

11-1-1978

Troubled Real Estate Leasing Companies Trapped Within Personal Holding Company Income Tax Provisions

Follow this and additional works at: <https://digitalcommons.law.byu.edu/lawreview>



Part of the [Taxation-Federal Commons](#)

Recommended Citation

Troubled Real Estate Leasing Companies Trapped Within Personal Holding Company Income Tax Provisions, 1978 BYU L. Rev. 980 (1978).

Available at: <https://digitalcommons.law.byu.edu/lawreview/vol1978/iss4/10>

This Comment is brought to you for free and open access by the Brigham Young University Law Review at BYU Law Digital Commons. It has been accepted for inclusion in BYU Law Review by an authorized editor of BYU Law Digital Commons. For more information, please contact hunterlawlibrary@byu.edu.

Troubled Real Estate Leasing Companies Trapped Within the Personal Holding Company Income Tax Provisions

I. INTRODUCTION

The personal holding company provisions of the Internal Revenue Code¹ have many times proved to be a "snare for the unwary."² The corporate taxpayer has often assumed that since it is not a passive investment company it is immune from the seventy-percent personal holding company tax.³ The expunging personal holding company tax provisions, however, have unfortunately swept within their reach certain types of operating real estate companies.⁴

In the recent case of *Parkside, Inc. v. Commissioner*,⁵ the president of Parkside and its sister corporation, both of whose assets consisted primarily of duplex homes, struggled for five years to profitably manage the corporations by renting the duplexes.⁶ After continual losses, he sold the duplexes separately through real estate agents. The sales eventually resulted in sub-

1. Unless otherwise indicated, all references to "Code" or "Section(s)" refer to the Internal Revenue Code of 1954, as amended.

The personal holding company provisions of the Code comprise I.R.C. §§ 541-547. The Tax Court once termed these sections as an "irritatingly convoluted statutory path." *Pleasanton Gravel Co. v. Commissioner*, 64 T.C. 510, 516 (1975) (footnote omitted), *aff'd per curiam*, 578 F.2d 827 (9th Cir. 1978).

2. Barsanti, *A Snare for the Unwary: The Personal Holding Company Tax and Real Estate Holding Companies*, 22 Mo. B.J. 112, 112 (1966).

3. For an excellent discussion of operating technology companies that can be subjected to the personal holding company tax because of the royalties provision, (I.R.C. § 543(b)(4)), see Morgan, *The Domestic Technology Base Company: The Dilemma of An Operating Company Which Might Be a Personal Holding Company*, 33 Tax L. Rev. 233 (1978).

4. In *Noteman v. Welch*, 108 F.2d 206 (1st Cir. 1939), one of the first cases to narrate the personal holding company legislative history, the court noted,

It not infrequently happens that legislative bodies, with specific instances of abuse in mind, phrase tax legislation in such broad terms as to include persons or groups of persons not specifically contemplated. . . . In the present instance it was pointed out at the committee hearings that the term "personal holding company" was so broadly defined that legitimate operating companies might be subjected to its provisions.

Id. at 208 (footnote omitted).

5. 571 F.2d 1092 (9th Cir. 1977).

6. Three brothers and a sister inherited the stock of Parkside in 1960 upon their father's death. Its principal assets consisted of 26 duplexes. Beaconcrest, the sister corporation, was formed in 1960 to receive part of the assets from a corporation previously organized by the father. Beaconcrest's assets consisted primarily of 21 duplexes. *Id.* at 1093.

stantial interest income from installment payments. The Commissioner determined that since the corporations were not in the business of selling duplexes, the interest was ordinary interest and the corporations fell within the personal holding company provisions. The Tax Court sustained the Commissioner's judgment,⁷ but on appeal the Ninth Circuit reversed.⁸ Explicitly relying on the capital asset criteria of section 1221(1),⁹ the court held that the corporations were primarily in the business of selling duplexes and hence the interest income should be classified as "rents" under section 543(b)(3).

A brief outline of the mechanics of the personal holding company provisions illustrates the difficulty of analyzing the application of the tax. Complex formulas and definitions¹⁰ provide that a corporation will be considered a personal holding company for tax purposes if: personal holding company income¹¹ is at least

7. *Parkside, Inc. v. Commissioner*, 34 T.C.M. (CCH) 54 (1975), *rev'd*, 571 F.2d 1092 (9th Cir. 1977).

8. 571 F.2d at 1096.

9. The court briefly stated, "[W]e can divine no reason to construe the thrust of these passages differently. We will, therefore, turn to section 1221(1) cases for guidance." *Id.* at 1094 (footnote omitted).

10. One commentator has ably stated:

Even prior to the Revenue Act of 1964, the personal holding company provisions constituted a maze of complex definitions, percentage tests pyramided one on another, and exceptions phrased in statutory detail which defied understanding—even by tax experts. The 1964 Act has greatly magnified these difficulties by piecemeal tinkering designed to curb tax avoidance. Such tinkering not only has complicated the provisions to a much greater degree by departing from familiar accounting standards, but it has also created a serious risk of imposing this severe penalty on active business operations.

Nolan, *Personal Holding Companies Under the 1964 Act: A Maze of Arbitrary Standards*, 1965 TUL. TAX INST. 171, 171 (footnote omitted).

The Tax Court has also referred to these sections as "exasperatingly complex statutory provisions." *Bell Realty Trust v. Commissioner*, 65 T.C. 766, 775, *aff'd mem.*, 546 F.2d 413 (1st Cir. 1976).

11. The applicable portions of I.R.C. § 543(a), defining personal holding company income, provide:

(a) GENERAL RULE.—For purposes of this subtitle, the term "personal holding company income" means the portion of the adjusted ordinary gross income which consists of:

(1) DIVIDENDS, ETC.—Dividends, interest, royalties . . . and annuities. This paragraph shall not apply to—

(A) interest constituting rent (as defined in subsection

(b)(3))

(2) RENTS.—The adjusted income from rents; except that such adjusted income shall not be included if—

(A) such adjusted income constitutes 50 percent or more of the adjusted ordinary gross income, and

(B) the sum of—

sixty percent of the adjusted ordinary gross income,¹² and not more than five individuals own directly or indirectly more than fifty percent of the outstanding stock.¹³ Interest on a debt for real

-
- (i) the dividends paid during the taxable year . . . ,
 - (ii) the dividends considered as paid on the last day of the taxable year . . . , and
 - (iii) the consent dividends for the taxable year . . . ,

equals or exceeds the amount, if any, by which the personal holding company income for the taxable year (computed without regard to this paragraph and paragraph (6), and computed by including as personal holding company income copyright royalties and the adjusted income from mineral, oil, and gas royalties) exceeds 10 percent of the ordinary gross income.

Also included in the definition of personal holding company income in paragraphs (3) through (8) of subsection (a) of § 543 are: mineral, oil, and gas royalties; copyright royalties; produced film rents; compensation for corporate property used by shareholders; personal service contracts; and estates, trusts, and beneficiaries.

