PHC CONVERSION—A TAX-SAVING WAY TO ARRANGE THE SALE OF MANY CLOSELY-HELD CORPORATE BUSINESSES

BY MICHAEL G. KADENS *

The sale of a closely-held incorporated business will often yield a sizeable profit to the owners. Since the owners can be expected to seek ways to retain the largest possible net amount from sale, tax planning to defer, minimize or entirely avoid the payment of capital gains taxes on the profits has become an important part of structuring business sales. The tax free reorganization ¹ and the installment sale ² are the most common methods for achieving varying degrees of deferral, minimization or avoidance. Neither is without its limitations, however. Qualification under each necessitates compliance with restrictive requirements of the Internal Revenue Code (Code). These restrictions—acceptance of solely buyer’s voting stock in “B” or “C” reorganizations, ³ and, receipt of no more than thirty percent of the sale price in the year of an installment sale, ⁴ will be unacceptable to many business sellers. ⁵ This article discusses a third method, the PHC Conversion, for indefinite deferral of gains taxes on the sale of a business at a profit to the owners. Although mentioned fleetingly in acquisition planning literature, ⁶ the PHC Conversion has never been examined in depth. The subject is topical in view of the continued pace of business sales, the 1976 and 1978 changes in the Code

*Associate Professor of Law, University of Toledo College of Law; A.B. 1956 University of Michigan; J.D. 1959 Stanford University.

1. I.R.C. §§ 368(a) (1) (A)-(C).
2. I.R.C. § 453(b).
3. I.R.C. §§ 368(a) (1) (B)-(C). But see Reeves v. Commissioner, 71 T.C. No. 69 (February 6, 1979) where the court held that the payment of cash to certain stock sellers in connection with a “B” reorganization did not disqualify non-taxable treatment. In “A” reorganizations (statutory merger or consolidation), the buyer may issue non-voting stock as well as other forms of consideration to seller or its shareholders; however, buyer’s stock must be in an amount sufficient to meet the “continuity of interest” test and the non-stock consideration may result in some immediate tax consequences to seller’s shareholders. See generally 13 B. Fox & E. Fox, CORPORATE ACQUISITIONS AND MERGERS § 4.02 (1978).
4. I.R.C. § 453(b) (2) (B).
affecting capital gains tax rates and estate and gift taxes,\(^7\) and several tax proposals and rulings that could substantially enhance the use of a PHC Conversion\(^8\) or variations of it.

In a PHC Conversion the shareholders of a closely-held corporation arrange to sell corporate operating assets, usually for cash. However, rather than adopt a plan to liquidate the corporation and distribute its assets to themselves\(^9\) as might be expected since the corporation has ceased conducting an active business, the shareholders maintain the corporation as a vehicle for investing the cash or other consideration received in marketable stocks or bonds, or real estate. In most instances the continuing entity will be a personal holding company (PHC) for federal tax purposes\(^10\) because five or fewer persons will own fifty percent or more of the value of the investment corporation's shares and more than sixty percent of its adjusted ordinary gross income\(^11\) will be personal holding company income (PHCI).\(^12\) Among other things, a PHC must annually distribute to shareholders most of its investment income or face a severe penalty tax\(^13\) on the undistributed amount (UPHCI).\(^14\) Although it is often contended that PHC status should be avoided,\(^15\) it is not in and of itself so undesirable.\(^16\) In appropriate cases, the benefits of converting to personal holding company status following the sale of a business may override all other considerations.

---

7. The Revenue Act of 1978 lowered the effective tax rate on large long-term gains realized by individuals from approximately 40% to 28%. This change should heighten interest in taxable cash transactions at the expense of earlier preferences for tax-free exchanges, installment sales and PHC conversions. See Ely, *The Impact of the 1978 Tax Cut Bill on Mergers and Acquisitions*, 14 Mergers & Acquisitions 4 (1979). See discussion on changes in the estate and gift tax law pp. 55, 57-59 infra.

8. See pp. 60-62 infra.


11. I.R.C. § 543(b) (1), (2).

12. I.R.C. § 543(a). PHCI includes dividends, taxable interest, certain types of royalties, and, under certain circumstances, adjusted rental income.


14. I.R.C. § 545. UPHCI, or "undistributed personal holding company income," is defined as "taxable income of a personal holding company" modified by certain adjustments, minus dividends paid in accordance with I.R.C. § 551. The key adjustments are the adding back of any dividend deductions (I.R.C. § 243) and the deduction of most income tax payable and most of net capital gains. "Taxable income" can include net income from sources besides PHC sources.


16. The concern that has been expressed about PHC status is really directed to circumstances where corporations inadvertently and unexpectedly fall into such status and must pay the penalty tax or deficiency dividends.
I. PHC Conversion—The Apparent "Tax-Savings"

Incorporated businesses that are the best candidates for PHC Conversion will have both of the following characteristics:

1. The tax basis which the corporation has in its operating assets is significantly greater than the shareholders aggregate tax basis in their shares; 17 and

2. Assuming a sale, the price received by the seller corporation for its operating assets is not significantly greater than its tax basis in those assets. 18

In such instances if the corporation is liquidated after selling its assets, the shareholders realize and pay taxes on substantial gains. Thus, the shareholders’ net amount realized is reduced significantly. In the event that the corporation is not liquidated, little, if any, gain is realized or tax paid, leaving the gross sales price and net amount realized from the sale either the same or only modestly different.

To illustrate these conditions and to provide a reference point for other matters discussed herein, the following example is presented.

Tiburon Plastics Corporation was founded in 1947 by two returning war veterans, Sam and Morry Steele. Sam and Morry used their mustering-out pay plus some personally borrowed funds, totalling $50,000 each, to start Tiburon. Soon after each found it necessary to invest an additional $50,000 in Tiburon. The balance of Tiburon's growth was funded by reinvested earnings and corporate borrowing. As of December 31, 1978, the audited financial statements disclosed the following:

17. The history of many closely-held (non-subchapter S) corporations follows a similar pattern:

(i) modest initial equity investment by the shareholders, often the only source of tax basis each shareholder has in his respective shares;

(ii) growth of earnings from meager to ample, although not always at an even pace;

(iii) aging owners, often theoretically well-to-do because of their successful business, but never "cash-rich" because of the disincentive to withdraw "earnings and profits" at high dividend tax rates; meanwhile the corporation acquires a separate tax basis in the assets it acquires with reinvested earnings;

(iv) the emergence of accumulated earnings tax problems, due, on the one hand, to meager dividends and consequent working capital buildup, and, on the other hand, to the aging owners' disinclination to take the new risks involved in expansion or diversification. The earnings left in the corporation have no effect on the shareholders' basis in their shares.

