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Personal Holding Companies - Personal Holding Company Income - Compensation for Use of Property by Shareholder - Use Should Not Be Imputed to Lessee Corporation's Shareholders

F. Snyder Gokey

CASE COMMENTS

PERSONAL HOLDING COMPANIES—PERSONAL HOLDING COMPANY INCOME—COMPENSATION FOR USE OF PROPERTY BY SHAREHOLDER—USE SHOULD NOT BE IMPUTED TO LESSEE CORPORATION'S SHAREHOLDERS

The taxpayer, a business trust with transferable shares, was considered a corporation for federal tax purposes.[1] The trust was owned by two brothers who were also principal shareholders of a second corporation which dealt in wholesale floor coverings.[2] A principal asset of the trust was a building, rented by the trust to the brothers' corporation.[3] The Commissioner of the Internal Revenue Service determined that the rental income to the trust from the corporation for the use of the building constituted personal holding company[4] income as "compensation for use of corporate property by a shareholder"[5] pursuant to section 543(a)(6) of the Internal Revenue Code of 1954.[6] The Commissioner's theory was that the use of the building should be imputed to the brothers as principal shareholders of the trust.[7] The taxpayer challenged the

1. Silverman & Sons Realty Trust v. Commissioner, 620 F.2d 314, 315 (1st Cir. 1980). The taxpayer was a Massachusetts business trust. *Id.*

2. *Id.* The trust was owned by Donald and Alan Silverman in equal shares. They also owned 73.2% of the stock of the lessee corporation, Joseph Silverman & Co., Inc., in equal shares. *Id.*

3. *Id.* The assets of the trust were comprised of a building and cash, some of which was invested in an interest-bearing certificate of deposit. Income in the taxable year included rent income from Joseph Silverman & Co., Inc. in the amount of $38,900 and interest income from the certificate of deposit in the amount of $13,169. *Id.*

4. *See infra* note 11 and accompanying text for definition of personal holding company.

5. I.R.C. § 543(a)(6). "Compensation for the use of corporate property by a shareholder" is a category of personal holding company income. *Id.*

6. I.R.C. § 543(a)(6) (compensation to corporation for shareholder's use of corporate property defined as personal holding company income). The text of section 543(a)(6) appears *infra* at note 27.

7. Silverman & Sons Realty Trust v. Commissioner, 620 F.2d 314, 318 (1st Cir. 1980).

Commissioner's decision in the Tax Court.[8] The court ruled in favor of the taxpayer, reasoning that because a stockholder of a corporation has no right to use the corporate property, the corporation's use of the property should not be imputed to the stockholder.[9] The United States Court of Appeals for the First Circuit affirmed, and *held* that the use of corporate property should not be imputed from a corporation to its shareholder for purposes of the personal holding company tax. *Silverman & Sons Realty Trust v. Commissioner,* 620 F.2d 314 (1st Cir. 1980).

The purpose of the personal holding company tax is to prevent the use of a corporation by its shareholders to shelter income from high personal income tax rates.[10] A corporation is deemed to be a personal holding company if two conditions are met:[11] first, if sixty percent of its "adjusted gross income"[12] is deemed to be personal holding company income;[13] and second, if at any time during the last one-half of the taxable year more than fifty percent, in value, of the corporation's outstanding stock is owned by no more than five individuals.[14] The stock ownership test is supported by an extensive set of rules for determining constructive ownership.[15]

The definition of "personal holding company income" makes up much of the relevant tax code provision.[16] The eight categories of personal holding company income listed in the Code are as follows: dividends; rents; mineral, oil, and gas royalties; copyright royalties; produced film rents; use of corporate property by a shareholder; personal service contracts; and estates and trusts.[17] Each category is subject to a separate test to determine whether a given sum is personal holding company income.[18] There are also

8. *Id.* at 315.

9. *Id.* at 318.

10. S. REP. No. 830, 88th Cong., 2nd Sess. 104 (1964). *See* I.R.C. §§ 541-47 (Internal Revenue Code provisions pertaining to personal holding companies).

11. I.R.C. § 542 (definition of personal holding company).

12. I.R.C. § 542(a)(1). Sections 543(b)(1) and 543(b)(2) define adjusted ordinary gross income. Roughly, gross income equals sales minus cost of goods sold. Ordinary gross income equals gross income minus capital gains and other gains defined in section 1231 of the Internal Revenue Code. *See* I.R.C. § 1231. The adjustments made to ordinary gross income include deductions for depreciation and amortization, property taxes, interest, and expenses from rent and mineral royalty income. I.R.C. § 543(b)(2). Thus, ordinary adjusted gross income generally will be less than gross income, thereby increasing the likelihood that a corporation will meet the 60% test required by the personal holding company tax provision. *Id.*

13. I.R.C. § 542(a)(1) (60% adjusted ordinary gross income as a requirement of a personal holding company).

14. I.R.C. § 542(a)(2) (defining stock ownership requirements of personal holding company).

15. I.R.C. § 544 (rules for determining stock ownership).

16. I.R.C. § 543(a) (enumerating types of income which constitute personal holding company income).

17. I.R.C. § 543. The court in *Silverman* dealt with section 543(a)(6) which states that personal holding company income includes compensation received from the use of corporate property by a shareholder who owns 25% or more of the outstanding stock of the corporation. 620 F.2d at 315. *See* I.R.C. § 543(a)(6).

