of section 333(g)(1). The following examples illustrate the dependency of section 333(g)(1) on section 333(g)(3).

(1) A corporation which was a PHC for both of its two most recent taxable years ending before the enactment of section 333(g) is not a corporation referred to in section 333(g)(3). This corporation cannot make use of a section 333(g)(1) liquidation.

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21. U.S. CODE CONG. & AD. NEWS 1390 (1964).

(2) A corporation which was not a PHC for either of the two years referred to and which will not be a PHC for either of those years under the new law does not qualify as a section 333(g)(3) corporation. The benefits of 333(g)(1) are not available.

(3) A corporation which was a PHC for both years under the old law, but would not be a PHC for either year under the new law is not a section 333(g)(3) corporation. Section 333(g)(1) is not available.

(4) A corporation which was not a PHC for either of the two years referred to, but would have been a PHC for either year if the new law had been in effect, is a corporation referred to in section 333(g)(3). Section 333(g)(1) is available.

(5) A corporation which was a PHC for only one of the two years referred to and which would have been a PHC in that other year if the new law had been in force, is a corporation referred to in section 333(g)(3). Section 333(g)(1) is available.

(6) A corporation which was a PHC for 1962, but not for 1963, under the old law, which would have been a PHC under the new law as to 1963 but not as to 1962, is still a corporation referred to in section 333(g)(3). Section 333(g)(1) is available.

Proceeding with the idea in mind that we are involved with a section 333(g)(3) corporation, the code then provides in 333(g)(1)(A) that the date December 31, 1953 referred to in subsection (e)(2) and (f)(1), of section 333, shall be treated as if such date read December 31, 1962. The effect of section 333(g)(1)(A) is to postpone gain which would ordinarily be recognized at the time of liquidation.

A normal section 333 liquidation requires an individual shareholder to recognize as a capital gain that portion of the distribution which consists of cash and marketable securities acquired after December 31, 1953 by the liquidating corporation. The gain to be reported cannot exceed the stockholder's ratable share of the corporation's earnings and profits.

In order to show the effect of section 333(g)(1)(A) on an individual stockholder, the following examples are presented.

#### 1. A NORMAL SECTION 333 LIQUIDATION

X, a corporation qualifying for liquidation under section 333, distributes \$200,000 in cash and securities with a fair market value of \$300,000, purchased in 1956, to its sole stockholder A, in return for the latter's stock. X corporation's accumulated earnings and profits, determined as of the close of the month in which the transfer in liquidation occurred, is \$100,000.

Pursuant to the liquidation A would have a realized gain of \$400,000, (\$500,000 received less an adjusted basis of \$100,000) all of which would be recognized. A would be required to report \$100,000 of his gain as a dividend, the amount of the earnings and profits, in accordance with section 333(e)(1). The remainder of his gain, \$300,000, would be reported as a capital gain (long term), in accordance with section 333(e)(2). The computation of this latter amount is as follows:

Amount Realized	\$500,000
Less: Adjusted Basis	100,000
	<hr/>
	400,000
Less: Dividend (Earnings and Profits)	100,000
	<hr/>
Long Term Capital Gain	\$300,000
	<hr/> <hr/>

## 2. THE EFFECT OF SECTION 333(g)(1)(A) ON A NORMAL 333 LIQUIDATION

In the above example A would still be required to report the \$100,000 as a dividend. The difference comes about when it is noted that section 333(g)(1)(A) changes the date of section 333(e)(2) to read December 31, 1962, rather than December 31, 1953. Since the securities above were purchased in 1956 they would not be taken into account in determining A's recognized gain. Since section 333(g)(1)(A) does not change the effect of any cash received there will be no postponement as to it. A would report a long term capital gain of \$100,000, computed as follows:

Cash received	\$200,000
Post 1962 securities	—0—
	<hr/>
	200,000
Less: Dividend	100,000
	<hr/>
Long Term Capital Gain	\$100,000
	<hr/> <hr/>

A's basis in the securities would be \$100,000, determined under section 334(c)(2). Assuming A sold the securities for its fair market value of \$300,000 his gain would be \$200,000. It can be seen that the gain is recognized upon sale rather than at the time of liquidation.