18. In this article it is assumed that the corporation will realize some gain on the sale of its assets. However, there is no reason why the corporation may not receive a price less than its tax basis in the assets sold. The consequent loss may be an ordinary loss, a capital loss or a mix of the two. Ordinary losses from the sale may be used to offset income generated from other sources during the year of sale or carried back or forward against other years' earnings. Capital losses due to the sale may offset capital gains realized during the year of sale or, within certain time constraints, carried back or forward against net capital gains of other years.
BALANCE SHEET

ASSETS
Current Assets
Cash $ 517,000
Accounts Receivable 1,558,000
Inventory 2,346,000

Total Current Assets $ 4,421,000

Fixed Assets
Land $ 191,000
Buildings (at cost) $1,419,000
Accumulated Depreciation 475,000 944,000

Equipment (at cost) 990,000
Accumulated Depreciation 331,000 659,000

Total Assets $ 6,215,000

LIABILITIES AND SHAREHOLDERS' EQUITY
Current Liabilities
Accounts Payable $ 1,605,000
Wages and Bonuses Payable 60,000
Taxes Payable 170,000
Notes Payable, including current portion of long-term debt 340,000

Total Current Liabilities $ 2,175,000
Long-Term Debt 1,040,000

Total Liabilities $ 3,215,000

Shareholders' Equity
Capital Stock $ 200,000
Earned Surplus 2,800,000

Total Shareholders' Equity $ 3,000,000

Total Liabilities and Shareholders' Equity $ 6,215,000

INCOME STATEMENT
Sales $11,000,000
Expenses 10,250,000

Net Income Before Federal Income Taxes 750,000
Federal Income Taxes 350,000

Net Income $ 400,000
Sam and Morry have negotiated with representatives of Mighty-Mite Corporation, a company listed on the American Stock Exchange, on the sale of Tiburon. The latest Mighty-Mite offers, both of which Sam and Morry find generally acceptable, are (i) $3,500,000 cash for 100% of Tiburon's stock, or (ii) $3,000,000 cash for all of Tiburon's assets except its cash plus assumption of all of Tiburon's liabilities. In addition, Sam and Morry will receive salaries of $100,000 each after the acquisition. During 1978 Sam and Morry received $85,000 each from Tiburon in salaries and bonuses. Sam will receive a five-year employment contract. Morry will receive only a one-year employment contract because he has made clear his intent to semi-retire after one more year of fulltime work.

Originally Mighty-Mite sought to convince Sam and Morry to accept Mighty-Mite voting stock having a value even greater than $3,500,000. They rejected that proposal even though it would have qualified for tax-free reorganization treatment, for four not uncommon reasons:

1. Mighty-Mite was not substantial enough for them to risk investing their life's accumulation of wealth in it. In addition, the stock would not be freely transferable because of securities law limitations.

2. They wanted broad diversification of their assets.

3. Even with over $3,500,000 of Mighty-Mite stock they would not be important factors in control of Mighty-Mite, and even if that opportunity existed that was not what they were interested in.

4. Mighty-Mite pays a small dividend on its common stock. This would preclude Morry's retirement plans. Mighty-Mite was not inclined to offer a special class of preferred stock at a dividend rate in excess of 6% or convertible into common stock.

Sam and Morry also rejected an installment payment plan whereby they would have received Mighty-Mite's 15-year $3,750,000 subordinated debentures. They were not inclined to be major creditors of Mighty-Mite, preferring diversification, more control over their investments and more potential for appreciation.

Sam and Morry are now considering the two cash offers.
**Comparison of the Two Cash Offers for Tiburon Plastics Corporation**

<table>
<thead>
<tr>
<th></th>
<th>Sale of Stock(a)</th>
<th>Sale of Corporate Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price</td>
<td>$3,500,000</td>
<td>$6,215,000</td>
</tr>
<tr>
<td></td>
<td>($3,000,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash plus</td>
<td></td>
</tr>
<tr>
<td></td>
<td>assumption of</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$3,215,000 of</td>
<td></td>
</tr>
<tr>
<td></td>
<td>liabilities)</td>
<td></td>
</tr>
<tr>
<td>Aggregate Basis of</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shareholders in</td>
<td>200,000</td>
<td>—</td>
</tr>
<tr>
<td>Stock to be Sold</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Aggregate Basis of</td>
<td></td>
<td>5,698,000(b)</td>
</tr>
<tr>
<td>Corporation in Assets Sold</td>
<td>—</td>
<td></td>
</tr>
<tr>
<td>Gain Realized</td>
<td>3,300,000</td>
<td>517,000(b)</td>
</tr>
<tr>
<td>Capital Gains Tax Paid by Shareholders at an assumed 28% rate</td>
<td>924,000</td>
<td>—</td>
</tr>
<tr>
<td>Capital Gains Tax Paid by Corporation at an assumed aggregate 30% rate</td>
<td>—</td>
<td>155,000</td>
</tr>
<tr>
<td>Net Assets Controlled after Pmnt. of Gains Tax</td>
<td>2,576,000(c)</td>
<td>3,362,000(d)</td>
</tr>
</tbody>
</table>

(a) Approximately the same outcome is reached if the corporation sells all its assets (including cash) and liquidates pursuant to a Section 337 plan.

(b) Assumes for this purpose that accounting basis and tax basis are the same, and that allocations will be made in a way most favorable to the seller, e.g., inventory and equipment sold at basis; gain allocated to land and goodwill.

(c) $3,500,000 - 924,000 = $2,576,000.

(d) $3,000,000 - 155,000 + 517,000 (cash retained) = $3,362,000.
Based on the table, a net savings of $786,000 results if the corporation sells its assets and does not liquidate versus the sale of stock by the shareholders (or its equivalent, the sale of corporate assets followed by liquidation and distribution of the proceeds to the shareholders). If nothing else, the magnitude of the apparent savings in cases similar to the Tiburon example means that a hard look at PHC Conversion, rather than a sale involving immediate tax payments by the shareholders, must be undertaken. In many states, income tax payable on capital gains would increase the difference.

II. PHC Conversion—Benefits and Drawbacks

There are at least six distinct benefits that may result from a PHC Conversion:

1. Retained Capital. The tax savings in the Tiburon example represents additional capital over which the PHC's shareholders retain ownership and control. To most people it would represent greater wealth and potential for appreciation.