12. Ordinary gross income, adjusted ordinary gross income, and adjusted income from rents are defined in I.R.C. § 543(b):

(1) **ORDINARY GROSS INCOME.**—The term "ordinary gross income" means the gross income determined by excluding—

- (A) all gains from the sale or other disposition of capital assets,
- (B) all gains (other than those referred to in subparagraph (A)) from the sale or other disposition of property described in section 1231(b) . . .

. . . .

(2) **ADJUSTED ORDINARY GROSS INCOME.**—The term "adjusted ordinary gross income" means the ordinary gross income adjusted as follows:

(A) **RENTS.**—From the gross income from rents (as defined in the second sentence of paragraph (3) of this subsection) subtract the amount allowable as deductions for—

- (i) exhaustion, wear and tear, obsolescence, and amortization of property other than tangible personal property which is not customarily retained by any one lessee for more than three years,
- (ii) property taxes,
- (iii) interest, and
- (iv) rent,

to the extent allocable, under regulations prescribed by the Secretary, to such gross income from rents. . . .

. . . .

(3) **ADJUSTED INCOME FROM RENTS.**—The term "adjusted income from rents" means the gross income from rents, reduced by the amount subtracted under paragraph (2)(A) of this subsection. For purposes of the preceding sentence, the term "rents" means compensation, however designated, for the use of, or right to use, property, and the interest on debts owed to the corporation, to the extent such debts represent the price for which real property held primarily for sale to customers in the ordinary course of its trade or business was sold or exchanged by the corporation

13. The two basic requirements are listed in I.R.C. § 542(a):

(a) **GENERAL RULE.**—For purposes of this subtitle, the term "personal holding company" means any corporation (other than a corporation described in subsection (c)) if—

estate may be characterized as either ordinary interest or, if the real estate is held primarily for sale to customers in the ordinary course of trade or business, as rents.¹⁴ While ordinary interest is always included in personal holding company income, rents may be excluded from personal holding company income if the adjusted income from rents is more than fifty percent of the adjusted ordinary gross income. Therefore, if a real estate company's only income is considered ordinary interest, a personal holding company will result.¹⁵ On the other hand, if the interest can be classified as rents under section 543(b)(3) the company will not be treated as a personal holding company.¹⁶

This Comment discusses three alternative methods of applying section 543(b)(3). The Tax Court's opinion in *Parkside* illustrates a mechanical approach—a strict statutory construction without regard to corporate intentions—a position that has often been taken by courts in determining personal holding company status. The Ninth Circuit, in reversing the Tax Court in *Parkside*, used a second alternative by employing section 1221(1) criteria to

(1) **ADJUSTED ORDINARY GROSS INCOME REQUIREMENT.**—At least 60 percent of its adjusted ordinary gross income (as defined in section 543(b)(2)) for the taxable year is personal holding company income (as defined in section 543(a)), and

(2) **STOCK OWNERSHIP REQUIREMENT.**—At any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than 5 individuals.

14. See I.R.C. § 543(a)(1), (b)(3).

15. For purposes of this Comment, a brief equation summary of the interest calculation can be made:

Personal Holding Company Income (PHCI) =

(1) dividends, interest, royalties, annuities, and

(2) rents, unless the adjusted income from rents \geq 50% of the adjusted ordinary gross income, and the dividends for the year $>$ the amount by which other passive income exceeds 10% of the ordinary gross income.

Adjusted Ordinary Gross Income (AOGI) = Gross Income less:

(1) capital gains and § 1231(b) gains, and

(2) depreciation, property taxes, etc., allocable to rents.

If the stock ownership requirement is met, a corporation's status as a personal holding company will depend upon whether or not $PHCI/AOGI \geq 60\%$. Assuming that the corporation's gross income consists entirely of interest income from real estate and that there are no applicable adjustments in arriving at AOGI, gross income = AOGI. If the interest is considered ordinary interest it is classified as PHCI. Thus, $PHCI/AOGI = 100\%$ and the corporation is a personal holding company.

16. Assuming again that interest income is the corporation's only income, the classification of the interest as rents removes it from the personal holding company income classification because the rents, being equal to AOGI, exceed 50% of AOGI. Therefore, $PHCI = 0$ and $PHCI/AOGI = 0\%$. The corporation is not considered a personal holding company.

interpret section 543(b)(3). This Comment suggests a third alternative—a revision of section 543(b)(3).

Such a revision would better achieve the purposes for which the section was originally intended and would provide a safeguard against the inappropriate application of the personal holding company tax to real estate leasing companies forced to divest.

II. LEGISLATIVE DEVELOPMENT OF PERSONAL HOLDING COMPANY PROVISIONS

A. *Early Attempts to Reach Tax Avoidance Corporations*

Since the early revenue statutes enacted at the close of the Civil War,¹⁷ Congress has employed various measures in an attempt to tax wealthy individuals who permit their income to accumulate in a corporation instead of receiving it personally. During the early part of this century, wealthy individuals exploited the use of this tax avoidance device because the flat corporate tax rates were lower than the high levels of the graduated tax on individual income.¹⁸

The sixteenth amendment, passed in 1913, empowered Congress to tax income "from whatever source derived."¹⁹ The first revenue act passed subsequent to this amendment allowed taxation of income to the shareholders of a corporation whether or not corporate income accumulated by the corporation was distributed to the shareholders.²⁰ This practice continued until 1920, when the Supreme Court's decision in *Eisner v. Macomber*²¹ cast serious constitutional doubt upon the validity of taxing undistributed corporate income to shareholders. Consequently, section 220 of the Revenue Act of 1921 omitted this provision and instead taxed surplus accumulated to avoid the surtax on individual income.²²

Under section 220 of the Revenue Act of 1921, use of a holding company was *prima facie* evidence of a design to escape the tax on individuals.²³ This presumption could be rebutted, however, by proving the accumulation was reasonable in view of cor-

17. *E.g.*, Tariff of 1913, ch. 16, § II(A)(2), 38 Stat. 114; Act of June 30, 1864, ch. 173, § 2, 13 Stat. 223 as amended by Act of Mar. 3, 1865, ch. 78, 13 Stat. 469.

18. See *Fulman v. United States*, 434 U.S. 528, 530 (1978); H.R. REP. No. 1860, 75th Cong., 3d Sess. 3 (1938).

19. U.S. CONST. amend XVI.

20. Tariff of 1913, ch. 16, § II(A)(2), 38 Stat. 114.

21. 252 U.S. 189 (1920).