The above examples point out the purpose of section 333(g)(1)(A). It permits a postponement of gain to a qualified electing shareholder with respect to the distribution of stock or securities acquired by the liquidating corporation before January 1, 1963.

Section 333(g)(1)(A) also changes the wording of section 333(f)(1) so that a corporate shareholder of the liquidating corporation may postpone its gain upon receiving stock or securities acquired by the

liquidating corporation prior to January 1, 1963. Usually a corporate shareholder must recognize gain to the extent of the cash and post 1953 securities received or its share of the earnings and profits, which ever is greater, but now it may postpone a good part of its gain by not taking into account pre 1963 securities.

### 3. THE EFFECT OF SECTION 333(g)(1)(A) UPON A CORPORATE DISTRIBUTEE

X corporation liquidates and distributes \$200,000 of securities, which it purchased in 1960, to Y, a corporate shareholder, in return for its stock. X has no earnings and profits. Y's basis in its X corporation stock is \$10,000.

Without section 333(g)(1)(A) Y corporation would have to report a \$190,000 gain in accordance with section 333(f)(1). Since section 333(g)(1)(A) does apply Y corporation will report no gain. A gain is not reported upon liquidation because the securities distributed were purchased by X corporation prior to January 1, 1963.

The preceding examples, relating to the non-corporate shareholder, indicate that regardless of a change in section 333(e)(2) the non-corporate shareholder will still have to recognize a dividend to the extent of his share of the corporation's accumulated earnings and profits. Congress, however, has provided a means of escaping this ordinary income treatment by inserting section 333(g)(1)(B).

Section 333(g)(1)(B) provides that in the case of a non-corporate shareholder, who has held his stock more than six months, the term dividend as used in section 333(e)(1) shall be treated as if such term were *long term capital gain*. The effect of this change is self explanatory.

Since a corporate shareholder never treats a distribution under 333 as a dividend, it follows that section 333(g)(1)(B) has no application to it.

The various requirements and effects of section 333(g)(1) liquidation having been discussed,<sup>22</sup> an all inclusive example, containing the effect of section 316(b)(2)(B),<sup>23</sup> will now be presented.

### 4. ALL INCLUSIVE APPLICATION OF A SECTION 333(g)(1) LIQUIDATION

P, a corporation referred to in section 333(g)(3) and whose books are kept on a calendar year basis, adopts a plan of liquidation and so

22. The only item relevant to § 333(g)(1) not discussed pertains to the earnings and profits acquired by the liquidating corporation pursuant to a prior reorganization or § 332 liquidation. This situation will rarely come about. If the reader desires to know more about this area he may refer to the statutory language dealing with this subject contained in § 333(g)(1). Similar language is found in § 333(g)(2).

23. The amendment made to § 562(b)(2) is not applicable to this example since there are no corporate distributees involved. Since this is a liquidation under § 333 the amendment to § 331(b) is likewise not applicable.

liquidates on October 1, 1966. Its assets on such date consist of the following items:

	<u>Fair Market Value</u>
Stock in corporation V (acquired in 1958)	\$3,000,000
Stock in corporation W (acquired in 1963)	550,000
Real Property	200,000
Total Assets	<u>\$3,750,000</u>

P is a PHC under the new law for the short taxable year ending October 1, 1966. Its UPHCI for this period is \$50,000. In order to avoid the PHC penalty tax it obtains a dividends paid deduction of \$50,000 by designating the \$50,000 as a dividend, in accordance with section 316(b)(2)(B), to its sole stockholder A.

As of October 1, 1966, corporation P's earnings and profits accumulated after February 28, 1913, but excluding the \$50,000 which has already been designated as a dividend, is \$250,000. Pursuant to the plan of liquidation P distributes all of its assets to A.