2. Increased Current Yield. Investment of the larger sum (e.g., $3,362,000 in the example) by the corporate investment vehicle may yield more current income to the shareholders than they could obtain from the smaller aggregate net amount (e.g., $2,576,000 in the example) they would have had if they had paid immediate gains taxes.

3. Estate and Gift Tax Benefits. Under the right circumstances, the availability of "stepped-up basis" or "fresh-start basis" may, as to individual shareholders, result in the identified tax savings becoming permanent rather than a mere deferral.19 In addition, for estate and gift tax purposes, stock in a closely-held corporation owning marketable investment assets will ordinarily be attributed a lower valuation than that given to the same investment assets owned outright by individuals.20

4. Diversified Investments. While receipt of the buyer's stock in a tax free reorganization may yield similar tax savings or deferral, it will not allow the investment diversification possible upon receipt of cash in a PHC Conversion.

5. Subsequent Opportunities. Even if the shareholders do not intend to maintain the corporation as a passive investment vehicle

individually it may be advantageous to do so temporarily. By maintaining the corporation, the shareholders can retain the "tax savings" until, and usually beyond, the time when final decisions concerning the long-term direction of the entity are made. Several attractive avenues may be available to the investment corporation including the purchase of a new business, merger into an existing regulated investment company, or liquidation following the death of a key, aged shareholder whose shares in the hands of his successors will have a substantially stepped-up tax basis.

6. Flexibility and Buyers' Preferences. For numerous reasons a business buyer may prefer to acquire another company in an assets acquisition rather than in a stock or merger transaction. By definition a PHC Conversion is an assets acquisition. Flexibility available to buyers in an assets acquisition includes the ability to assume no liabilities or selected liabilities of the seller, the ability to acquire selected assets, and the possibility of writing up the value of depreciable assets without any ordinary income recapture being imposed on the buyer.

There are at least seven potentially significant drawbacks to continuing an investment corporation pursuant to a planned PHC Conversion.

1. Required Payout of Personal Holding Company Income. PHCs must distribute to shareholders most of their taxable income each year or be assessed a penalty tax of seventy percent of UPHCI. An offsetting feature, however, is that PHCs are excepted from the accumulated earnings tax provisions of the Code.

2. Double tax on PHC's Income. PHCs' substantial passive income inhibits them from effectively qualifying for continued election under subchapter S. Consequently, a PHC will incur income taxes if it has any taxable income. Combined with the required distribution to shareholders of most of taxable income, double taxation of source income results.

3. Restricted Investment Spectrum. In order to mitigate the impact of the double tax, most PHCs find it desirable to restrict their selection of investments to those that result in little or no

---

21. See Westin, supra note 10, at 33-35. See also pp. 61-62 infra.
22. I.R.C. § 532(b) (1).
23. I.R.C. § 1372(e) (5).
24. Strictly speaking a PHC is not "required" to pay out any dividends. But the 70% penalty tax is so significant that for practical purposes it is treated as a requirement by those corporations that know they are personal holding companies.
tax to the PHC on the income yielded. The primary types of investment selected are real estate and stocks paying dividends. The latter type is attractive because of the eighty-five percent inter-corporate dividend deduction;\(^{26}\) the former type, if of investment quality rather than a tax loss "deep shelter," is attractive because it typically provides a high yield tax-sheltered cash payout.\(^{28}\) Taxable and tax-exempt interest bearing securities are less attractive to PHCs. Interest on taxable bonds does not receive any benefit similar to the dividend deduction. Tax-exempt securities are not attractive because (1) interest income paid thereon does not retain its tax-exempt characteristic if paid out to PHC shareholders as a dividend;\(^{27}\) (2) they bear lower rates than most other forms of debt; and (3) the corporation's tax rate on taxable income, if any, usually will be lower, \textit{e.g.}, seventeen percent, than is considered necessary to make tax-free securities a competitive yielding investment.\(^{28}\)

4. \textit{Loss of Section 337 Benefits}. Section 337 of the Code was enacted so the sale of a corporation's assets could be followed by a liquidation to shareholders without resulting in two gains taxes, one at the corporate level\(^{29}\) and another at the shareholder level. Section 337 is only available where the corporation adopts a plan of liquidation before selling its assets and actually completes the liquidation within twelve months thereafter. Usually, in a PHC Conversion, no plan is adopted before sale. Even if a plan is adopted prior to sale, the liquidation does not normally take place within 12 months, thus ruling out application of the benefits of Section 337 \textit{(i.e., to the gain at the corporate level at the time of

\[25\]. I.R.C. \S\ 243.

\[26\]. However, if the cash generated from real estate investments was distributed to shareholders it would be taxable as a dividend to shareholders to the extent of current or accumulated earnings and profits. I.R.C. \S\S 301(c), 316(a). In other words, the non-taxability of the income at the corporate level cannot be "passed-through" to PHC shareholders. \textit{See also} note 36 infra.

\[27\]. Although under I.R.C. \S\ 103, interest on tax-exempt obligations is excluded from gross income (and, therefore, will not be personal holding company income under I.R.C. \S\ 543), it does increase "earnings and profits" under I.R.C. \S\ 316. Accordingly, distributions based upon such income, even by a corporation lacking historic earnings and profits or current earnings and profits generated by other sources, would be given dividend treatment under I.R.C. \S\ 301. Since 1976, regulated investment companies are capable of investing in tax-exempt obligations and passing-through to shareholders the tax-exempt feature if more than 95\% of such income is distributed annually. I.R.C. \S\ 852(b)(5).

\[28\]. Despite these remarks many existing PHCs have significant investments in tax-exempt obligations. These PHCs prefer income which can be accumulated without being subject to the penalty tax. While real estate investments may provide similar opportunity for PHCs to accumulate (and at a higher yield), these PHCs' preference for better marketability, lower risk and diversification available in tax-exempt bonds apparently justifies the lower yield.

\[29\]. \textit{See} note 18 supra.
the original assets sale) if and when the corporation is ultimately liquidated.  

5. Evaporation of Purported Tax Savings. If the PHC is ultimately liquidated a full gains tax will be imposed on the shareholders based on their respective realized gains. Thus, the assumed “tax savings” may turn out to be at most a deferral rather than an avoidance. In addition, any shareholder selling his stock or having it redeemed by the PHC will at least have to pay gains tax on the gain realized. Sometimes redemptions by the PHC may even result in dividend treatment to the redeeming shareholder. However, if shares have been transferred due to a shareholder’s death, the transferee may escape some or all of the gains tax when he disposes of the shares.