22. Revenue Act of 1921, ch. 136, § 220, 42 Stat. 227.

23. *Id.*

porate needs.²⁴ Subsequent personal holding company provisions have retained two aspects of section 220: (1) an additional penalty tax above normal tax rates for corporations, and (2) a tax on holding companies employed to avoid the individual tax.²⁵

Section 220, however, was insufficient to inhibit the diversion of personal income from wealthy individuals to various incorporated devices, commonly known as incorporated pocketbooks, incorporated yachts, incorporated talents, or incorporated country estates.²⁶ The basic scheme of these devices, later called personal holding companies, was explained by Congressman Dough-ton:

[A] number of wealthy individuals have organized personal holding companies and have transferred to such companies their houses, yachts, or other property used for their purely personal enjoyment, along with sufficient income-producing assets to produce enough revenue to pay the running expenses of such property. To provide a background of reality for this obviously fictitious transaction the stockholder pays his holding company a normal rental for the use of such estate or yacht.²⁷

As the Commissioner could not always prove that these incorporated devices were unreasonably accumulating income for evasion of individual income taxes, the need to effectively eliminate this tax avoidance instrument became apparent to Congress.²⁸ Accordingly, the House of Representatives, in 1928, proposed separate tax provisions for personal holding companies. The proposal defined personal holding companies as corporations whose income from royalties, dividends, rents, interest, annuities, or sales of securities amounted to more than eighty percent of the annual corporate income and whose stock was owned directly or indirectly by ten or fewer individuals.²⁹ The Senate rejected this detailed definition as arbitrary because corporations that appeared to unreasonably accumulate earnings could be penalized even though in actuality they were appropriately build-

24. Subsequent case law interpreted "prima facie evidence" as presumptive evidence. See *United States v. R.C. Tway Coal Sales Co.*, 75 F.2d 336, 337 (6th Cir. 1935). This provision exists in the current Code and has been termed a "rebuttable presumption" by the Supreme Court. *Ivan Allen Co. v. United States*, 422 U.S. 617, 628 (1975).

25. See Revenue Act of 1921, ch. 136, § 220, 42 Stat. 227.

26. See B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 8.20 (1971 ed.).

27. 81 CONG. REC. 9019 (1937).

28. See *American Package Corp. v. Commissioner*, 125 F.2d 413, 416 (4th Cir. 1942); Federal Legislation, *The 1937 "Tax Loophole" Act: Purpose* (pt. 1), 26 GEO. L.J. 380, 392-93 (1937).

29. H.R. REP. NO. 2, 70th Cong., 1st Sess. 17 (1928).

ing a surplus for later business necessities.³⁰ Since receipts from federal taxes and tariffs exceeded government expenditures during this period, the Senate may not have sensed a need for stricter tax legislation.³¹

B. Statutory Enactment

1. The Revenue Act of 1934

There was a drastic change in the fiscal conditions of the country between 1928 and 1934; the Great Depression stunned the country. Emergency expenditures by the federal government to subsidize employment programs and stimulate the economy caused large deficits in the federal accounts.³² Accordingly, the Revenue Act of 1934 was designed to increase revenues by preventing tax avoidance.³³

One of the tax evasion devices that Congress most desired to eliminate was the domestic personal holding company.³⁴ Congress considered the incorporated pocketbook to be the most prevalent form of tax avoidance.³⁵ Since the individuals employing these schemes were usually in the best position to pay the most taxes, Congress was particularly motivated to curb this tax avoidance device.

The 1934 House proposal for meeting this need paralleled its suggested 1928 personal holding company provisions. The Senate

30. S. REP. NO. 960, 70th Cong., 1st Sess. 12 (1928).

31. The surplus accumulated by the Treasury Department was reported accordingly:

Year	Surplus (in millions)
1923	\$309
1924	505
1925	250
1926	377
1927	635
1928	455 (estimated)
1929	274 (estimated)

See H.R. REP. NO. 2, 70th Cong., 1st Sess. 8 (1928).

32. The government had a large increase in emergency expenditures during the years of the depression. The deficit for the fiscal year 1933 was \$2.6 billion, and in 1934 the estimated deficits for 1934 and 1935 (exclusive of debt retirement) were \$7.3 billion and \$1.99 billion, respectively. See S. REP. NO. 558, 73d Cong., 2d Sess. 1-3 (1934); H.R. REP. NO. 704 (pt. 1), 73d Cong., 2d Sess. 2 (1934). It is therefore apparent why the Congress of 1934 was concerned over any reputed form of tax avoidance.

33. H.R. REP. NO. 704 (pt. 1), 73d Cong., 2d Sess. 1 (1934).

34. *Id.* at 11-12.

35. *Id.*

accepted the House proposal with one important exception. The House had included rents as part of personal holding company income, but the Senate, fearing actively operating family real estate businesses would be classified as personal holding companies, excluded rents from personal holding company income.³⁶

Unlike the 1921 provisions taxing accumulated earnings, the personal holding company tax did not permit a company to prove that its retention of surplus earnings was reasonable in light of business necessities.³⁷ Indeed, the personal holding company provisions were meant to work "automatically" because Congress in 1934 believed that the tax would only reach corporations formed for the sole purpose of avoiding the surtax.³⁸

2. *The Revenue Act of 1937*

The Senate's desire to protect bona fide operating real estate companies apparently did not enjoy continued support after President Franklin D. Roosevelt made an emphatic speech condemning tax avoidance through personal holding companies.³⁹ Because it was believed that personal holding companies were using minimal amounts of rental income to cover substantial passive investment income, personal holding company income was expanded to include rents.⁴⁰ Based on the arbitrary assumption that the rental income of "bona-fide and legitimate operating companies" would

36. The Senate report stated,

While agreeing with the general method proposed in the House bill to remedy this situation, it is believed that section 102 of the House bill, dealing with personal holding companies imposes a heavy penalty on many companies which do not properly fall into the classification of the "incorporated pocketbook."

... A great part of the real-estate business is done by small family corporations. These partake more of the nature of operating companies than mere holding companies. Your committee is of the opinion that it is unwise to include such companies within the category of personal-holding companies. Therefore, the word "rents" is omitted from the definition. . . .

... The fact that some companies, such as real estate companies, have been placed outside the scope of this provision does not result in a serious opportunity for tax avoidance. Such companies, and, in fact, all other corporations, are still subject to section 102 [the accumulated earnings provision] of the bill.

S. REP. NO. 558, 73d Cong., 2d Sess. 13-15 (1934).

37. One court stated Congress was attempting to foreclose the accumulated earnings defense that the funds were legitimately accumulated. *O'Sullivan Rubber Co. v. Commissioner*, 120 F.2d 845, 847-48 (2d Cir. 1941). See also *Federal Legislation*, *supra* note 28, at 392-93.

38. H.R. REP. NO. 704 (pt. 1), 73d Cong., 2d Sess. 12 (1934).

39. See H.R. REP. NO. 1546, 75th Cong., 1st Sess. 3 (1937).

40. *Id.* at 6.

not be less than fifty percent of the gross income, rental income was excluded from personal holding company income only if it surpassed fifty percent of the company's gross income.⁴¹

This revenue Act marked one of the first congressional attempts to distinguish active from passive income in an industry in which Congress recognized that both active and passive businesses could exist. The vague concept of passive income is generally understood to include dividends, annuities, interest, royalties, rents, and income from sales of stock and securities.⁴² Passive income is considered to be derived from passive investments requiring little or no management.⁴³ Active income includes other types of income requiring active operation and management. There are exceptions to this general statement, some of which Congress has statutorily recognized. For example, the receipt of interest from a small number of loans may represent passive income to a creditor, while numerous loans may produce the major source of income for a finance or lending company.⁴⁴ A single piece of rented or leased property may require little or no attention of a corporate owner and may represent only a side investment, but a large apartment complex may represent an active operating company and may require the constant efforts of numerous employees to generate profits.⁴⁵ Thus, protecting the active operating real estate business has presented a difficult problem to Congress since an active business may, due to statutory imprecision, earn what is considered passive income.