Individual A has an adjusted basis of \$2,000,000 in the P corporation stock. A's total realized gain upon liquidation is \$1,750,000 (\$3,750,000 distribution less his adjusted basis of \$2,000,000). Assuming that a proper election was made under section 333(d), A recognizes and treats as a long term capital gain \$250,000, under the authority of section 333(e)(1) and 333(g)(1)(B). If it were not for section 333(g)(1)(B), A would have to treat the \$250,000 as a dividend. A recognizes and treats as a long term capital gain \$300,000 under sections 333(e)(2) and 333(g)(1)(A). The gain of \$300,000 is computed as follows:

Fair Market Value	
of Corporation W stock (acquired in 1963)	\$550,000
Less: A's ratable share of the Earnings and Profits	250,000
Long Term Capital Gain	<u>\$300,000</u>

If it were not for the provisions of section 333(g)(1)(A), A would have had a long term capital gain of \$1,500,000, the remainder of his realized gain of \$1,750,000. This would be the result since the V and W stock were both acquired by corporation P after December 31, 1953.

In this example A will have a total recognized gain of \$550,000. The remaining gain, yet to be recognized, of \$1,200,000 will be recognized when A disposes of the property by sale (assuming the asset values remain the same). The gain will never be recognized if A passes the property by devise, for then the devisee will pick up a basis equivalent to the fair market value of the assets.<sup>24</sup>

B. *Liquidations After December 31, 1966—Section 333(g)(2)*

Many cases had been called to the attention of the Senate Finance Committee wherein certain corporations had entered into commitments to use their incomes to pay off qualified indebtedness, and as a result it was difficult, if not impossible for them to liquidate before this indebtedness was paid off. For this reason section 333(g)(2) was added to the code. It will apply only if the corporation liquidates in the year in which it either pays off the pre-December 31, 1963 indebtedness or could have payed off the pre-December 31, 1963 indebtedness, if it had devoted all of its earnings and profits, depreciation, amortization, and depletion to this purpose.

A liquidation which takes place after December 31, 1966, may be afforded specialized or preferential treatment if it meets the following requirements:

(1) The liquidating corporation must be a corporation referred to in section 333(g)(3).

(2) The requirements of subparagraph (B) of section 333(g)(2) must be met.

The requirements of section 333(g)(3) having previously been discussed, the following discussion of section 333(g)(2)(B) presumes that its qualifications have been met.

Section 333(g)(2)(B) first provides that the corporation must owe qualified indebtedness, as defined in section 545(c), on January 1, 1964. Secondly, the corporation must notify the Internal Revenue Service that it may wish to use the section 333(g)(2) liquidation. This notice must be filed by January 1, 1968. Along with this notice the corporation must submit such information as the regulations (not yet published) may prescribe. Thirdly, the corporation must liquidate before the close of the taxable year in which it ceases to owe qualified indebtedness or (if earlier) the taxable year referred to in subparagraph (C) of section 333(g)(2).

Subparagraph (C) of section 333(g)(2) provides a definition of the words "taxable year," in the situation where a corporation will liquidate earlier than the year in which it ceases to owe qualified indebtedness. For this purpose the taxable year referred to is the first taxable year at the close of which the corporation's *adjusted post 1963 earnings and profits* equal or exceed the amount of its qualified indebtedness on January 1, 1964.

The term *adjusted post 1963 earnings and profits* means the sum of the earnings and profits of the corporation for the taxable years beginning after December 31, 1963, without taking into account any



distribution of earnings and profits during this period, and the deductions allowed for taxable years beginning after December 31, 1963, for depreciation, amortization, and depletion.

For the purpose of applying the above rules the corporation is considered as having no earnings and profits or accumulated deficit as of January 1, 1964.

The term "qualified indebtedness" is defined in section 545(c)(3). As a general rule it means the outstanding indebtedness incurred by a section 333(g)(3) corporation after December 31, 1933, and before January 1, 1964. There are many exceptions and limitations as to what will be considered "qualified indebtedness," but for the most part these differences pertain to the inclusion of outstanding indebtedness, incurred after December 31, 1963, as "qualified indebtedness." Since section 333(g)(1), with respect to liquidations occurring before January 1, 1964, there is no need to go any further into the exceptions and limitations of post 1963 "qualified indebtedness."

Assuming that the above qualifications have been met, section 333(g)(2)(A)(i) provides that the date of December 31, 1953 referred to in sections 333(e)(2) and 333(f)(1) shall be treated as if such date were December 31, 1962.