6. Inconsistent Shareholder Interests. PHC Conversion assumes the continued existence of a corporation that might otherwise have been liquidated when it was no longer conducting an active business. This has at least three important consequences. First, the individual shareholders will not have unfettered use of the fruits of the sale of their holdings in the going business. The fruits of the sale will be in the PHC and its management will rest with those shareholders who control the PHC. Second, shareholders who had a community of interest while there was an active business, may have entirely different interests and objectives in relation to a co-owned investment vehicle. Differing attitudes towards risk, speculation, yield, amounts distributed and cash flow requirements may create dissension where none existed before, and where none would exist, if the corporation had been liquidated and each shareholder received his respective portion of the sale proceeds. Third, even the shareholders who control the PHC may not be in the “cash rich” position they had hoped to be on the sale of their business. To obtain cash to make personal investments or consumer purchases, the PHC shareholder will typically have to pay a high price, namely, ordinary income tax on extraordinary dividend distributions.

7. Not a “Trade or Business.” PHCs are generally not considered to be a “trade or business” as that term is used through-

30. See note 38 infra.
32. See pp. 55, 57-59 infra.
33. Of course, a PHC shareholder might be able to arrange a loan from a third party or from the PHC. Cf., Borini, supra note 6, at 174 (describing dangers of a loan by a PHC to a decedent shareholder’s estate to enable the estate to pay the estate taxes).
out the Code. As a result, among other opportunities lost to PHCs or their shareholders are tax free split-ups or spin-offs under section 355 and extended payment of estate taxes under sections 6166 or 6166A.  

III. PHC Conversion—Critical Analysis

Summarizing the preceding discussion, on the positive side, PHC Conversion can in appropriate cases yield large, potentially permanent, tax savings while permitting the shareholders to indirectly own and control a diversified investment portfolio. On the negative side, the PHC arrangement will result in some double taxation of source income, tend to limit the investment options available, and may ultimately yield no long-term tax savings. Given this mixture, is it possible to determine when a PHC Conversion makes good sense? The answer is yes, and the basis for this conclusion is constructed around the following four propositions:

1. If the predominant investment objective of the shareholders is the highest current after-tax income yield, liquidation (or sale of their stock) and payment of immediate gains taxes will often be preferable to a PHC Conversion. If the predominant objective is for long-term appreciation, PHC Conversion is preferable. If the predominant objective is a combination of reasonable current after-tax yield and long-term appreciation, PHC Conversion is probably preferable.

The following tables set forth the after-tax yields obtainable under various investment programs by the PHC (with $3,362,000 to invest) and by the shareholders of a liquidated corporation (with $2,576,000 to invest). Tables I and II assume that the highest possible after-tax retention of income (or cash flow) is desired by all parties. The tables also include a breakdown of results based on three different “effective” tax brackets applicable to the shareholders as a whole. Conclusions to be drawn from the results follow the tables.

The tables do not attempt to exhaust all investment approaches the PHC or the individual shareholders might pursue. Yet, given the primary objective contemplated in Tables I and II—highest after-tax retention of income by the shareholders—certain investment programs appear more logical. For example, in Table II, if all the individual shareholders are in high tax brackets, the normal expectation would include investment in tax-exempt bonds or in real estate which provides

34. See Lynch, supra note 15, at 788.
<table>
<thead>
<tr>
<th>INCOME AND TAXATION ELEMENTS</th>
<th>Best Case</th>
<th>Worst Case</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in high quality, high yield, modest growth, dividend paying common and preferred stocks, such as American Telephone, Southern California Edison, American Brands, at an average overall yield of 8%.</td>
<td>Investment in high quality, long-term corporate bonds, single A rate or better—at an average overall yield of 8½%.</td>
<td></td>
</tr>
</tbody>
</table>

1. Gross Income | $268,960 | $285,770 |
2. Dividend Deduction | 228,616 (§ 243 IRC) | — |
3. Net Taxable Income before Expenses | 40,344 | 285,770 |
4. Administrative Expenses and Salaries | 15,344 (estimated) | 15,770 (estimated) |
5. Personal Holding Company Taxable Income | 25,000 (Tax = $4,250) | 270,000 (Tax = $104,950) |
7. PHC Dividend Taxable to Shareholders as Ordinary Income | 249,366 | 165,050 |
8. Taxes Paid by Shareholders if assumed average rate is (a) 70% (b) 50% (c) 35% | (a) 115,535 (b) 82,525 (c) 57,768 |
9. Net Retained by Shareholders | (a) 74,810 (b) 124,683 (c) 162,088 |
10. Total Taxes Paid by PHC and Shareholders (Lines 5 and 8) | (a) 178,806 (b) 128,933 (c) 91,528 |
11. Overall Tax Rate on Original Income Source net of Line 4 Expenses | (a) 70.5% (b) 50.8% (c) 36.1% |
12. Net After-Tax Yield to Shareholders on Assets Invested at PHC Level | (a) 2.22% (b) 3.71% (c) 4.82% | (a) 1.45% (b) 2.45% (c) 3.19% |
<table>
<thead>
<tr>
<th>INCOME &amp; TAXATION ELEMENTS</th>
<th>High-Quality Intermediate to Long-Term Municipal Bonds Average Yield</th>
<th>High-Quality Real Estate Investments with Substantial Depreciation Expense, Providing Tax-Sheltered 7% Cash-on-Cash Return</th>
<th>High-Quality Long-Term Corporate Bonds, Single A rated or better at an Average Overall Yield of 8½%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Gross Income or Net Cash Flow</td>
<td>$141,680</td>
<td>$180,320</td>
<td>$218,960</td>
</tr>
<tr>
<td>2. Taxable Portion of Line 1</td>
<td>0</td>
<td>0</td>
<td>218,960</td>
</tr>
<tr>
<td>3. Federal Income Taxes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) 70%</td>
<td>0</td>
<td>0</td>
<td>(a) 153,272</td>
</tr>
<tr>
<td>(b) 50%</td>
<td></td>
<td></td>
<td>(b) 109,480</td>
</tr>
<tr>
<td>(c) 35%</td>
<td></td>
<td></td>
<td>(c) 76,636</td>
</tr>
<tr>
<td>4. Net Retained by Investors</td>
<td>141,680</td>
<td>180,320</td>
<td>(a) 65,688</td>
</tr>
<tr>
<td>5. After-Tax Yield on Investment (Line 4 ÷ $2,576,000)</td>
<td>5.5%</td>
<td>7%</td>
<td>(a) 2.55%</td>
</tr>
<tr>
<td>6. Taxable Income Equivalent of Lines 1 or 4 at average investor tax rate of</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) 70%</td>
<td></td>
<td></td>
<td>(a) N/A</td>
</tr>
<tr>
<td>(b) 50%</td>
<td></td>
<td></td>
<td>(b) N/A</td>
</tr>
<tr>
<td>(c) 35%</td>
<td></td>
<td></td>
<td>(c) N/A</td>
</tr>
<tr>
<td>(a) 472,266</td>
<td>(b) 283,360</td>
<td>(c) 217,969</td>
<td></td>
</tr>
<tr>
<td>(a) 601,066</td>
<td>(b) 360,640</td>
<td>(c) 277,415</td>
<td></td>
</tr>
</tbody>
</table>
sheltered cash flow, rather than high dividend paying stocks or high yield long-term or short-term taxable interest bearing securities. In Table I it is readily apparent that, for PHCs and their shareholders, high dividend pay out stocks are far superior to taxable bonds from an after-tax standpoint (versus pure risk). Whenever distribution of income to the shareholders is expected, alternatives to stocks as the primary investment of the PHC are unattractive due to a lower after-tax yield or an inability to pass through tax-exempt or tax-sheltered characteristics.