18. I.R.C. § 543 (general rules and definitions of personal holding company income).

interrelationships among the categories of personal holding company income.[19]

If it is determined that a corporation is a personal holding company under the statutory test, a seventy percent penalty tax is levied against the company's "undistributed personal holding company income."[20] Aside from the high rate, there are two other effects of this tax that can be devastating. First, it is levied in addition to the ordinary corporate tax, not in place of that tax.[21] Second, certain deductions from gross income allowable for federal income tax purposes are not allowed for purposes of the personal holding company tax.[22] For example, the eighty-five percent "dividends received deduction" is not allowed.[23] Also, net operating losses attributable to years earlier than the previous year are not allowed as deductions when calculating undistributed personal holding company income.[24]

Since the purpose of the personal holding company tax is only to prevent individuals from sheltering income, deductions are allowed for dividends which have been paid to shareholders and taxed at individual income tax rates.[25] There are also provisions which allow for the payment of limited dividends after year's end.[26]

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19. *Id.*

20. I.R.C. § 541. Section 541, which provides for a personal holding tax at a rate of 70%, has been amended by section 101(d)(2) of the Economic Recovery Tax Act of 1981 to impose a reduced tax rate of 50% on personal holding company income. The purpose of the reduction is to conform the personal holding company tax rate to the reduction in the maximum individual income tax rate from 70% to 50%. I.R.C. § 541, *as amended by* Act of Aug. 13, 1981, Pub. L. No. 97-34, § 101(d)(2) (to be codified in I.R.C. § 541).

21. I.R.C. § 541. I.R.C. section 541, entitled "Imposition of Personal Holding Company Tax" provides:

> In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the undistributed personal holding company income (as defined in section 545) of every personal holding company (as defined in section 542) a personal holding company tax equal to 70 percent of the undistributed personal holding company income.

Id.

22. I.R.C. § 545 (undistributed personal holding company income).

23. I.R.C. § 545(b)(3). Generally, when one corporation receives dividends from another corporation, the recipient corporation is allowed to deduct 85% of those dividends from its income for federal income taxation purposes. I.R.C. § 243. This figure may be increased to a 100% deduction if the recipient corporation owns 80% or more of the declaring corporation's outstanding stock. *Id.* These reductions in taxable income, however, are not allowed for determining undistributed personal holding company income, the sum upon which the personal holding company tax is levied. I.R.C. §§ 541, 545.

24. I.R.C. § 545(b)(4) (disallowance of net operating loss as an adjustment to taxable income for purposes of determining undistributed personal holding company income).

25. I.R.C. § 545(a) (definition of undistributed personal holding company income).

26. I.R.C. §§ 563(b), 547. Section 563 dividends are limited to 20% of the dividends paid during the taxable year. *Id.* Furthermore, section 547 sets forth an "escape hatch" provision for those who are innocently caught by the personal holding company tax provisions. By following the narrowly defined procedure, the corporate taxpayer can declare deficiency dividends within a 90 day period after a determination of a personal holding company tax liability. I.R.C. § 547. Section 547 dividends are not limited by the 20% limit set forth in section 563. *Id.* It should be noted that this is a highly technical area of the law and only the strictest adherence to the letter of the Code will allow

One of the eight categories of personal holding company income is found in section 543(a)(6)(A) of the Code which provides that personal holding company income includes as follows:

> Amounts received as compensation [by a corporation] for the use of . . . property of the corporation . . . where . . . 25 percent or more in value of the outstanding stock of the corporation is owned directly or indirectly by . . . an individual entitled to the use of the property (whether such right is obtained directly from the corporation or by means of a sublease or other arrangement).[27]

This is, in effect, a specialized form of rental income which occurs when the lessee is also a shareholder who owns twenty-five percent or more of the corporation's stock. Rents for the use of corporate property by a shareholder are treated more strictly than rents in general.[28] The purpose of this section was to plug a tax loophole whereby taxpayers were able to increase the gross income of their corporations by donating yachts and hunting lodges to them, and then rent them back in such a manner that additional personal

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use of this "escape" section. *See* Leck Co. v. United States, 32 Am. Fed. T. Rep. 2d 73-5891 (D.C. Minn. 1973).

27. I.R.C. § 543(a)(6). Section 543(a)(6) provides as follows:

> (A) Amounts received as compensation (however designated and from whomever received) for the use of, or the right to use tangible property of the corporation in any case where, at any time during the taxable year, 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property (whether such right is obtained directly from the corporation or by means of a sublease or other arrangement).
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> (B) Subparagraph (A) shall apply only to a corporation which has personal holding company income in excess of 10 percent of its ordinary gross income.
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> (C) For purposes of the limitation in subparagraph (B), personal holding company income shall be computed—
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> (i) without regard to subparagraph (A) or paragraph (2),
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> (ii) by excluding amounts received as compensation for the use of (or right to use) intangible property (other than mineral, oil, or gas royalties or copyright royalties) if a substantial part of the tangible property used in connection with such intangible property is owned by the corporation and all such tangible and intangible property is used in the active conduct of a trade or business by an individual or individuals described in subparagraph (A), and
>
> (iii) by including copyright royalties and adjusted income from mineral, oil, and gas royalties.

Id.