This clause has exactly the same effect with respect to liquidations occurring after December 31, 1966, as does subparagraph (A) of section 333(g)(1), with respect to liquidations occurring before January 1, 1967.<sup>25</sup>

Clause (ii) of section 333(g)(2)(A) provides that the amount of any gain which is recognized under section 333(e)(1) as attributable to the earnings and profits of the corporation accumulated after February 28, 1913, and before January 1, 1967, shall, in the case of stock in such corporation held for more than six months, be treated as a long term capital gain, and only the remainder of such gain shall be treated as a dividend.

By virtue of the clause above the non-corporate stockholder will recognize and treat as a long term capital gain, assuming he has held his stock for more than six months, so much of his gain in liquidation which is attributable to his share of the corporation's earnings and profits which have been accumulated after February 28, 1913 and before January 1, 1967. Any portion of his gain which is attributable to his share of the corporation's earnings and profits accumulated subsequent to December 31, 1966, will still be treated as a dividend.<sup>26</sup>

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25. The stocks or securities acquired by the liquidating corporation before January 1, 1963, and subsequently distributed in liquidation will not give rise to any recognized gain at the time of distribution, rather the gain will be postponed until the stockholder disposes of these assets.

26. Clause (ii) is rendered inapplicable to any earnings and profits which the liquidating

The following example will illustrate the application of a section 333(g)(2) liquidation:

The X corporation was organized on January 1, 1961. Individual A and corporation W each owned fifty percent of X corporation's outstanding stock. Both A and W have an adjusted basis of \$1,000,000 in said stock.

In June of 1963 the X corporation purchased land at a cost of \$150,000, agreeing to pay \$25,000 down and \$25,000 per year for the next five years.

The X corporation is a section 333(g)(3) corporation. A notice was sent to the Internal Revenue Service in June of 1967 stating that the X corporation may wish to liquidate under the provisions of section 333(g)(2).

On July 31, 1968 the X corporation is liquidated. As of the date of liquidation there is \$700,000 of accumulated earnings and profits, \$25,000 of which is attributable to the short taxable year, January 1, 1968, to July 31, 1968.<sup>27</sup> The following assets are distributed in liquidation.

	<u>Fair Market Value</u>
Stock in K corporation (acquired in 1963)	\$ 200,000
Land	800,000
Cash	100,000
Stock in C corporation (acquired in 1962)	1,400,000
Stock in V corporation (acquired in 1961)	1,500,000
	<hr/>
Total Distribution	\$4,000,000
	<hr/>

The realized gain to both A and W is \$1,000,000, their basis of \$1,000,000 less fifty percent of the \$4,000,000 distribution. A's share

corporation succeeded to after December 31, 1963, pursuant to a corporate reorganization or a § 332 liquidation. However, if those earnings and profits came from a § 333(g)(3) corporation, clause (ii) will still be applicable. If clause (ii) is rendered inapplicable for the reasons just stated, the stockholder will divide his ratable share of the liquidating corporation's earnings and profits into three parts, as follows:

(1) *Dividend*: The part which represents earnings and profits (to which the corporation succeeded to after December 31, 1963) which on December 31, 1963 constituted earnings and profits of a corporation which is not referred to in § 333(g)(3).

(2) *Capital Gain*: The part which represents the earnings and profits of the liquidating corporation accumulated after February 28, 1913 and before January 1, 1967, other than the part described in (1) above.

(3) *Dividend*: The part which represents the earnings and profits of the corporation accumulated after December 31, 1966.