Comparing Tables I and II the reader will note that if the shareholders are already in high tax brackets and desire to invest the proceeds from the sale of the business so as to provide them substantial, additional after-tax income, they will be better off liquidating the corporate asset-seller rather than maintaining it as a PHC. The magnitude of the improved yield depends on the investment program selected and the tax brackets of the shareholders. For example, shareholders in the fifty percent bracket selecting a tax-exempt bond program would realize approximately $17,000 more in after-tax income than the PHC “best case” program ($141,680 versus $124,683). Of course, if PHC administrative expenses were kept to a minimum (or if it were assumed that as much as $12,000 of the administrative expenses were really salary income paid to one or more of the shareholders), then the net difference would be slight. But even when the difference is slight, the element of risk may be an important consideration. If shareholders in the 70% bracket are considered, the annual difference is approximately $67,000 ($141,680 versus $74,810) if the tax exempt program is selected, and $105,500 ($180,320 versus $74,810) if the sheltered cash-flow real estate program is selected.

Suppose, however, the shareholders (or at least the controlling shareholders) are not current yield oriented. Shareholders in highly salaried positions (perhaps with the buyer of their corporation’s business) or enjoying substantial non-personal service income from sources other than the PHC may prefer that the proceeds from the sale of the business be invested primarily in non-income producing investments. The PHC resulting from a PHC Conversion can match most of the types of investments these shareholders would have made had liquidation occurred, except the PHC will have more to invest. If non-income producing investments are desired, e.g., raw land, fast-growth common stocks without dividends, gold, collectibles, and/or high risk ventures, the shareholders would have $2,576,000 to invest if the corporation had been liquidated whereas the ongoing PHC would have $3,362,000. Net capital gains realized by the PHC on the disposition of such assets
would not be included in the computation of UPHCI \textsuperscript{35} and thus could be retained by the PHC and reinvested. Similar analysis applies if the shareholders' investment objectives include tax-sheltered income which is not required to be distributed. The continuing corporation could invest $3,362,000 in the same tax-sheltered real estate as the shareholders except that the shareholders, if liquidation had occurred, would only have $2,576,000 to invest. Since it would probably not even be a PHC,\textsuperscript{30} the corporation could retain all the net cash flow, thus building up the PHC's net assets by approximately $50,000 or more per year which the shareholders would have been able to retain. An appreciation-oriented investment program focusing on fast-growth, low dividend common stocks similarly enables the PHC to invest $3,362,000 as opposed to $2,576,000 which the shareholders have to invest. The small tax the PHC will pay on the dividend income\textsuperscript{37} and the expense of administration saved by the shareholders will be minimal compared to the opportunity for appreciation resulting from having the additional amount, i.e., the "savings" to invest.

Finally, unless all the shareholders are in the 70\% tax bracket or are unwilling to invest predominantly in stocks, Table III (at page 56 below) demonstrates that the shareholders of a PHC can obtain a reasonable after-tax yield from the PHC and preserve the "tax savings" for potential long-term appreciation. The two investment programs in Table III yield the shareholders (assumed in the table to be in the 55\% tax bracket) between 55\% and 65\% of what the same shareholders might have received in after-tax income from the investment of the net funds available after the sale of the corporate assets and immediate

\textsuperscript{35} I.R.C. \textsection 545(b)(5). If the investment corporation had no passive investments yielding PHCI type income, it would not even be a PHC. If it was not a PHC it would not be excepted from the accumulated earnings tax provisions. However, net capital gains are also not included in the computation of "accumulated taxable income" for purposes of accumulated earnings tax. I.R.C. \textsection 535(b)(6).

\textsuperscript{36} If the corporation invested exclusively in income-producing real estate, it would not be a PHC. However, that portion, if any, of the net cash flow that was taxable could be subject, after tax, to the accumulated earnings tax unless the corporation established that its real estate activities constituted a trade or business and its entire net cash flow was reasonably required to be reinvested in the business. See also note 28 supra.

Net rental income from the lease of real or personal property can be PHCI. I.R.C. \textsection 543(a)(2). The determination of whether rents are or are not PHCI depends on the relationship of adjusted income from rents to adjusted ordinary gross income of the corporation and the amount of undistributed PHCI originally derived from other sources. I.R.C. \textsection\textsection 543(b)(2)(A) and 543(b)(3). See generally D. KAHN \& P. GANN, CORPORATE TAXATION AND TAXATION OF PARTNERSHIPS AND PARTNERS, 435-36, 439-42 (1979). Most corporations that have sold off their regular business assets and are seeking to reinvest the consideration received will be in a position to control these relationships.

\textsuperscript{37} If a PHC received $300,000 of dividend income in a year, and had no other income and minimal deductions, its federal income tax for the year would be less than $8,250. If it had only $50,000 of dividend income, its tax would be less than $1,300.
liquidation. If the dominant shareholders are not high yield oriented, they would presumably view the diminished yield as a suitable trade-off for the opportunity to preserve the tax savings.