28. I.R.C. § 543(a)(2)(6). Rent for the use of corporate property paid by a stockholder who owns 25% or more of the outstanding stock is deemed personal holding company income of the corporation if the corporation has personal holding company income from other sources equal to 10% of ordinary gross income. Rent from non-stockholders is treated less harshly in that the 10% test is modified to take into account, and deduct from personal holding company income, dividends paid out before applying the 10% ordinary gross income test. I.R.C. § 543(a)(2). There is, however, an additional test which must be satisfied to enable rent paid by non-shareholders to escape taxation as personal holding company income. The adjusted income from such rent must constitute 50% or more of adjusted ordinary gross income. *Id.*

holding company income would not be created.[29] By increasing gross income, the taxpayer could ensure that the personal holding company income would be less than sixty percent of gross income, and the company would then be outside of the personal holding company tax code provisions.[30]

For some years, rents for the use of corporate property by a shareholder were not personal holding company income if the rents had a business purpose.[31] The 1954 Internal Revenue Code eliminated the business purpose doctrine.[32] It added instead a test which objectively determines whether rent paid for the use of corporate property by a shareholder is personal holding company income. The personal holding company tax should thus be contrasted with the accumulated earnings tax, which is levied only when a tax avoidance purpose is evident.[33] Any corporation that meets the personal holding company criteria is subject to the penalty tax regardless of good intentions. In this sense it is a trap

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29. H.R. Doc. No. 337, 75th Cong., 1st Sess. 12-13 (1937); H.R. Rep. No. 1546, 75th Cong., 1st Sess. 6 (1937). The personal holding tax was instituted in 1934. Revenue Act of 1934, ch. 227, § 351, 48 Stat. 751. The predecessor of section 543(a)(6), section 353(f), was added in 1937. Revenue Act of 1937, ch. 815, § 1, 50 Stat. 813. In the 1939 Internal Revenue Code, section 353(f) was changed to section 502(f). Finally, in the 1954 Internal Revenue Code, the section was changed to its present number, section 543(a)(6). I.R.C. § 543(a).

30. Prior to the enactment of section 543(a)(6), personal holding company income was required to be less than 80% of gross income in order to avoid the personal holding company income tax. Revenue Act of 1934, I.R.C. § 351(b)(1)(A). Because it was possible to avoid the personal holding company tax by having a mere 21% of non-personal holding company income, corporations experienced little difficulty in avoiding the personal holding company tax. The 80% personal holding company income requirement created a tax loophole, which was exercised by stockholders who rented corporate property such as hunting lodges. Section 543(a)(6) has closed this loophole by requiring that personal holding company income must be less than 60% of gross income in order to avoid the personal holding company tax. I.R.C. § 543(a)(6).

31. Section 223 of the Revenue Act of 1950 states:

> Section 502(f) of the Internal Revenue Code (relating to use of corporation property by a shareholder) shall not apply with respect to rents received during taxable years ending after December 31, 1945, and before January 1, 1950, if such rents were received for the use by the lessee, in the operation of a bona fide commercial, industrial, or mining enterprise, of property of the taxpayer.

Revenue Act of 1950, § 223, 64 Stat. 947, *as amended by* Revenue Act of 1955, § 223, 69 Stat. 693. *See also infra* note 46.

32. *See supra* note 27.

33. I.R.C. § 532(a). Aside from the personal holding company tax, the accumulated earnings tax is the only other major penalty tax on accumulated earnings in the Internal Revenue Code. Section 532 provides as follows:

> (a) General Rule — The accumulated earnings tax imposed by section 531 shall apply to every corporation . . . formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

Id. The language of section 532 requiring a tax avoidance purpose as a condition precedent to liability under the accumulated earnings tax provision should be noted. The personal holding company provisions contain no such provision. *See* I.R.C. §§ 541-47. Under the personal holding tax provisions a taxpayer, although acting in good faith, can be liable for the penalty tax if the taxpayer falls within the objective criteria set forth by the statute. *Id.*

for the unwary. The new tests, set forth in section 543(a)(6)(B), provide that compensation for the use of corporate property by a shareholder is personal holding company income if the corporation has other personal holding company income, computed without regard to these rental amounts, in excess of ten percent of ordinary gross income.[34] This is sometimes referred to as the ten percent test.

A fundamental question arises concerning use of corporate property by a shareholder when two or more corporations rent property from each other, but are owned by the same individual. If Corporation A rents to its twenty-five percent stockholder, the rent income will clearly be personal holding company income if the other tests are met.[35] If Corporation A rents to a second corporation which is owned by A's stockholder, however, the result is unclear. This raises the issue of whether the "use" of that property should be imputed to A's stockholder. This question has caused a split in authority.

The Tax Court first decided the issue in 1944 in the case of *Minnesota Mortuaries v. Commissioner.*[36] The Tax Court held that use of corporate property should not be imputed from a corporation to its shareholders for purposes of the personal holding company tax. By 1965 the United States Court of Appeals for the Second Circuit and the Internal Revenue Service had split with the Tax Court on the issue and decided, in the situation above, that the "use" should be imputed to A's stockholder and that rent paid to Corporation A by the lessee corporation should be personal holding company income.[37] Most recently, in *Silverman* the United States Court of Appeals for the First Circuit split with the Second Circuit and adopted the Tax Court's position.

The Tax Court's position, first set forth in *Minnesota Mortuaries,* is based on the well established rule that "an individual, as a stockholder of a corporation, has no right, title, or interest in,

34. I.R.C. § 543(a)(6)(B) (declaring amounts received by a corporation for the use of corporate property by a shareholder to be personal holding company income only if personal holding income constitutes more than 10% of the corporation's ordinary gross income).

35. I.R.C. § 543(a)(6). The other tests are the 10% personal holding company income test and the 25% or more shareholder test. I.R.C. §§ 542, 543(a)(6)(B). *See also supra* notes 27 & 34 and accompanying text.

36. 4 T.C. 280 (1944).