27. The X corporation is a PHC for 1968 but it will not be subject to the PHC tax since §§ 545(a) and 545(c) permits a deduction for qualified indebtedness in computing UPHCI. Since the qualified indebtedness equals the UPHCI of \$25,000, there remains no UPHCI subject to the PHC tax. It should be noted that should there be some portion of the UPHCI remaining after deducting the qualified indebtedness §§ 316(b)(2)(B) and 562(b)(2) would then come into play.

of the X corporation earnings and profits accumulated prior to January 1, 1967 is \$325,000. It is assumed that the earnings and profits of 1967 were the same as the earnings and profits for 1968 (\$25,000). Therefore, subtracting the accumulated earnings and profits of \$50,000 from the years 1967 and 1968 from the total earnings and profits of \$700,000 and dividing the remainder by fifty percent, we arrive at the earnings and profits for A prior to January 1, 1967. This \$325,000 will be treated as a long term capital gain in accordance with section 333(g)(2)(A)(ii). The remaining \$25,000 of earnings and profits attributed to A from post 1966 earnings must be reflected by him as a dividend in accordance with section 333(g)(2)(A)(ii). There will be no recognition of gain with respect to the land as recognition is not required in any form of section 333 liquidation. The cash of \$50,000 (fifty percent of \$100,000) plus the \$100,000 of K corporation stock (fifty percent of \$200,000) must be reflected by A as a long term capital gain in accordance with section 333(e)(2). It will be noted that the K corporation stock was acquired after December 31, 1962, thus section 333(g)(2)(A)(i) is not applicable. Also the relief provisions do not apply to any cash which is received. The stock of corporations C and V will not result in any recognition of gain at this point since both stocks were acquired by X corporation prior to December 31, 1962, and therefore falls into section 333(g)(2)(A)(i).

To recap A must report the following:

Dividend—\$25,000 (Earnings and profits after January 1, 1967)  
 Long Term Capital Gain—\$325,000 (Earnings and profits before January 1, 1967)  
 Long Term Capital Gain—\$150,000 (Cash and post 1962 securities)

A has a new basis of \$1,450,000 for assets received, computed as follows:

A's adjusted basis in the X stock	\$1,000,000
Less: Cash received	50,000
	<hr/>
	950,000
Plus: Recognized gain	500,000
	<hr/>
	\$1,450,000
	<hr/> <hr/>

Corporation W's realized gain is also \$1,000,000. W will recognize gain to the extent of the greater of the cash and stock received, the latter having been acquired by the liquidating corporation after December 31, 1962, or its ratable share of the X corporation's earnings and profits accumulated after February 28, 1913. W's share of the earnings and profits is \$350,000. Cash received of \$50,000 and K corporation

stock of \$100,000 equals a total of \$150,000. Therefore W corporation will recognize only \$350,000 of its realized gain of \$1,000,000.

W has a new basis computed as follows:

Basis in X corporation stock	\$1,000,000
Less: Cash received	50,000
	<hr/>
	950,000
Plus: Recognized gain	350,000
	<hr/>
	<u>\$1,300,000</u>

It should be noted that the section 333(g)(2) provisions do not recognize dividend income to the corporate shareholder for he could then avail himself of the eighty-five percent dividend credit of section 243.

*C. Liquidations before January 1, 1966—Section 225(h)  
of the Revenue Act of 1964*

Section 225(h) of the Revenue Act of 1964 contains a special provision for section 333(g)(3) corporations. A section 333(g)(3) corporation which completely liquidates and distributes all of its property under such liquidation before January 1, 1966, will not be subject to the new definition of a PHC. However the amendments made by section 225(f), pertaining to the dividends paid deduction and section 225(g), relating to the section 333(g)(1) special liquidation, apply to such a corporation.

The following subsections will illustrate the workings of section 225(h) with and without section 225(f) and 225(g).

1. SECTION 225(h)—GENERAL APPLICATION WITHOUT SECTION 225(f)

X is a section 333(g)(3) corporation. Its books are kept on a calendar-year basis. In 1964 X corporation pays a PHC tax because it is now a PHC under the new law.

On October 1, 1965, X corporation liquidates. Since the provisions of section 225(h) are applicable X may receive a refund for the PHC tax which it paid in 1964. This refund will be claimed in the usual manner, subject to the applicable statute of limitations.

For the short taxable year January 1, 1965 to October 1, 1965, X corporation was a PHC under the new law but would not have been a PHC for such year if the old law had been applicable. Once again the provisions of section 225(h) come into play and apply the old law to the income of this short taxable year. Therefore, X corporation will not pay the PHC tax in 1965.