2. The ability to indefinitely defer, and to a lesser degree make permanent, the "tax savings" is largely within the control of the PHC shareholders. Thus the shareholders are in a good position to gauge, at the time of the sale of the business, how well they can utilize the savings. In addition, the potential for further savings of estate and gift taxes due to valuation discounts is well established.

If a corporation sells its assets and opts for PHC Conversion, the shareholders' basis in their respective shares will be unaffected. Thus, should the corporation liquidate later, a full gains tax will have to be paid by the respective shareholders and no permanent savings will result from the PHC Conversion. Furthermore, even if the PHC is not liquidated, individual shareholders who sell part or all of their shares to a third party or to the corporation in a redemption qualifying under section 302(b)(2) or (b)(3) of the Code, will have to pay gains tax on their profit.

Prior to the Tax Reform Act of 1976 (TRA 1976) most of the unrealized appreciation in PHC shares owned by individuals escaped capital gains tax on sale or redemption if such shares were held until death. In the hands of the deceased shareholder's successors those shares automatically had a basis "step-up" to the value assigned for estate tax purposes. In essence, as to those shares the tax savings resulting from PHC Conversion became permanent. A radically different approach to the treatment of the tax basis of shares (as well as most kinds of property) owned by the decedent, was enacted in the TRA 1976 but its effectiveness was postponed until December 31, 1979. Thus, shares owned by persons dying before that date continue to receive a stepped-up basis equal to the estate value.

At this time there is overwhelming support in the United States Senate and good support in the House of Representatives for repeal of those sections of TRA 1976 that eliminated the stepped-up basis at

---

38. In addition, if the corporation realized a gain at the time of the original sale, it would have paid a gains tax that could have been avoided had it been liquidated at that time pursuant to a §337 plan. However, this does not mean the corporation is foreclosed from adopting a §337 plan when it finally does liquidate. If the corporation has unrealized appreciation in its investment assets when it eventually liquidates, it can avoid a separate gains tax on the disposition of those appreciated assets.


40. I.R.C. §1023(a).
<table>
<thead>
<tr>
<th>TABLE III</th>
<th>Common and Preferred Stock Investment(s) ($3,362,000) Providing Mix of Safety, Reasonable Yield (6% Overall), and Potential Appreciation</th>
<th>Investment of $2,576,000 in high quality, high yield (8% average) stocks and the $786,000 &quot;tax savings&quot; in fast-growth common stocks or venture risks (average income yield of 2%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Gross Income</td>
<td>$201,720</td>
<td>$221,800</td>
</tr>
<tr>
<td>2. Dividend Deduction (I.R.C. § 243)</td>
<td>171,462</td>
<td>188,530</td>
</tr>
<tr>
<td>3. Net Taxable Income Before Expenses</td>
<td>30,258</td>
<td>33,270</td>
</tr>
<tr>
<td>4. Administrative Expenses and Salaries</td>
<td>15,258</td>
<td>15,270</td>
</tr>
<tr>
<td>5. Personal Holding Company Taxable Income and (Taxes)</td>
<td>15,000 (2,550)</td>
<td>18,000 (3,060)</td>
</tr>
<tr>
<td>6. PHC Dividend to Avoid Penalty Tax</td>
<td>183,912 (201,720-15,258-2,550)</td>
<td>203,470 (221,800-15,270-3,060)</td>
</tr>
<tr>
<td>7. PHC Dividend Taxable to Shareholders as Ordinary Income</td>
<td>183,912</td>
<td>203,470</td>
</tr>
<tr>
<td>8. Taxes Paid by Shareholders at Assumed Rate Average of 55%</td>
<td>101,152</td>
<td>111,909</td>
</tr>
<tr>
<td>9. Net Retained by Shareholders</td>
<td>82,760</td>
<td>91,561</td>
</tr>
</tbody>
</table>
death. The Carter Administration has opposed these moves; but it is probable that the administration opposition will be unsuccessful and that stepped-up basis will be restored completely or that the TRA 1976 sections relative to basis at death will be postponed for an additional period such as two or three years.

Should stepped-up basis be fully restored then PHC Conversions remain an excellent vehicle for obtaining permanent tax savings in connection with the sale of a business at a profit. However, taxpayers and tax planners should not allow themselves to be blinded by the attractions of stepped-up basis. It is sometimes a dangerous siren. From an investment standpoint it is generally a good idea to set up objectives which, once met, call for a predetermined response. In the context of a PHC if its investment portfolio has substantially appreciated there will be a tendency to avoid taking gains because of a feeling that those gains may be taxed a second time if and when the PHC liquidates. This hesitation is often abetted by the anticipation of stepped-up basis due to the expected death of a large shareholder. Such vacillation from taking gains when the investor instinctively feels it is the right time to do so may prove costly, especially in the volatile climate prevailing today.

If, however, the pertinent provisions in TRA 1976 relative to basis of property held at death are not repealed or postponed again, then property owned by persons dying after December 31, 1979 will have a "carryover basis" in the hands of the decedent's successors with the exception of property owned prior to December 31, 1976, which will receive a "fresh-start adjustment." Since such possibility still exists at this date, certain observations about it are warranted.

41. See H.R. Rep. No. 3919, 96th Cong., 2d Sess. (1979). Hearings before the House Ways and Means Committee on that portion of H.R. 3919 which relates to repeal of carryover basis commenced on November 13, 1979. In late November the Senate voted 81-4 for repeal. H.R. 3919 principally covers the so-called windfall profits tax on oil. The carryover basis repeal provision was added as a rider in the Senate presumably to enhance the chances for its passage. The House version of H.R. 3919 did not include such a rider. However, support for repeal of carryover basis is known to exist in the House, and it is expected that the rider will be added to the windfall profits tax bill finally agreed upon by the House-Senate conferees. The Carter Administration has continually opposed a return to fully stepped-up basis at death. It has supported a bill known as the Carryover Simplification Bill, H.R. Rep. No. 4694, 96th Cong., 1st Sess. (1979) which, among other things, would provide a minimum carryover basis at death of $175,000 to each individual.