37. 320 E. 47th St. Corp. v. Commissioner, 243 F.2d 894 (2d Cir. 1957); Rev. Rul. 65-259, 1965-2 C.B. 174. Inopposite decisions of the Tax Court and the courts of appeals are significant because the taxpayer determines whether the action will be brought in the United States District Court or the Tax Court. The district court, of course, is bound by the rulings of the court of appeals of its circuit. The Tax Court is not. Although the courts of appeals can overturn Tax Court rulings, the Tax Court has nationwide jurisdiction and is not bound to the views of any particular regional court of appeals. *See* J. CHOMMIE, FEDERAL INCOME TAXATION 15 (2d ed. 1968). The impact of forum shopping is lessened when the Commissioner appeals Tax Court decisions. *Id.*

or right to use the corporate property."[38] In its decision not to impute the corporation's use of property from the corporation to its shareholder, the Tax Court also relied upon congressional intent[39] and the fact that the corporations involved seemed to act without the intent to avoid taxes.[40]

The Second Circuit reached a different conclusion on the issue in *320 East 47th St. Corp. v. Commissioner,*[41] and thus started the split in authority. The case originated in the Tax Court.[42] The Tax Court's holding in that case was an example of the apparent harshness of the personal holding company tax.[43] The taxpayer had received an unusually large sum of interest on a condemnation award from the City of New York.[44] Even though the taxpayer gave up the land involuntarily, the taxpayer was still faced with a penalty tax on part of the payment received.[45] In an effort to reduce its personal holding company income to a point below the level that triggers the penalty tax, the taxpayer presented an argument which would seem unusual today. It argued that $6,000 of rent, which it had received from a corporation whose stockholders were the same as its own stockholders, was not normal rent[46] but rather compensation received by a corporation for use of corporate property by a shareholder.[47] Under current law this would be an argument for a higher personal holding company income and therefore a higher penalty tax. At the time it was made, however, the argument had a different effect due to an applicable clause in the 1950 Revenue Act. The clause provided that rents for

38. Minnesota Mortuaries v. Commissioner, 4 T.C. 280, 285 (1944) (citing Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943)); *See* New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934) (general rule that a corporation and its stockholders are considered separate entities for tax purposes); *see also* 1 FLETCHER, CYCLOPEDIA CORPORATIONS ch. 2 (1974).

39. 4 T.C. at 284. (quoting the Ways and Means Committee Report on the Revenue Act of 1937, H.R. REP. No. 1546, 75th Cong., 1st sess.). House bill 1546 provides as follows:

> Subsection (f) includes in personal holding company income amounts received as compensation for the use of, or the right to use, property of the corporation. However, this rule only applies where during the taxable year of the corporation, 25 percent or more in value of its outstanding stock is owned, directly or indirectly, by an individual leasing or otherwise entitled to use of the property. It makes no difference whether the right to use the property is obtained by the individual directly from the corporation or by means of a sublease or other arrangement.

Id. From the above language the court found that "[t]he legislative history of the statute indicates that the use referred to is an actual use rather than a use imputed to an individual from activities or rights of a corporation in which he owns stock." 4 T.C. at 284.

40. 4 T.C. at 285.

41. 320 E. 47th St. Corp. v. Commissioner, 243 F.2d 894, 899 (2d Cir. 1957).

42. 320 E. 47th St. Corp. v. Commissioner, 26 T.C. 545 (1956).

43. *Id.*

44. *Id.* at 546.

45. *Id.* at 549.

46. The Internal Revenue Code sections in effect at the time this case was litigated were sections 502(f) and 502(g), which correspond respectively to section 543(a)(6) (rents from stockholders) and section 543(a)(2) (rents in general). *See* I.R.C. § 543(a).

47. 26 T.C. at 548.

the use of corporate property by a shareholder for years 1946 through 1949 would be exempt from the penalty tax if it could be shown that the property was used in a bona fide commercial venture.[48] Thus, if the taxpayer could succeed in having the rent reclassified as "rent from a shareholder," the income would come within the temporary exemption. The Tax Court followed its position in *Minnesota Mortuaries* and refused to impute the use of corporate property from the corporation to its shareholders, thereby subjecting the taxpayer to the personal holding company penalty tax.[49]

On appeal, the United States Court of Appeals for the Second Circuit reversed the Tax Court, in *320 East 47th Street Corp. v. Commissioner,*[50] and held that the use of the property should be imputed to the stockholder under the "other arrangement" language in the provision.[51] The result in *320 East 47th Street Corp.* was really an exception to the general rule the case established. Due to the temporary legislative exemption for "rent from a shareholder" when a commercial venture could be shown, the court's holding benefited the taxpayer in the case at bar by relieving the taxpayer of its penalty tax liability.[52] In the vast majority of cases, however, the court's holding would expose taxpayers to additional personal holding company tax liability.[53] The court supported its finding by pointing out the broadness of the statute, which provides that the shareholder does not actually need to use the property, but need only have the right to use it.[54] The stock ownership can be actual or constructive,[55] and the right to use the corporate property may be obtained directly or by means of a sublease or other arrangements.[56] The court found no reason to believe that Congress had intended that the "rent from stockholder" provision could be "frustrated by the mere creation of a second corporation which would pay the rent instead of the

48. S. REP. No. 2375, 81st Cong., 2d Sess., *reprinted in* [1950] U.S. CODE CONG. SERV. 3053, 3239. *See also supra* note 31 for the text of section 223 of the 1950 Revenue Act.

49. 26 T.C. at 549.

50. 243 F.2d 894 (2d Cir. 1957).

51. 243 F.2d at 898. Personal holding company income includes "[a]mounts received . . . for the use of . . .property of the corporation . . . (whether such right is obtained directly from the corporation or by means of a sublease or other arrangement)." I.R.C. § 543(a)(6)(A).