The statement was previously made that although the new PHC definition will not apply, still the amendments made by section 225(f), pertaining to the dividends paid deduction, will apply. That statement is true, but *only* when the liquidating corporation would be a PHC in the year of liquidation *under both the old and new laws*. In the present example X corporation would not have been a PHC in 1965 had the old law applied, therefore, it is not subject to the provisions of section 225(f).

If the provisions of section 225(f) were applicable an inconsistent position would be maintained. Congress, through section 225(h), is permitting corporations which were not PHC's but which will become PHC's under the new law, to liquidate before January 1, 1966, and avoid PHC classification. On the other hand, Congress has specifically provided that a PHC will not escape the PHC tax in the year that it liquidates, unless it designates its UPHCI for the liquidating year as dividends to its non-corporate stockholders, and as non-dividends to its corporate shareholders. If this designation is made the PHC will receive a dividend paid deduction and avoid the PHC tax. The provisions of the code which pertain to this dividends paid deduction are sections 316(b)(2)(B) and 562(b)(2). Both of these Code provisions speak in terms of PHC's. Section 225(h) makes these corporations non-PHC's. Therefore, since we do not have a PHC the provisions of section 225(f) do not apply. In the present factual situation a liquidation by X under section 331 would be treated in the same manner as any other non-PHC liquidation under such section.

However, if X corporation was a PHC for 1965 under the old law and the new law, then the provisions of section 225(f) would apply. Therefore, assuming a section 331 liquidation, X corporation must designate its 1965 UPHCI as a dividend to its sole stockholder, individual A. Then X corporation will get a dividends paid deduction and avoid the PHC tax. The distribution in liquidation to A will be treated as a long term capital gain (after deleting the portion which has just been treated as a dividend) to the extent of his realized gain. The following subsection illustrates this principle.

## 2. SECTION 225(h)—A SECTION 331 LIQUIDATION WITH SECTION 225(f)

A has a basis of \$1,000,000 in his X corporation stock. X corporation has \$300,000 of taxable income for the 1965 short taxable year. X corporation winds up having UPHCI of \$162,500. (The \$300,000 of taxable income less the normal tax and surtax of \$167,500.) X corporation distributes all of its assets, having a fair market value of \$3,000,000, to A, in a section 331 liquidation. A will receive a dividend of \$162,500 and a long term capital gain of \$1,837,500, computed as follows:

Total distribution	\$3,000,000
Less: A's adjusted basis	1,000,000
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Realized Gain	2,000,000
Less: Dividend income (Section 316(b)(2)(B))	162,500
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Long Term Capital Gain	<u>\$1,837,500</u>

The application of section 225(h) to the special liquidation provisions of section 333(g)(1) is shown in the following subsection.

3. SECTION 225(h)—A SECTION 333(g)(1) LIQUIDATION  
WITH SECTION 225(f)

X is a PHC in 1965 under both the new and old laws. Instead of liquidating under section 331 (previous sub-sections) X decides to liquidate under section 333(g)(1). This is permissible since section 225(h) provides that this special liquidation will apply to a corporation which avails itself of section 225(h).<sup>28</sup>

A proper election having been made in accordance with sections 333(c) and 333(d), X liquidates under section 333(g)(1). All the facts of the above example are the same except that X corporation has \$237,500 of earnings and profits as of October 1, 1965 (the date of liquidation). The distribution of the \$3,000,000 consists of the following:

	<i>Fair Market Value</i>
Real Property	\$1,000,000
Z corporation stock (acquired in 1961)	1,950,000
Cash	50,000
	<hr/>
	<u>\$3,000,000</u>

Section 225(h) specifically provides that section 225(f) will be applicable in a section 333(g)(1) liquidation. As such, A will report a dividend to the extent of the UPHCI for the liquidation year. In this case (from the above example) it is \$162,500. The earnings and profits of \$237,500 is treated as a long term capital gain in accordance with section 333(g)(1)(B). The cash received by A will also be treated as a long term capital gain in accordance with section 333(e)(2). It should be remembered that section 333(g)(1)(A) does not pertain to cash. Any gain on the Z corporation stock is postponed because of section 333(g)(1)(A) which has moved the important date up to December 31, 1962. The real property gain is likewise postponed.