3. *The Revenue Act of 1938*

The language now incorporated in section 543(b)(3), referring to interest on debts from real estate held primarily for sale to customers in the ordinary course of business, originated with the Revenue Act of 1938.⁴⁶ The accompanying House Report explained the change:

In order to relieve from the surtax imposed by Title IA of the bill certain operating companies whose principal business

41. *Id.*

42. See *Bates v. United States*, 581 F.2d 575, 578-79 (6th Cir. 1978); I.R.C. § 1372(e)(5)(C).

43. See *Robida v. Commissioner*, 460 F.2d 1172, 1174 (9th Cir. 1972).

44. A lending or finance company is exempted from personal holding company status under I.R.C. § 542(C)(6), which is further limited by I.R.C. § 542(d).

45. Real estate companies with largely rental income are exempted from personal holding company status through the adjustments in I.R.C. §§ 542(a)(2) and 543(b)(3).

46. Compare Revenue Act of 1938, ch. 289, § 403(g), 52 Stat. 447 (now I.R.C. § 543(b)(3)) with Revenue Act of 1936, ch. 690, § 351, 49 Stat. 1648.

consists in the development of real estate for sale, section 403 makes a change in the treatment of certain types of interest This change will help those bona fide real estate operating companies which might otherwise find themselves subject to the tax under Title IA of the bill in years in which, by reason of an inactive market for the sale of real estate, the greater part of their income is derived from interest on second mortgages on property previously sold by them and from rent from property leased pending its sale and the rents in themselves do not constitute 50 percent or more of gross income. Under the proposed definition of "rents", such companies will not be classified as personal holding companies.⁴⁷

Evidently Congress did not contemplate the dilemma of a real estate leasing company forced to sell its properties because of an "inactive market." The House report does identify two types of "bona fide real estate operating companies which might otherwise find themselves subject to the tax": first, those "whose principal business consists in the development of real estate for sale," and second, those who receive rents from "property leased pending its sale [when] the rents in themselves do not constitute 50 percent or more of gross income." Neither of these descriptions adequately provides protection for the financially troubled real estate leasing company. Perhaps Congress did not foresee that a bona fide real estate leasing company could, upon sale of its properties, find itself subject to the tax. It is also possible that Congress intended to exempt real estate leasing companies forced to liquidate from personal holding company status. At the time such companies decide to sell their real estate, it could be considered as "property leased pending its sale."

Upon enacting the predecessor to section 543(b)(3), Congress apparently anticipated the possibility that a recessive market might cause an otherwise active company to be classified as a personal holding company. Congress, however, did not foresee and provide for all the situations in which a personal holding company would result from market fluctuations.

C. *Subsequent Development—Numerous Exceptions*

The language used in the Revenue Act of 1938 to qualify certain interest on real estate debts as rents was incorporated in subsequent acts and codes without substantial change.⁴⁸ There

47. H.R. REP. NO. 1860, 75th Cong., 3d Sess. 51 (1938).

48. Compare Revenue Act of 1938, ch. 289, § 403(g), 52 Stat. 447 (now I.R.C. § 543(b)(3)) with Int. Rev. Code of 1939, ch. 2, § 502(g), 53 Stat. 1 and I.R.C. § 543(b)(3).

have been numerous refinements, however, in other provisions of the personal holding company tax designed to avoid taxing active companies not within the original congressional intent. The Revenue Act of 1934 recognized an exception for banks, life insurance companies, and surety companies, even though these institutions acquired income that could technically be classified as passive so as to otherwise invoke the personal holding company provisions.⁴⁹ Furthermore, one critic recently noted a procession of at least eighteen supplicants from various industries and businesses that have been granted relief from the overly broad personal holding company provisions.⁵⁰ He concluded this "endless parade" indicates "[t]he personal holding company tax, despite the intent of Congress, is fundamentally defective in failing adequately to shield active businesses from its impact."⁵¹

49. Revenue Act of 1934, ch. 277, § 351(b)(1), 48 Stat. 680. Concerning the present major statutory exemptions, one treatise comments:

Generically, these exempted corporations are corporations which receive personal holding company income but are not considered to be within the concept of incorporated pocketbooks because they receive such income as a result of carrying on an active trade or business. Corporations exempted on this basis include banks, life insurance companies, surety companies, certain lending and finance companies, and federally licensed small business investment companies.

T. NESS & E. VOGEL, *TAXATION OF THE CLOSELY HELD CORPORATION* § 6.1(a) (3d ed. 1976) (footnote omitted).

50. Mr. Morgan has written:

From the inception of the personal holding company tax, banks, life insurance companies and surety companies were also recognized as active businesses, and were excluded from the personal holding company provisions. Thereafter, a steady procession of supplicants has been granted relief by Congress for comparable reasons: holders of mineral oil or gas royalties (in 1937), licensed personal finance companies (in 1938), affiliated groups of railroad corporations (in 1938), industrial banks and Morris Plan companies (in 1942), other small loan companies and financing companies (in 1950), corporations renting property to shareholders for use in an active commercial, industrial or mining enterprise (in 1950, retroactive to 1945), domestic building and loan associations (1951), shipping enterprises depositing amounts in Merchant Marine Act reserves (in 1954), corporate affiliated groups generally (in 1954), corporations renting property to shareholders but not having other significant personal holding company income (in 1954), small business investment companies (in 1959), music publishers (in 1960), movie producers (in 1964 and again in 1976), securities dealers handling U.S. government bonds (in 1964), manufacturers leasing their products and also realizing related royalty income (1964 and again in 1966), corporate affiliated groups with life insurance subsidiaries (in 1974), and franchisors [*sic*] leasing the franchise and other property to shareholders for use in an active business (in 1976). Congress, in aiding those afflicted, has repeatedly expressed the intention to keep active businesses out of personal holding company entanglements.

Morgan, *supra* note 3, at 241-44 (footnotes omitted).

51. *Id.* at 244.

III. JUDICIAL INTERPRETATION OF PERSONAL HOLDING COMPANY PROVISIONS

A. *The Mechanical Approach to Personal Holding Company Determination*

Personal holding company provisions have been mechanically applied against the taxpayer without concern for harsh results.⁵² This mechanical approach is reflected in the Tax Court's decision in *Parkside, Inc. v. Commissioner*.⁵³ Relying on legislative history, the court pointed out that the statute was intended to exempt only "bona fide real estate operating companies" and was "strictly mechanical"—applying without regard to corporate intentions.⁵⁴ The court implied the corporations could not be considered bona fide real estate operating companies because the corporations were "merely leasing companies."⁵⁵ No explanation was given to indicate why leasing companies could not be considered bona fide real estate operating companies. The distinction may have been trivial, yet the unexplained conclusion resulted in a stiff seventy-percent tax.