42. I.R.C. §1023(a) (1) (b).

43. I.R.C. §1023(h) provides an adjustment to basis on all types of property, including securities, owned prior to December 31, 1976 by a decedent dying after December 31, 1979. The method of adjustment is divided into two groups, (i) marketable bonds and securities, and (ii) all other property. Since closely-held corporation shares, including PHC shares, are not considered marketable, they would fall into the latter group. For a comprehensive discussion of the carry-over basis and fresh-start adjustment provisions, see generally Ullman, Planning for Shareholders of Closely-Held Corporations Under the Carryover Basis Rule, 36
First it should be stressed that regardless of when a shareholder obtained his shares, a gains tax is not assessed at death but only on the sale of the PHC shares or liquidation of the PHC. Consequently, so long as the shareholder (or his successor(s)) retains the PHC shares or the PHC is not liquidated, no gains tax will have to be paid. If the estate or beneficiary of a decedent who is a PHC shareholder arranges for payment of estate taxes, if any, from assets other than funds derived from the sale of PHC shares, deferral of payment of gains tax on any unrealized appreciation in the PHC shares would continue indefinitely.44

Second, proceeding on the assumption that the TRA 1976 will become fully effective on January 1, 1980, shares in closely-held corporations acquired by inheritance or devise from decedents who owned such shares prior to December 31, 1976, will be entitled to a "fresh-start adjustment" of basis at the decedent's death if the shares are given an estate tax value in excess of unadjusted basis as of that date.45 The fresh-start adjustment determines the fraction of the total unrealized appreciation which shall be given a step-up in basis. The numerator of the fraction is the decedent's holding period prior to January 1, 1977 and the denominator is decedent's total holding period. For example, if Sam Steele from the Tiburon Plastics example were to die on December 31, 1982, he would have a total holding period of thirty-five years, and a pre-1977 holding period of thirty years. The fresh-start adjustment would be 86%, or eighty-six percent of the appreciation (estate tax value less pre-death adjusted basis)46 in his Tiburon stock at date of death. In addition, estate taxes paid by Sam's estate on the non-stepped-up portion, i.e., fourteen percent, of the appreciation would also be added to the basis of the retained shares.47 Of course, (i) the shorter the total holding period, (ii) the greater the portion of the total holding period which is after December 31, 1976, or (iii) the more time that expires after December 31, 1976 regardless of the length of holding prior to that date, the less favorable becomes the percentage of appreciation eligible for step-up. Nevertheless, it is probably true that numerous individuals exist whose holding


44. If §303 of the Code was available a partial redemption of shares by the PHC in order to raise money to pay estate taxes would be assured of "sale or exchange" treatment. The unrealized gain on the balance of the shares would continue to be deferred. Under one test eligibility for §303 benefits would depend on whether the value of the decedent's shares in the PHC exceeded 50% of the value of his adjusted gross estate. I.R.C. §303(b)(2).


47. I.R.C. §1023(c).
periods in shares of closely-held corporations start many years prior to 1977. Successors to these persons can derive substantial benefit from the fresh-start adjustment for some time to come.48

A number of courts have held that the estate or gift tax value of shares in PHCs may properly be set at modest to substantial discounts from underlying asset values.49 If the same underlying assets were in fact readily marketable securities owned by individuals, no discounts at the time of donation or passage at death would be possible. The resulting estate or gift tax savings may reduce pressures to liquidate the PHC or redeem shares of the PHC, thus extending the period during which the initial tax savings resulting from PHC Conversion can be retained. Also, transfers to achieve income splitting can be made at a lower gift tax cost.

3. Conflicts between shareholders as to whether to liquidate or adopt PHC Conversion can ordinarily be resolved to the satisfaction of all the shareholders.

The larger the number of shareholders of a corporation which is about to be sold, the greater the likelihood of contrasting tax rates, and differences in cash-flow requirements, investment approaches and risk orientation. Accordingly, there may be substantial disagreement on whether to liquidate or to affect a PHC Conversion. Yet, there are several ways to resolve these opposing objectives without bitterness, stalemate or litigation. These include: (1) the PHC's redemption of shares of those shareholders who prefer paying the gains tax in order to directly control their assets and income yield level; or (2) an "E" reorganization,50 or "recapitalization," in which those shareholders desiring income receive a special class of stock with preferred dividend rights and presumably lesser or no rights to participate in appreciation of the PHC's investments.51

---

48. The fresh-start adjustment also includes some subtle advantages in favor of preserving ownership of shares of a corporation that existed for a considerable period prior to December 31, 1976. See Fed. Tax Coordinator 2d, July 28, 1977, at 5 (Weekly Alert); cf. Sussman & Corman, supra note 20, at 632-84.


51. If the dissatisfied shareholders are in a high tax bracket, they may be better off having their shares redeemed since they will almost certainly obtain a greater after-tax yield by investing in tax-free bonds or sheltered cash flow from real estate than from dividends paid by the PHC. On the other hand, if such shareholders are
Selective redemptions qualifying under section 302(b)(2) or (b)(3) will have no effect on the remaining shareholders.\(^6\) Given the liquid nature of the typical PHC's assets, cash redemptions will be easy to do. In-kind redemptions are also feasible and offer some interesting tax savings opportunities. Under section 311(d)(2)(A) of the Code, if the redeeming shareholder owns at least ten percent of the corporation and has been a shareholder for at least twelve months by the date of redemption the corporation may, in exchange for its own stock, transfer appreciated assets valued at their current market value without realizing any gain for federal income tax purposes.\(^6\) Furthermore, in-kind redemptions can be arranged (assuming consent of the PHC) whereby the redeeming shareholder receives a pro rata share of each asset owned by the corporation. Pro rata redemptions make it unnecessary to set an express value on the individual shares, thus avoiding precedential approaches to valuation.

Disagreements among the shareholders even after the corporation is operating as a PHC can be handled in much the same way. Dissident minority shareholders can be redeemed out or a recapitalization fashioned to satisfy specific requirements for cash flow or a preferred position.

4. Various opportunities following PHC Conversion are sufficiently attractive and attainable that even temporary disadvantages of being a PHC can prove worthwhile.

Individuals who sell their businesses often do not remain as managers for the buyer. In the event they do remain, they commonly terminate their involvement within several years due to disenchantment of one sort or another. The same individuals typically express the desire to be back in their own business. Funds received from the buyer may be used to acquire new businesses. Since the size of the purchase price of a new business cannot be predicted, the "tax savings"

\(^1\) In low brackets, e.g., unmarried adults or minors without any other significant source of income, earned or unearned, then the PHC dividends may provide a greater after-tax yield.

\(^5\) If a series of redemptions is contemplated, I.R.C. §305 and the regulations thereunder should be reviewed. The effect of the family attribution under §318 of the Code must also be considered. Finally, if the redemption is to be consummated before the corporation has become a PHC, see pp. 67-69 infra, one should consider whether it will be viewed favorably or unfavorably from a accumulated earnings tax standpoint.