52. 243 F.2d at 899.

53. *See* I.R.C. 543(a)(6). Taxpayers would incur additional personal holding company tax liability because the ruling has the effect of increasing the amount of rent for use of property by the shareholder, which is no longer exempt from being personal holding company income as it was when the facts arose. For a comparison of section 223 of the Revenue Act of 1950 with section 543(a)(6) of the Revenue Act of 1954, see *supra* notes 27 & 31.

54. I.R.C. § 543(a)(6). Section 543(a)(6) discusses "compensation . . . for the use of, or the right to use . . . property of the corporation. . . ." *Id.*

55. I.R.C. § 554(a) (rules for determining constructive stock ownership).

56. I.R.C. § 543(a)(6). *See supra* note 27.

individual shareholder."[57] Rather, the court imputed use of the property to the shareholder as one of the "other arrangements" referred to in the section.[58] In subsequent cases, the Second Circuit reaffirmed its support for this rationale.[59]

In 1965 the Internal Revenue Service adopted the position of the Second Circuit in Revenue Ruling 65-259 and withdrew the Commissioner's acquiescence in the holding of *Minnesota Mortuaries*.[60]

The question of whether to impute to the shareholder of the lessee corporation the use of the lessor corporation's property was brought to the Tax Court again in 1979 in *Allied Industrial Cartage Co.*[61] The corporate taxpayer's principal business was the leasing of real estate and trucks to a second corporation.[62] Both corporations were owned by one individual.[63] The Tax Court reaffirmed its position as set forth in *Minnesota Mortuaries* and refused to follow the holding of the Second Circuit in *320 East 47th Street,* thus making concrete the split in authority.[64] The court cited

57. 243 F.2d at 898.

58. *Id. See supra* note 51 for relevant text of section 543(a)(6)(A), which defines personal holding company income.

59. Hilldun Corp. v. Commissioner, 408 F.2d 1117 (2d Cir. 1969). Because the owners of the corporation renting office space from the corporate taxpayer were stockholders of the taxpayer, use of the office was imputed to them by the "other arrangement" provision of section 543(a)(6), and the rent was deemed personal holding company income to the taxpayer. *Id.*

60. 1965-2 C.B. 174. The full text of Revenue Ruling 65-259 provides as follows:

> Advice has been requested whether rental income derived from corporate lessees may constitute personal holding company income within the meaning of section 543(a)(6) of the Internal Revenue Code of 1954.
>
> The United States Court of Appeals for the Second Circuit in the case of *320 East 47th Street Corporation,* 243 Fed. (2d) 894 (1957), held that where rental income is derived from a corporate lessee, the shareholders of the lessee corporation indirectly have the right to use the leased property and such indirect right is obtained by means of an "other arrangement" within the meaning of section 502(f) of the Internal Revenue Code of 1939 (now section 543(a)(6) of the 1954 Code). The Service believes that this decision reflects the correct application of the personal holding company provisions of the Code to the extent that the court so held.
>
> Accordingly, it is held that rental income derived from a corporate lessee, any one of whose shareholders directly or indirectly owns 25 percent or more in value of the outstanding stock of the lessor corporation, constitutes income from the use of corporation property described in section 543(a)(6) of the Code. Pursuant to the authority contained in section 7805(b) of the Code, this Revenue Ruling will be applied only with respect to taxable years beginning after June 30, 1965.
>
> In this connection, the Service will no longer follow the contrary decision in *Minnesota Mortuaries Inc.*, 4 T.C. 280 (1944). The acquiescence in that decision has been withdrawn and nonacquiescence has been substituted therefor.

Id. During oral argument in the *Silverman* case, counsel for the Commissioner indicated that the "extreme" position of this revenue ruling had been abandoned by the Commissioner. 620 F.2d at 319. Counsel was, however, "unable to specify what degree of 'control' over the lessee corporation was required in order to impute the corporation's right [to use the leased property] to the shareholder." *Id.*

61. 72 T.C. 515 (1979).

62. Allied Industrial Cartage Co. v. Commissioner, 72 T.C. 515 (1979).

63. *Id.*

64. *Id.* at 520. Prior to the decision in *Allied Industrial Cartage Co.*, it was unknown whether the Tax Court would alter its position in light of the Second Circuit's holding in *320 East 47th Street Corp. See also supra* note 37.

legislative history and Treasury Department regulations to support its contention that "subsection 543(a)(6) was enacted with personal, nonbusiness-type use of corporate property by a shareholder in mind."[65]

The Tax Court examined the issue a fourth time in *Silverman & Sons Realty Trust v. Commissioner.*[66] With little discussion, the Tax Court stated that it would follow *Allied Industrial Cartage Co.* and *Minnesota Mortuaries* and would not impute the use of corporate property to the corporation's shareholders.[67] The Commissioner appealed to the United States Court of Appeals for the First Circuit.[68] The First Circuit decided to follow the position of the Tax Court, thereby causing a split between the only two circuits which had decided the issue.[69] In *Silverman* the First Circuit held that the use of property by a corporation should not be imputed to the shareholders for purposes of the personal holding company tax.[70]

The Commissioner made two main arguments in *Silverman.* The first was the "other arrangement" argument.[71] The Internal Revenue Code provides that rental paid to a corporation by a shareholder who has the "right to use" the property is personal holding company income to the corporation.[72] The Code also provides that this "right to use" can be obtained directly or "by means of a sublease or other arrangement."[73] The Commissioner argued that by using this language in the statute, Congress

65. Allied Industrial Cartage Co., 72 T.C. 515, 520 (1979). The Treasury Department's Regulations lend support to the Tax Court's contention. Section 1.543-1(b)(9) of the Treasury Regulations provides in part: "[I]f a shareholder . . . uses, or has the right to use a yacht, residence, or other property owned by the corporation, the compensation to the corporation for such use, or right to use, the property constitutes personal holding company income." Treas. Reg. § 1.543-1(b)(9) (1980). *Allied Industrial Cartage Co.* is presently on appeal to the Sixth Circuit. *See* 72 T.C. 515 (1979).