In another case that arguably could have been decided for the taxpayer, the Tax Court held that a company formed to buy property for resale to others on easier terms did not fall within section 543(b)(3) since the property was not technically held primarily for sale to customers in the ordinary course of business. Thus, the receipt of interest from these sales resulted in the company being considered a personal holding company.⁵⁶

52. The Tax Court has stated that since the statute is designed to correct the serious evil of the incorporated pocketbook, it must be strictly construed. *Kurt Frings Agency, Inc.*, 42 T.C. 472 (1964), *aff'd per curiam*, 351 F.2d 951 (9th Cir. 1965). See 320 E. 47th St. Corp. v. Commissioner, 243 F.2d 894, 897 (2d Cir. 1957); *O'Sullivan Rubber Co. v. Commissioner*, 120 F.2d 845, 847-48 (2d Cir. 1941); *Bell Realty Trust v. Commissioner*, 65 T.C. 766, 775, *aff'd mem.*, 546 F.2d 413 (1st Cir. 1976); *Darrow v. Commissioner*, 64 T.C. 217, 221-22 (1975).

Justification for applying the tax automatically is found in the language of the 1934 House report which removed the Commissioner's burden of proving there was a purpose to avoid surtaxes on individual income. H.R. REP. No. 704 (pt. 1), 73d Cong., 2d Sess. 12 (1934). An addendum to the report, entitled "Additional Views of James A. Frear," leaves little doubt there was stiff opposition to the passage of this entire bill. It was passed without public hearings and was formulated by a small group of tax experts who differed radically in their opinions. It was also reported that the Treasury "unqualifiedly differed" with the personal holding company provisions proposed. *Id.* at 43.

53. 34 T.C.M. (CCH) 54 (1973), *rev'd*, 571 F.2d 1092 (9th Cir. 1977).

54. *Id.* at 61.

55. *Id.*

56. *Sieh v. Commissioner*, 56 T.C. 1386 (1971), *aff'd mem.*, 31 A.F.T.R.2d 73-694 (8th Cir. 1973).

Although Congress apparently intended that the personal holding company tax be levied in an automatic fashion, courts have seldom noted Congress' subsequent interest in protecting active corporations. Congress' intent to protect active companies has not been broadly stated, but is nonetheless clearly evident in most of the personal holding company provisions enacted since 1937. The numerous exceptions included in these provisions represent a response to the cry of active companies caught in the personal holding company trap. Indeed, the provisions for excluding rents when they constitute more than fifty percent of the adjusted ordinary gross income was based on the premise that active companies would thereby be protected.⁵⁷

B. Application of Section 1221 Criteria

Since the language of section 1221(1)⁵⁸ is similar to the language of section 543(b)(3), some courts have looked to section 1221(1) cases for guidance.⁵⁹ The Ninth Circuit in *Parkside*, how-

57. H.R. REP. No. 1546, 75th Cong., 1st Sess. 6 (1937).

58. Under § 1221 of the current Code all properties are considered capital assets with certain listed exceptions. Among the listed exceptions is "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." I.R.C. § 1221(1). Since the gains on capital assets are taxed at a lesser rate than ordinary gains, taxpayers normally urge the courts to construe the capital asset exceptions narrowly. The statutory capital gains provisions for corporations are codified at I.R.C. § 1201(a), while the provisions applicable to individuals are codified in I.R.C. §§ 1201(b) and 1202. Prior to the Revenue Act of 1924 the capital asset definition of § 1221(1) did not exclude property "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." See Revenue Act of 1921, ch. 136, § 206(a)(6), 42 Stat. 227. Assets constituting inventory were implicitly distinguished from capital assets because they were sold to customers in the ordinary course of business. At that time, however, real property held for sale to customers was not considered inventory and could thus be classified as a capital asset. See Helen M. Dunigan, 23 B.T.A. 418 (1931), *aff'd*, 66 F.2d 201 (D.C. Cir. 1933); Gilbert S. Wright, 22 B.T.A. 1045 (1931); Albert F. Keeney, 17 B.T.A. 560 (1929). Legislative provisions were added in 1924 to constrict the capital asset definition and exclude as a capital asset real estate held primarily for sale in the course of business. Revenue Act of 1924, ch. 234, § 208(a)(8), 43 Stat. 253. This was intended to prevent tax avoidance and add greater clarity to the classes of property excluded from the capital asset definition. S. REP. No. 398, 68th Cong. 1st Sess. 122 (1924). In 1934, the words "to customers" and "ordinary" were added to the definition. Revenue Act of 1934, ch. 277, § 117(b), 48 Stat. 680. Since 1934, similar language has been found in each major revenue act and Code. Compare I.R.C. § 1221(1) with Int. Rev. Code of 1939, ch. 1, § 117(a)(1), 53 Stat. 1; Revenue Act of 1938, ch. 289, § 117(a)(1), 52 Stat. 447; and Revenue Act of 1936, ch. 690, § 117(b), 49 Stat. 1648.

59. See *Kent Indus. Corp.*, 25 T.C. 215, 219 (1955); *Webster Corp.*, 25 T.C. 55, 60 (1955), *aff'd per curiam*, 240 F.2d 164 (2d Cir. 1957); *Frederick Smith Enterprise Co.*, 6 T.C.M. (CCH) 595, 599 (1947), *aff'd*, 167 F.2d 356 (6th Cir. 1948).

Other courts construing § 543(b)(3) have summarily found that the property was not held primarily for sale to customers in the ordinary course of business with little analysis or reliance on other cases. See *Sieh v. Commissioner*, 56 T.C. 1386, 1390 (1971), *aff'd mem.*, 31 A.F.T.R.2d 73-694 (8th Cir. 1973).

ever, appears to be the first federal appellate court to explicitly apply the section 1221(1) criteria to section 543(b)(3) without modification.⁶⁰

The *Parkside* case demonstrates how section 1221(1) criteria can be applied to section 543 to provide a needed avenue of relief for companies that have unwittingly stumbled into the personal holding company provisions. The court stated that since the language of section 1221(1) was similar to section 543(b)(3), section 1221(1) criteria could be adopted. The section 1221(1) criteria used by the court were

“the length of holding of the property, the nature of the acquisition of the property, the frequency and continuity of sales over an extended period of time, the nature and the extent of the taxpayer’s business, the activity of the seller about the property, and the extent and substantiality of the transactions.”⁶¹

Without indicating whether its analysis was based entirely on the foregoing factors, the court discussed other “indicia” that were “sufficiently compelling to sway the balance” in favor of *Parkside* and its sister corporation.⁶² The court concluded the taxpayers were in the business of selling duplexes and found the Tax Court “clearly in error.”⁶³ The *Parkside* opinion did not refer to the legislative history of section 543(b)(3) although most courts do so when determining personal holding company status.⁶⁴

While the Ninth Circuit conveniently circumvented the harsh legislative intentions documented in the 1930’s⁶⁵ and was

60. 571 F.2d at 1094.