28. A § 333(g)(2) liquidation cannot be applicable since it must take place after December 31, 1966, whereas Pub. L. No. 272, 88th Cong., 2d Sess., § 225(h) (Feb. 26, 1964) only applies to a liquidation *before* January 1, 1966.

A has a new basis of \$1,400,000 determined under section 334. A had a realized gain of \$2,000,000 of which \$450,000 has just been recognized. The remaining realized gain of \$1,550,000 will be recognized when A disposes of the assets. Assuming no increase in value, the \$2,950,000 (fair market value of the assets) received by A, less his new basis of \$1,400,000, will yield the remaining gain of \$1,550,000.

The foregoing examples have demonstrated the application of a section 331 liquidation with and without section 225(f) and a section 333(g)(1) liquidation with section 225(f). The applicability of a section 333(g)(1) liquidation without section 225(f) remains to be discussed. It was previously stated that section 225(f) had no application where section 225(h) applied, since the latter excepted certain corporations from being PHC's. But this was only true where the corporation was not a PHC under the old and new law during the liquidation year. Assuming that the corporation was a PHC during the liquidation year, but would not have been one had the old law applied, the question becomes whether or not this corporation can avail itself of a section 333(g)(1) liquidation, and if so, will it be subject to section 225(f).

To answer the first inquiry: there appears to be nothing wrong with this corporation using section 333(g)(1), for a requirement of that preferential liquidation is that the corporation be a section 333(g)(3) corporation, and the same requirement is necessary in order to use section 225(h).

The question as to the applicability of section 225(f) is not so simply answered: Just because a section 225(h) corporation may use the provisions of section 333(g)(1) does not mean that it will be subjected to section 225(f) treatment. Once again it should be pointed out that section 225(f) does not pertain to corporations which are not PHC's. Here we have a corporation able to avail itself of section 333(g)(1) because it is a section 333(g)(3) corporation, but it is not a PHC in the liquidation year because of section 225(h). Since it is not a PHC in the liquidation year, it will not be subject to section 225(f). The following subsection illustrates this principle.

#### 4. SECTION 225(h)—A SECTION 333(g)(1) LIQUIDATION WITHOUT SECTION 225(f)

In the preceding example A had to report a dividend of \$162,500 because of section 225(f). However, since section 225(h) is now applicable (because X is not a PHC for 1965 under both the old and new law) there will be no UPHCI for the liquidation year and thus no need for section 225(f). As such the \$162,500 will become a part of X corporation's earnings and profits. Therefore, the entire \$400,000 of earnings and profits will be subjected to capital gains treatment in accordance with

section 333(g)(1)(B). The remaining recognition of gain, and A's basis, are the same.

#### IV. CONCLUSION

Liquidation of corporations now in the PHC status should become more pronounced in the not too distant future. The new liquidation provisions provide the answer for those corporations which can no longer escape PHC categorization. Indeed, it allows those corporations which had not been organized to avoid the PHC definition, to liquidate before feeling the PHC bite. Through the use of these special methods of liquidation, the *would have been* corporation will be provided with a tax advantage greater than that permitted under the ordinary section 331 or 333 liquidations. It is felt that most, if not all, corporations in the *would have been* position will conclude that it is far better to liquidate under the new provisions and reap the tax savings involved, than to continue to operate paying the PHC penalty tax and being unable to take advantage of the new liquidation provisions at a later date.

With the exception of a few minor items,<sup>29</sup> this article has discussed all of the new provisions pertaining to the liquidation of PHC's. It was intended to familiarize the reader with the new provisions and to explain to him the mechanics of its operation. There will, undoubtedly, be questions which have not been raised, but the answers to these questions will not readily be found. Practitioners must await the regulations, rulings, and judicial interpretations.

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29. One such area pertains to § 333(g)(4). This paragraph deals with an election to liquidate under the new provisions where the provisions are inapplicable to the electing corporation. Section 333(g)(4) states that under these circumstances the election will not be binding and is of no consequence.