66. 1979 TAX CT. MEM. DEC. (P-H) 1567.

67. Silverman & Sons Realty Trust v. Commissioner, 1979 TAX CT. MEM. DEC. (P-H) 1567.

68. 620 F.2d 314 (1st Cir. 1980).

69. *Id.*

70. *Id.* at 319. The corporate taxpayer in *Silverman* leased a building it owned to Joseph Silverman & Co., another corporation. Both the taxpayer and Silverman & Co. were owned largely by the same shareholders, Donald and Alan Silverman. The Commissioner claimed that the rent paid by Silverman & Co. to the corporate taxpayer was personal holding company income. The Commissioner contended that the use of the building should be imputed to Donald and Alan Silverman by virtue of their ownership of Silverman & Co. Therefore, the Commissioner argued, the renting of the corporate taxpayer's building to Silverman & Co. constituted a renting to the corporate taxpayer's own shareholders, Donald and Alan Silverman. Because section 543(a)(6) states that amounts paid to a corporation for the use of its property by a 25% or greater shareholder are personal holding company income, *see* I.R.C. § 543(a)(6), the Commissioner maintained that the taxpayer corporation was liable for the personal holding company penalty tax. 620 F.2d 314. Apparently the rental income had not been paid to the taxpayer corporation's shareholders in the form of dividends and was still accumulated in the corporation. *Id.*

71. 620 F.2d at 318. *See supra* note 51 for relevant text of section 543(a)(6)(A), which defines personal holding company income.

72. I.R.C. § 543(a)(6) (defining compensation to corporation for use of corporate property by a shareholder as personal holding company income).

73. *Id. See supra* note 27 for the text of section 543(a)(6).

"implicitly meant to cover the situation where the shareholder has access to property through his control of a lessee corporation."[74] Further, the Commissioner argued that different interpretation of the code section could lead to tax avoidance through the use of sham corporations as lessees.[75]

The court did not accept this argument, however, because it believed that the problem would be better decided on a case by case basis.[76] It noted that when the lessee corporation was established for tax avoidance purposes, such purposes would be readily ascertainable.[77] An example is recreational property leased by a corporation and placed at the disposal of its shareholders.[78] The court stated that if there were evidence of a tax avoidance purpose, appropriate measures should be taken "including piercing the corporate veil, to see that the Congressional scheme of taxation is not frustrated."[79] The *Silverman* court noted that there was no evidence of a tax avoidance purpose or of personal use of the corporate property by the shareholders.[80] It also noted that the majority shareholders had no legal entitlement to use the corporate property as individuals, and owed each other and the minority shareholders a fiduciary duty not to convert corporate property to personal use.[81]

The court further noted that imputing a corporation's use of property to its shareholder is not the same as the shareholder's becoming entitled to use the property through a "sublease or other

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74. 620 F.2d at 318.

75. *Id.*

76. *Id.* at 318-19.

77. *Id.* at 318. The court is amply supported by legislative history on this point. Nearly all of the legislative history of the predecessor of section 543(a)(6) discusses very blatant tax avoidance through the renting of a corporation's property to its shareholders. Most frequently mentioned is the renting of yachts, hunting lodges, country estates, or city residences. H. R. REP. No. 1546, 75th Cong., 1st Sess. 6 (1937); H. R. Doc. No. 337, 75th Cong., 1st Sess. 12-13 (1937). It seems likely that interposing a lessee corporation will not make such transactions more subtle or difficult to detect.

78. 620 F.2d at 318.

79. *Id.* An inquiry into the purpose of the transaction is arguably the approach originally intended by the framers of the predecessor of the present statute. The original predecessor of section 543(a)(6) had a closely connected sister provision in which a business purpose test was included. The sister provision was never adopted. It is uncertain whether the business purpose test was deleted intentionally by Congress on its own merits or deleted unintentionally on the merits of the sister provision. The sister provision dealt with the allowability of certain deductions from income by personal holding companies. It provided, for example, that deductions for the cost of maintaining yachts and country estates should be allowed only to the extent "[t]hat the property was held in the course of business carried on bonafide for profit, and . . . [t]hat there was reasonable expectation that the operation of the property would result in a profit, or that such property was necessary to the conduct of the business." H. R. Doc. No. 337, 75th Cong., 1st Sess. 13 (1937). It should be noted, however, that Congress subsequently has included and then removed a business purpose test relating to I.R.C. section 543(a)(6). *See supra* note 31 for the text of section 223 of the Revenue Act of 1950, which excluded income from personal holding company tax if such income was received in the operation of a bona fide business.

80. 620 F.2d at 318. The building leased by Silverman & Co. from the taxpayer corporation was used in Silverman & Co.'s wholesale floor covering business. 1979 TAX CT. MEM. DEC. (P-H) 1567.