61. *Id.* at 1096 (quoting *Los Angeles Extension Co. v. United States*, 315 F.2d 1, 3 (9th Cir. 1963)).

62. *Id.*

63. *Id.*

64. See *Fulman v. United States*, 434 U.S. 528, 530-31 (1978); *Commissioner v. Lane-Wells Co.*, 321 U.S. 219, 221 (1944); *Doehring v. Commissioner*, 527 F.2d 945, 947 (8th Cir. 1975); *Bayou Verret Land Co. v. Commissioner*, 450 F.2d 850, 853-54 (5th Cir. 1971); *Hilldun Corp. v. Commissioner*, 408 F.2d 1117, 1122 (2d Cir. 1969); *Frelbro Corp. v. Commissioner*, 315 F.2d 784, 788 (2d Cir. 1963); *320 E. 47th St. Corp. v. Commissioner*, 243 F.2d 894, 897-98 (2d Cir. 1957); *Frederick Smith Enterprise Co. v. Commissioner*, 167 F.2d 356, 359 (6th Cir. 1948); *O’Sullivan Rubber Co. v. Commissioner*, 120 F.2d 845, 847-49 (2d Cir. 1941); *Noteman v. Welch*, 108 F.2d 206, 208-10 (1st Cir. 1939); *Irving Berlin Music Corp. v. United States*, 487 F.2d 540, 547-48 (Ct. Cl. 1973), *cert. denied*, 419 U.S. 832 (1974); *Fidelity Commercial Corp. v. Commissioner*, 55 T.C. 483, 489 (1970), *aff’d mem.*, 28 A.F.T.R.2d 71-5751 (4th Cir. 1971); *Callan v. Commissioner*, 54 T.C. 1514, 1519 (1970), *aff’d per curiam*, 476 F.2d 509 (9th Cir. 1973); *Jos. K., Inc.*, 51 T.C. 584, 596-98 (1969); *Coshocton Secs. Co.*, 26 T.C. 935, 939 (1956); *Kent Indus. Corp.* 25 T.C. 215, 218-19 (1955).

65. One court recognized the unfortunate results of this legislative period when the facts of the case caused a company to fall within the personal holding company trap. “It is true that the result in this particular case is undoubtedly a hardship such as Congress

able to successfully rescue a troubled company from the personal holding company trap, it is doubtful whether section 1221(1) criteria can be relied upon in the future to resolve section 543(b)(3) questions. Although extensive litigation involving section 1221(1) has identified numerous criteria for determining whether property is held as a capital asset, it is difficult to distill clear and consistently applied criteria.⁶⁶ One court in apparent exasperation with this subsection stated, "Finding ourselves engulfed in a fog of decisions with gossamer like distinctions, and a quagmire of unworkable, unreliable, and often irrelevant tests, we take the route of ad hoc exploration to find ordinary income."⁶⁷ One commentator bemoaned the fact that "any attempt to reconcile the cases in this area would likely produce nothing more than an exercise in futility."⁶⁸ Reconciliation of section 1221(1) criteria is not within the scope of this Comment; rather, the effect of applying the criteria from this ambiguous section of the Code to section 543(b)(3) is considered.

may not have had in mind in enacting the statute. However, it is the type of hardship which sometimes follows an attempt to remedy a serious evil by *drastic measures*." *Cedarburg Canning Co. v. Commissioner*, 149 F.2d 526, 528 (7th Cir. 1945) (emphasis added).

One author has noted that the "New Dealers" had a "political passion" to eliminate holding companies because of the expansive control they often maintained over the economy. See Schaffer, *The Income Tax on Intercorporate Dividends* 6 (June 7, 1978) (unpublished report prepared for the American Bar Association, Section of Taxation: Committee on Affiliated and Related Corporations).

66. In speaking of the capital gains definition, which is dependent upon the capital asset definition in I.R.C. § 1221, one commentator has noted:

The income tax provisions of the 1954 Internal Revenue Code represent probably the most complex revenue law ever enacted in the fiscal history of any country. The subject singly responsible for the largest amount of complexity is the treatment of capital gains and losses. And the factor in that treatment which is accountable for the resulting complexity is the definition of capital gain and of capital loss.

Surrey, *Definitional Problems in Capital Gains Taxation*, 69 HARV. L. REV. 985, 985 (1956).

For examples of courts struggling with the capital gains definition in the sale of land, see *Malat v. Riddell*, 383 U.S. 569 (1966); *Biedenharn Realty Co. v. United States*, 526 F.2d 409 (5th Cir. 1976), cert. denied, 429 U.S. 819 (1977); *International Shoe Mach. Corp. v. Commissioner*, 491 F.2d 157 (1st Cir. 1974); *Goodman v. United States*, 390 F.2d 915 (Ct. Cl. 1968); *S.O. Bynum*, 46 T.C. 295 (1966). For a discussion of factors affecting courts in their analysis of capital gains in land sales, see AMERICAN LAW INSTITUTE, DISCUSSION DRAFT OF A STUDY OF DEFINITIONAL PROBLEMS IN CAPITAL GAINS TAXATION 21-27, 33-35, 61, 71-72, 92-96 (1960); P. ANDERSON, TAX FACTORS IN REAL ESTATE OPERATIONS 1-7 (1973); J. HIGGINS, THE TAX CONSEQUENCES OF THE SALE OF LAND 1-7 (1973); 3B J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION §§ 22.15, .138-.142, .144, .145 (rev. ed. 1973).

67. *United States v. Winthrop*, 417 F.2d 905, 906 (5th Cir. 1969).

68. Libin, "Transactions Entered into for Profit," "Regular Trade or Business," and/or "Investment": Some Distinctions and Differences, 27 N.Y. INST. FED. TAX. 1209, 1213 (1969).

Application of section 1221(1) criteria to section 543(b)(3) can be advantageous to the taxpayer. The ambiguity and flexibility of section 1221(1) can be employed by courts to temper the mechanical application of the personal holding company tax. Indeed, the flexibility of section 1221(1) may represent the judicial answer to the plight of uncautious corporations caught within the snare of the personal holding company provisions.

