NEW TAX PROBLEM IN CLOSE HOLDINGS

Bill in Congress Affects Personal Companies Which Avoid Higher Brackets.

PROPOSED LEVY ANALYZED

Pending Measure Is Expected to Add Large Amount of Federal Revenue.

By GODFREY N. NELSON.

When is a holding company a "personal holding company"? If section 102 of the newly introduced 1934 revenue bill is enacted into law in its present form, imposing an annual tax of 35 per cent upon the undistributed adjusted net income of such companies, this will become an important question to the government as well as to the taxpayer.

Moreover, whether or not the legality of this section is ultimately upheld by the courts, its enactment will certainly occasion some immediate scurrying on the part of the threatened closely held corporation for a broader range of activities, or for a spreading out of its outstanding capital stock, or both, in order that it may be adjudged without the scope of the prescribed classification.

It would appear that the tax may be regarded either as a privilege or as a penalty tax, and that the taxpayer may, in this regard, affix his own appellation. A holding company, for example, that is willing to pay the additional tax for the right to accumulate income, instead of distributing it, may deem it a privilege tax; one that is unwittingly caught in the net, on the other hand, would probably designate it a penalty tax.

Scope of the Definition.

The definition ascribed to the term "personal holding company" comprehends any corporation, other than a banking or insurance corporation, if it falls within the following prescribed conditions:

(a) If at least 80 per cent of its gross income for the taxable year is derived from rents, royalties, dividends, interest, annuities and (except in the case of regular dealers in stock or securities) gains from the sale of stock or securities, and

(b) If on the last day of the taxable year more than 50 per cent of its voting stock is owned, directly or indirectly, by or for not more than five individuals.

For the purpose of the definition of the term "personal holding company" the proposed act provides that:

(c) Stock owned, directly or indirectly, by a corporation, partnership, estate or trust shall be considered as being owned proportionately by its shareholders, partners or beneficiaries;

(d) An individual shall be considered as owning, to the exclusion of any other individual, the stock owned, directly or indirectly, by his family, and this rule shall be applied in such manner as to produce the smallest possible number of individuals owning, directly or indirectly, more than 50 per cent of the voting stock; and

(e) The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors and lineal descendants.

The annual levy of 35 per cent is in addition to the regular corporation tax of 13¾ per cent and the 15¾ per cent rate applicable to consolidated returns of affiliated corporations.

The tax is imposed upon what is termed in the proposed act as the "undistributed adjusted net income," and this in turn is defined as the "adjusted net income" minus the sum of an exemption of 10 per cent and the amount of dividends paid during the taxable year.

Calculation of the Tax.

Disregarding the terminology employed in the bill, the taxable amount will be calculated as follows:

Add:

(a) The net income as shown by the corporation's tax return (Form 1120);

(b) The amount of dividends received from domestic corporations for which deduction was made on line 21 of the corporation return;

(c) The amount of interest upon obligations of the United States is-

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sued after Sept. 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner.

From the sum of the foregoing items deduct the sum of the following items:

come, war-profits and excess-profits

come. war-profits and excess-profits taxes paid or accrued, but not including the tax of 35 per cent imposed upon personal holding companies.

(e) The amount of contributions or gifts not allowed as deductions in the corporation's income tax return.

(f) The amount of losses from sales or exchanges of capital assets which are disallowed as deductions in the corporation's income tax return.

The balance represents the "adjusted net income."

From this balance, deduct the sum of:

(1) An exemption of 10 per cent of the "adjusted net income," and

(2) The amount of dividends paid during the taxable year.

The balance represents the "undistributed adjusted net income" upon which the tax of 35 per cent is imposed.

Unquestionably the personal holding company has been one of the prevalent devices used as a means of escaping the imposition of the surtax. If the proposed tax should be enacted, and cannot be circumvented, it will not only be the means of procuring large amounts of revenue, but it will tend to equalize taxation as between the taxpayers who have heretofore availed themselves of the corporate form of organization and those taxpayers who have not so availed themselves.

The New York Times
Published: February 18, 1934