81. 620 F.2d at 318 (citing 1 FLETCHER'S CYCLOPEDIA OF CORPORATIONS § 1 at 132-33 (1974)).

arrangement."[82] A "sublease or other arrangement" would give the shareholder a legal right to the personal use of the property, while he has no such legal right to personal use of property rented by a corporation in which he is a stockholder.[83] Finally, the court observed that there was no evidence that the corporate property had been used for any other than a proper corporate and business purpose.[84] On these grounds, the court held that the shareholders were not entitled to the use of the corporate property.[85] The court deemed that the shareholder's right to use the corporate property was critical to the Commissioner's argument. It therefore held that the rent paid by the lessee corporation was not personal holding company income to the lessor corporation.[86]

A second argument the Commissioner put forth was that the Tax Court was mistaken in its view that there was a distinction between "rental arrangements having a business purpose and those having only a tax related purpose."[87] The Commissioner argued that there had been no such distinction made if the property was rented from the corporation by an individual or a partnership whose members were also shareholders of the corporation.[88] The *Silverman* court found this to be irrelevant since the case at bar concerned rent from a corporation, not from an individual or a partnership.[89] It followed the Tax Court's view that a tax avoidance purpose is a relevant consideration when deciding whether the use of corporate property should be imputed to a shareholder. Until a tax avoidance purpose is evident, the court decided that the use of a corporation's property should not be imputed to its shareholders for purposes of the personal holding

82. 620 F.2d at 318.

83. *Id. See also* 1 FLETCHER'S CYCLOPEDIA OF CORPORATIONS § 1 at 132-33 (1974).

84. *See supra* note 80.

85. *Id.*

86. *Id.*

87. *Id.* at 319. The Commissioner argued against the application of a business purpose test under which the arrangements at bar would not be found to be a personal holding company if there was a justifying business purpose for those arrangements. *Id.* This argument was probably set forth due to the finding by the Tax Court in *Minnesota Mortuaries* that "[t]he organization of the two companies [involved] served a useful business purpose and there is no element of the evasion involved in the separation of the business activities of the two companies." 4 T.C. 280, 285. The court in *Minnesota Mortuaries* did not expressly state that it was applying a business purpose test, but the fact that the court discussed the companies' business purpose suggests the existence of a bona fide business purpose was relevant to the court's holding. *Id.* Although the Tax Court in *Minnesota Mortuaries* did not openly embrace the business purpose test, the *Silverman* court expressly employed such a business test. 620 F.2d at 319.

88. 620 F.2d at 319.

89. *Id.* The Tax Court in *Minnesota Mortuaries* recognized the distinction between property leased by a partnership and facts, such as those at bar, in which the property is leased by a corporation. For tax purposes the partnership was not considered an entity separate and apart from the individual partners. 4 T.C. at 285. Therefore, it is less difficult to impute the use of property by a partnership to its individual partners than to impute the use of property by a corporation (which is considered a separate entity) to its shareholders. 4 T.C. at 285.

company tax.[90]

The First and Second Circuits are the only circuits that have dealt with this issue.[91] Other circuits have addressed the issue with respect to imputing use of property to members of partnerships, when the partners are shareholders of a corporation and the partnership rents property from the corporation.[92] Even the Tax Court agrees that this type of use should be imputed to the shareholder.[93]

The question of whether to impute a corporation's use of property to the corporation's shareholder, with its resulting personal holding company consequences, might be of particular relevance in a state like North Dakota, which has recently repealed, at least in part, an anticorporate farming law.[94] The reason for this is that many farmers have structured their business affairs in complex ways in an attempt to get the tax advantages of incorporation while not running afoul of state law.[95] One way a farmer might accomplish this would be to start a corporation in which he places all of his farm equipment. That corporation would not be in the business of farming, but rather in the business of equipment leasing. The farmer would then lease the equipment

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90. 620 F.2d at 319.

91. Some legal writers contend that the Second Circuit's position on imputing the use of corporate property to the stockholder is too extreme because such a position disregards the legal "separateness" of the corporation and its stockholders. *See* 3A F. CAVITCH, BUSINESS ORGANIZATIONS § 69.03(3)(1976); 2 J. RABKIN & M. JOHNSON, FEDERAL INCOME, GIFT AND ESTATE TAXATION 1722 (1980).

92. Randolph Prods. Co. v. Manning, 176 F.2d 190 (3d Cir. 1949).

93. 4 T.C. at 285. *See also supra* note 89.

94. The North Dakota anticorporate farming act was amended in 1981 to allow farming by "family corporations." Before the amendment, the North Dakota Century Code provided that "[a]ll corporations, both domestic and foreign, except as otherwise provided in this chapter, are hereby prohibited from engaging in the business of farming or agriculture." N.D. CENT. CODE § 10-06-01 (1976). The exceptions provided were not broad enough to allow a meaningful degree of corporate farming in the state. As of July 1, 1981, however, a corporation is permitted to farm in North Dakota if it meets the seven requirements set forth in section 10-06-07 of the North Dakota Century Code. N.D. CENT. CODE § 10-06-07 (Supp. 1981). These requirements limit the number and composition of possible shareholders so that the only corporations which can engage in the business of farming in North Dakota are those owned by families who are residents of North Dakota.

One of the limitations imposed by section 10-06-07 is that "the corporation's income from rent, royalties, dividends, interest, and annuities does not exceed twenty percent of the corporation's gross income." *Id.* Meeting this requirement will tend to prevent a corporation formed under this section from becoming a personal holding company since the farm corporation will be unlikely to reach the 60% level of personal holding company income set forth in section 543 of the Internal Revenue Code. It should be noted, however, that the requirement in section 10-06-07 does not prevent a farm corporation from taking the role of the lessee corporation in a situation similar to that in the *Silverman* case. In sum, this section will not prevent the problem.