In *Parkside* both the Ninth Circuit and the Tax Court relied upon section 1221(1) cases to analyze the application of section 543(b)(3). For example, when both courts considered the fact that the sales had actually occurred during a liquidation of assets, both cited cases determined under section 1221(1).⁶⁹ The Tax Court found insufficient sales activity for *Parkside* to be considered a dealer or in the business of selling real estate.⁷⁰ The Ninth Circuit, however, held that these sales in the course of a liquidation involved property technically held for sale in the ordinary course of business.⁷¹ The ambiguity of section 1221(1) often causes contrary results in similar transactions because, as the Ninth Circuit stated, "In the final analysis, each case must be decided upon its own facts."⁷²

The flexibility of section 1221(1) is further demonstrated by contrasting *Parkside* with *Heller Trust v. Commissioner*.⁷³ In *Heller Trust*, the taxpayer had built and rented duplexes that after a few years proved unprofitable. The duplexes were subsequently advertised and sold by independent agents. Although the taxpayer sold his 169 duplexes over a three-year period, he claimed the profits were entitled to capital gains treatment because they resulted from liquidation of investment property and not a sales business. The court agreed and decided that the duplexes were held as an investment until just prior to the time of sale. Gain from a sale prompted by liquidation of investment property was classified as a capital gain because the property was not held primarily for sale to customers in the ordinary course of business. Even though *Heller Trust* and *Parkside* involved similar factual circumstances, the Ninth Circuit was able to reach opposite conclusions by construing the flexible criteria of section 1221(1) differently.

Thus, courts that apply section 1221(1) to section 543(b)(3) may be able to grant relief to unwary corporations that have

69. See 571 F.2d at 1096; 34 T.C.M. (CCH) at 59-60.

70. 34 T.C.M. (CCH) at 59-60.

71. 571 F.2d at 1096.

72. *Id.*

73. 382 F.2d 675 (9th Cir. 1967).

stumbled into the personal holding company provisions. However, the danger always exists that the flexibility and ambiguity of section 1221(1) may be used to defeat the valid claims of the taxpayer.⁷⁴

Applying section 1221(1) criteria to section 543(b)(3) may present serious problems for the corporation attempting to plan its activities in order to avoid the personal holding company tax. A company should be able to ascertain with reasonable certainty whether it will become subject to a seventy-percent tax. Because of the uncertain future provided by section 1221(1), the company may choose to cease operations and terminate employees, thereby depriving the community of any benefits otherwise provided.

In addition, both the object and focus of section 1221(1) are different than those of section 543(b)(3). Substitution of one section's interpretation for the other may be inappropriate. Section 1221(1) was incorporated into the Code to prevent tax avoidance by constricting the advantageous capital gain treatment to a limited category of assets. Section 1221 focuses on the character of the asset and seeks to provide favorable treatment to gains that accrue due to the passage of time.⁷⁵ The section 543(b)(3) exception to personal holding company income, however, was designed to broaden the category of corporations exempt from personal holding company status by providing relief to certain real estate businesses that would otherwise be classified as personal holding companies. This provision focuses on the character of the corporation and the type of income earned.⁷⁶ Finally, because section

74. Another disadvantage for taxpayers when § 1221(1) is used to interpret § 543(b)(3) is that taxpayers may tend to make inconsistent reports on their returns. Large gains from property may inadvertently be reported as capital gains. By claiming capital gain rates on their tax returns, taxpayers may be precluded from later denying capital asset status. See *In re Steen*, 509 F.2d 1398, 1402 n.4 (9th Cir. 1975); *Maletis v. United States*, 200 F.2d 97, 98 (9th Cir. 1952). Thus, the taxpayer will be forced, because of the similar language currently used in the two sections, to admit the property was not held for sale to customers in the ordinary course of business.

In an unusual fashion, Parkside had reported its duplexes as § 1231(b)(2)(B) property (property not held primarily for sale to customers in the ordinary course of a trade or business), which would have qualified for capital gains treatment. However, it had paid the normal tax rate. The Ninth Circuit noted a "disquieting inconsistency" in the Commissioner's assertion that Parkside could not later deny the § 1231(b)(2)(B) reporting, while the Commissioner had not previously refunded the excess tax. The court sustained Parkside's claim that the entry on the tax return was merely "inadvertent." See 571 F.2d at 1096-97.

75. See Simmons & O'Hara, *Three New Tests Appear for Obtaining Capital Gains on Real Estate Sales*, 28 J. Tax. 218 (1968).

76. See *Kent Indus. Corp.*, 25 T.C. 215, 218-19 (1955); *Webster Corp.*, 25 T.C. 55, 60-61 (1955), *aff'd*, 240 F.2d 164 (2d Cir. 1957); *West End Co.*, 23 T.C. 815, 819-20 (1955).

1221(1) pertains to a broader category of assets than section 543(b)(3), a court could choose criteria from section 1221(1) cases to construe section 543(b)(3) that may include factors not relevant in evaluating whether a corporation has been sufficiently involved in real estate sales activities to be classified as a business. Thus, there may be appropriate objections to an unmodified application of section 1221(1) to section 543(b)(3).

IV. STATUTORY REVISION

Although temporary relief from the oppressive personal holding company tax may be afforded real estate leasing companies through the application of section 1221(1) criteria to section 543(b)(3), the continued use of this approach may only create additional uncertainties in this already complex area of taxation. On the other hand, if the personal holding company provisions are to be mechanically applied, the mechanism should be adjusted and refined so that the tax is levied only on corporations that are clearly passive or designed to avoid surtaxes on individuals. This ultimate relief must come from Congress.

A. *Deficiencies in the Present Personal Holding Company Provisions*

The exceptions to personal holding company status tend to be tailored and narrow in scope since most have been granted after business and industry protest. Three of these exceptions are relevant to an analysis of troubled real estate companies, and include the exception for real estate leasing companies with large rental income,⁷⁷ the exception for companies that principally sell real estate,⁷⁸ and the exception granted certain finance or lending companies.⁷⁹ A problem arises when a company that clearly falls within the first exception is forced to sell its property. After the sales, the company probably appears most similar to a lending or finance company because it will be forced to manage debts and collect an extensive amount of interest. Yet, because of the stringent requirements of the third limited exception, the company may not qualify. Thus, the company can only be extricated from

The Tax Court in *Parkside* followed this approach by noting the "overall picture" of *Parkside* to show that this situation was a liquidation of inherited property. 34 T.C.M. (CCH) at 59.

77. I.R.C. § 543(a)(2) provides this exception by excluding rental income when it is more than 50% of the adjusted ordinary gross income.

78. See I.R.C. § 543(a)(2), (b)(3).

79. See I.R.C. § 542(c)(6), (d).

personal holding company status by fitting in the second category. Some stretching of the language of the second exception is required in order to find that a company that previously only leased and rented property now sells the property in the ordinary course of business. The availability of section 1221(1) for stretching the language has, therefore, not been unnoticed.

In *Parkside*, the corporations shifted from the first exception to a position actually closer to the third—finance and lending companies. The gradual change of *Parkside* from a rental company to a finance company was accompanied by a change in the type of income received after the duplexes were sold. While the monthly income *Parkside* received for the duplexes sold on installment contracts may have been nearly equal to the rental payments it had received prior to the sales, the label of the company's income shifted from rental income to debt payments. The activities of *Parkside*'s president also illustrate how the character of the company shifted slightly from a rental business to include the services of a lending or finance company. The president associated with mortgage officers and members of financial institutions to stay abreast of developments and possible loan sources, kept close financial record of payments to *Parkside*, studied the Wall Street Journal along with various government and private financial publications and statistics, and continued to offer services to the duplex purchasers as a consultant to assist them in their other purchases.⁸⁰ Although *Parkside* resembled a finance company, the Ninth Circuit employed section 1221(1) criteria to characterize *Parkside* as a company doing business within the second exception.