95. The tax advantages consist mainly of lower rates for corporations than for individuals. To the extent that investments for expansion can be made out of corporate accumulated earnings, such investments are "cheaper" than if they were to be made out of personal earnings. Fewer pre-tax dollars are needed to accumulate a given amount of corporate post-tax dollars simply because the tax bite out of the pre-tax dollar is smaller. Of course, the corresponding disadvantage is double taxation if the owners of the corporation wish to spend the corporation's funds on items for personal use. Dividends from the corporation are taxable to the owners, thereby creating "double" taxation. *See* I.R.C. § 301.

from the corporation. The amount of the lease payment would be a business deduction to him and thus reduce his personal net income. The amount would also be income to the corporation. The farmer would therefore accomplish his goal of getting some of his income taxed at corporate rates.

There are potential problems with the described approach, but these problems can be avoided. It is important to note that these sorts of arrangements have been used before in North Dakota. Consequently, many farmers were majority or sole stockholders of corporations even before the new corporate farming law came into existence. Undoubtedly, since limited corporate farming is now allowed by state law, additional farming corporations will be formed.[96] It is also likely that some of these will be formed by the farmers who previously owned corporations. This is especially likely if some farmers are prevented from broader use of their original corporations, due to limitations of the corporation's purpose or powers. Such limitations may have been included in the corporation's articles of incorporation in an effort to comply with the old anticorporate farming law. Of course there are numerous non-tax reasons why a farmer, or any other individual, might own multiple corporations.[97] When an individual uses more than one corporation in his affairs, however, there is the possibility of a problem similar to that in *Silverman.* The conscientious business planner must learn to be wary not only of rent from shareholders, but of rent from a shareholder's corporation as well. With the number of corporations increasing due to the new corporate farming law, this is an area that will need to be watched more carefully in the future.

In the original example given above, illustrating how a farmer might attempt to gain some of the benefits of incorporation under the old anticorporate farming act, the farmer has to be careful if he is to avoid the personal holding company tax. The amount paid to the corporation in leasing the equipment would be personal holding company income under the category of "compensation for the use of corporate property by a shareholder."[98] If, when presented with the identical question, the Eighth Circuit follows the Second Circuit, rent paid by one corporation to another, when both have a common owner, would fall into the same category. If, however, the Eighth Circuit follows *Silverman,* this would not be true. Therefore,

96. *See supra* note 94 for text of North Dakota's anticorporate farming act, N.D. CENT. CODE § 10-06-07 (Supp. 1981).

97. Non-tax benefits include, among others, limited personal liability and ease of transfer of ownership from generation to generation.

98. *See supra* note 27 for text of I.R.C. § 543(a)(6).

until this question is resolved in the Eighth Circuit, some precautionary measures would be wise.

There are at least three steps the farmer in the example, or a taxpayer owning multiple corporations, can take to ensure that none of the corporations are found to be personal holding companies and therefore subject to the penalty tax due to rent paid to the corporation by the taxpayer or by the other corporations. The first is to make sure that the personal holding company income does not comprise sixty percent of the corporation's adjusted gross income,[99] since one of the criteria for being a personal holding company is to have sixty percent personal holding company income.[100] This can be achieved by giving the corporation in question some other business activity that does not give rise to personal holding company income. This may not be practical though, especially if the sole purpose for the corporation is to lease out farm equipment.

The second way to avoid making the corporation a personal holding company is to make sure that the corporation has less than ten percent "other" personal holding company income.[101] A company is not a personal holding company, even if it has substantial rents from shareholders, unless it has personal holding company income of at least ten percent of ordinary gross income from sources other than rents from shareholders.[102] This means that such a corporation should avoid, among other sources, all income stemming from mineral, oil, or gas royalties, dividends, or personal service contracts with its shareholders.[103]

The third method depends on whether the Eighth Circuit decides to follow the First Circuit's holding in *Silverman.* If the Eighth Circuit does follow *Silverman,* there will be no problem in the multiple corporation situation. Use of the property will not be imputed to the lessee corporation's shareholders, and the amount will not be personal holding income. Furthermore, if *Silverman* is adopted by the Eighth Circuit, the farmers in the single corporation example can change the character of the lease payments to the corporation so that they will not be personal holding company income. They can do this by forming a second corporation to make

99. *See supra* note 12 and accompanying text.

100. *See supra* note 13 and accompanying text.

101. *See supra* text accompanying note 34. *See also* I.R.C. § 543(a)(6)(B) (quoted *supra* in note 27). Rent from shareholders is not personal holding company income unless there is other personal holding income (other than rent from shareholders) of at least 10%. I.R.C. § 543(a)(6)(B).

102. *See supra* note 34 and accompanying text. For other types of personal holding company income, see *supra* note 17 and accompanying text.

103. *See supra* notes 17 & 34 and accompanying texts.

the payments.[104] Of course, to satisfy the *Silverman* rule, there must be a business purpose for the second corporation.[105]

Finally, as long as the Eighth Circuit's position is uncertain, or if it chooses not to adopt *Silverman,* the facts of *Silverman* are important to remember when doing any business planning. The personal holding company provisions include no "intent" requirement, and it is therefore easy to come within those provisions.[106] Dividends can be declared in an orderly fashion if one knows of the problem in advance.[107] The main requirement is that the owner be aware of his affairs and keep a wary eye on the possibility of a personal holding company tax.

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104. 620 F.2d at 319.
105. *Id.*
106. *See supra* notes 33 & 34 and accompanying texts.
107. *See supra* note 26 and accompanying text.