The court implicitly recognized that the personal holding company exceptions and the policies supporting them do not clearly manifest an intent to tax real estate leasing companies forced to liquidate holdings and receive interest on debts due to market inactivity. Most leasing companies forced to liquidate desire to retain their corporate identity and established good will in hopes of returning to the rental business when a better rental market returns. In *Parkside*, for example, it may have been necessary to retain corporate status to avoid personal liability of the shareholders because the corporation was still liable on the original mortgages for the duplexes sold.⁸¹

Thus, a major deficiency with the personal holding company provisions in the real estate leasing area is that the legislative

80. 34 T.C.M. (CCH) at 57-58.

81. *Id.* at 58.

intent to exempt certain classes of companies has been unduly limited. Recessive market forces may cause an active real estate leasing company to fall outside the limited boundaries of one exception and assume characteristics similar to active companies within the other excepted categories. Yet, the company usually will not be able to meet the technical qualifications of the other personal holding company exceptions.

Another major deficiency of the personal holding company tax is that it reaches many closely held corporations even though the shareholders are not wealthy individuals seeking to avoid the personal income tax. The seventy-percent personal holding company tax is equal to the highest tax levied on individual income.⁸² This is consistent with the rationale of the personal holding company provisions; the provisions tax corporations created by wealthy individuals to improperly avoid the highest levels of the individual income tax. This rationale, however, does not support the Tax Court's finding in *Parkside*. During the years in question, *Parkside*'s president averaged an annual salary of approximately \$7,000,⁸³ a salary comparable to that received by janitors, watchmen, and guards in the same area at that time.⁸⁴ Ironically, a tax once aimed at wealthy individuals who amassed millions of dollars in the 1920's can now be employed to reach individuals receiving \$7,000 from a small, debt-ridden corporation.

B. Revision of Section 543(b)(3)

1. Shifting the emphasis

Without attempting a massive restructuring of section 543(b)(3), operating companies with rental and interest income could be appropriately protected from personal holding company status through a change in the wording of the section. By deleting "primarily" and adding "active," the adjusted income from rents would include

interest on debts owed to the corporation, to the extent such debts represent the price for which real property held primarily for sale to customers in the ordinary course of an active trade or business was sold or exchanged by the corporation

Under this proposed statute, the emphasis would shift from determining whether the property is held primarily for sale, to iden-

82. See I.R.C. § 1.

83. The president's annual salary in 1966, 1967, and 1968 was \$6,300, \$7,300, and \$7,200, respectively. 34 T.C.M. (CCH) at 57, 61.

84. *Id.* at 57.

tifying legitimately operating businesses. In interpreting section 1221(1) courts have normally concentrated on whether property is held primarily for sale.⁸⁵ This detracts from focusing on the nature of the corporation, which is a more appropriate basis for analysis under section 543(b)(3).

The Supreme Court has held that "primarily" as used in section 1221(1) means "of first importance" or "principally."⁸⁶ If this word were deleted,⁸⁷ decreased emphasis would be placed on whether the property was held in the ordinary course of a business since at the same time the property could be held for other significant purposes. The Ninth Circuit's decision in *Parkside* in effect decreased the importance of "primarily" by limiting its application to "the relevant tax years."⁸⁸ Obviously, during the years of the sales or immediately thereafter the court could easily find that the property was held primarily for sale. Deletion of "primarily" from section 543(b)(3) similarly would direct focus away from the holding of the asset and toward the nature of the corporation.

2. Drawing from other sections of the Code: The active business criterion

The addition of "active" to section 543(b)(3) would emphasize the type of business to be excluded from classification as a personal holding company. The requirement of an active trade or business for favorable tax treatment has been employed in other sections of the Code and could be appropriately used in section 543(b)(3). The foreign personal holding company provisions employ this criterion and exclude rents "derived in the active conduct of a trade or business"⁸⁹ from foreign personal holding company income. The rents are treated as receipts from an active business when the lessor has produced, acquired, or substantially added to the real estate; participated in active and substantial management and operational functions related to the real estate;

85. One recent case that emphasized the manner in which the property was held is *Jersey Land & Dev. Corp. v. United States*, 539 F.2d 311 (3d Cir. 1976). "[I]t is the taxpayer's primary purpose in holding that property at the time of sale which determines whether the gain therefrom will qualify as capital gains or be taxed as ordinary income." *Id.* at 315 (citations omitted). The Ninth Circuit in *Parkside* took the same approach. 571 F.2d at 1096.

86. *Malat v. Riddell*, 383 U.S. 569, 572 (1966).

87. See Bernstein, "Primarily for Sale": A Semantic Snare, 20 STAN. L. REV. 1093 (1968). This article discusses the undesirable effect *Malat* had on § 1221(1) case law and suggests legislative elimination of "primarily" to remedy this effect.

88. 571 F.2d at 1096.

89. I.R.C. § 954(c)(3)(A).

or rented the property only because it is temporarily idle in his normally active trade or business.⁹⁰ Other provisions for foreign personal holding companies exclude certain forms of interest when received through an active business.⁹¹

Section 355(b), in the setting of divisive corporate reorganizations, attempts to distinguish "the active conduct of a trade or business" from the passive conduct of a business. One important test employed in this section is whether the business has been actively conducted for the past five years.⁹² A determination is also made whether the corporation is presently engaged in active business.⁹³

V. CONCLUSION

The "downright confiscatory"⁹⁴ personal holding company tax should not be arbitrarily exercised without regard to the status of the taxpayer as an active corporation. Present personal holding company provisions are the product of the vindictive surge of the 1930's to eliminate holding companies and tax avoidance corporations. The provisions are not the result of a moderate, carefully calculated analysis of the personal holding company problem.

The tax is particularly oppressive for real estate leasing companies forced to liquidate as a result of a depressed market economy. In *Parkside v. Commissioner*, the court used the extensively litigated, yet flexible criteria of section 1221(1) to rescue the corporations. Today, the personal holding company mechanism needs refinement and consistency to avoid sweeping innocent corporations within its grasp. Modification of the personal holding company mechanism, by changing section 543(b)(3) so that the major determination would be whether the company can be considered active would noticeably improve its application.

Stephen C. Fuller

90. Treas. Reg. § 1.954-2(d), T.D. 6784, 1965-1 C.B. 344.

91. I.R.C. § 954(c)(3)(B).

92. I.R.C. § 355(b)(2)(B).

93. I.R.C. § 355(b)(1)(A), (b)(2)(A). See also B. BITTKER & J. EUSTICE, *supra* note 26, ¶ 13.04.

94. Drake, *Distributions in Kind and the Dividends Paid Deduction—Conflict in the Circuits*, 1977 B.Y.U. L. Rev. 45, 45.