\(^7\) The twelve months refers to the shareholder's total holding period; it is not limited to the time period since the corporation became a PHC.

The shareholder receives a new basis in the distributed property equal to the fair market value assigned for computing his gain or loss on his exchange of the shares.
in a PHC Conversion could be crucial. The individual owners may also have formulated plans to acquire a new business following the sale of the old one. However, no one purchases the first business offered solely because the funds to do so are available. During the investigation period the owners may wish to keep the corporation alive as a PHC rather than liquidate and pay substantial gains taxes.

PHCs can enter into tax free reorganizations with other corporations and with regulated investment companies. The net result is ordinarily that the shareholders of the PHC directly own shares of a publicly-held entity and still do not pay any capital gains tax. Prior to 1976, it was not uncommon for existing PHCs to enter into tax free reorganizations with regulated investment companies. In 1976 two Code amendments affected this trend in conflicting ways. An amendment encouraging reorganization permitted open-end tax-exempt bond funds to obtain the favorable “pass through” tax treatment available to regulated investment companies. Discouraging reorganization was the enactment of section 368(a)(2)(F) which limits reorganizations between certain investment companies. In particular a PHC (which will invariably be an “investment company” as defined in section 368(a)(2)(F)(iii)) is now disabled from being a party to a reorganization with another investment company, including regulated investment companies, if its portfolio is insufficiently diversified. However, if a PHC meets the diversification requirements it apparently remains eligible for reorganization with another investment company.

In 1978 several private letter rulings promised to heat up interest in reorganizations between private investment corporations and mutual funds to a fever pitch. Private Letter Ruling 7829097 (April 24, 1978), for example, approved as non-taxable a transaction whereby a closely-held corporation sold its operating business assets to one party for cash and almost immediately thereafter entered into a “C” reorganization with a tax-exempt bond fund, exchanging its cash for fund stock which it then distributed to its shareholders pursuant to a plan of liquidation. This, and two similar rulings, excited substantial interest in the investment community. However, doubt has been expressed whether these rulings were sound and likely to be followed

54. But see note 60 infra.
55. I.R.C. § 852(b)(5).
57. See Snyder, Investors in Private Corporations Have Some Choices, FORTUNE, June 19, 1978, at 201. See also Klipper, Firms Joining Municipal Funds to Defer Capital Gains Taxes Risk Fight With IRS, WALL ST. J., Apr. 16, 1979 at 29, col. 1.
indefinitely. These doubts have just been confirmed by several internal revenue service pronouncements relating to “continuity of interest.” The new I.R.S. position not only undercuts the transactions described in the above letter rulings but may also inhibit most tax-free reorganizations between longtime PHCs and other investment companies.

If a corporate business, about to be sold, is controlled by an individual of advanced age or in ill health, the prospect of obtaining a stepped-up basis (or at worst a substantial fresh-start basis adjustment) upon that individual’s death may make PHC Conversion extremely attractive. The PHC can be liquidated within a reasonable time after the decedent’s death with little or no capital gains tax exposure.

Several legislative proposals presently under active discussion would be favorable to PHC Conversion. As stated earlier, legislation proposing to fully restore stepped up basis at death is pending before the Congress and is likely to be enacted. In addition, the staff of the Joint (House-Senate) Committee on Taxation has proposed changes in the subchapter S provisions which would appear to make PHCs eligible for subchapter S election. The principal change would allow total pass through of income characteristics, e.g., tax-exempt income. If these changes were enacted, by election under subchapter S the PHC shareholders could avoid any double taxation of investment income and enjoy an unlimited selection of investments rather than the limited spectrum they are now confined to. The result would obsolete the comparisons made in Tables I and II and make PHC Conversion more attractive than liquidation under an even wider set of circumstances.

IV. Planning the PHC Conversion

Once it has been decided that PHC Conversion is the preferred method of selling the business, a number of considerations should be examined before finalizing the acquisition contract and closing. These

59. Klapper, supra note 57.
62. If such corporations could elect subchapter S status, query whether it would still be necessary to categorize them as PHCs.
63. For example, all $3,362,000 in the Tiburon Plastics example could be invested in tax-exempt bonds and the interest income distributed to the shareholders without any tax on anyone.

The proposed changes recommended by the staff include the right to have more than one class of common stock provided the only difference between the classes relates to voting rights. Consequently, a PHC that recapitalized its outstanding stock into common and preferred would still be unable to elect subchapter S status.
considerations may be divided into three parts: (i) those dealing with the negotiations between the buyer and seller; (ii) those relating to the relationship between the shareholders of the corporate seller; and (iii) those relating to the planned operation of the seller-corporation during the period (a month to almost two years) immediately after consummation of the assets sale.

A. Considerations in Negotiating the Sale

Like any other corporate assets seller, the PHC Conversion candidate will be vitally concerned with allocation of the purchase price to the various assets being sold. If the seller-corporation expects to realize gain on the sale, it will ordinarily desire to have the allocations made in a fashion which will maximize capital gain treatment and minimize ordinary income or recapture treatment. In addition, allocation is important even if the corporate seller will realize an overall loss, since the type of loss (capital or ordinary) may determine whether the loss can be immediately offset against ordinary income or must await subsequent realization of net capital gain. The buyer may desire different allocations in order to recognize his advantages.

One of the merits of assets acquisitions is their flexibility. In theory, buyers may pick and choose among the assets they desire and among the liabilities to be assumed. Conversely, the corporate seller may refuse to sell certain assets or insist that certain liabilities or all liabilities be assumed. While this may lead to extensive negotiation between the parties, it does allow them to state strong preferences and provides more ways to compromise fundamental issues. These considerations are possibly more significant in PHC Conversions than in other assets transactions. Since the new PHC will be investment oriented, there may be more reason to retain certain assets than would be the case otherwise. Improved real estate which could be leased to the buyer rather than sold, is a good example. Additionally, there would be no reason to transfer cash or marketable securities owned by the seller. In fact, if the seller had unrealized appreciation in any marketable securities, he would not ordinarily wish to transfer them unless such gains could be used to offset his own capital losses. From the buyer's standpoint the more assets retained by the seller, the less the amount of cash, debt or stock the buyer will have to pay.

Liabilities are a troublesome issue in most acquisitions. Asset acquisitions provide at least a chance for buyers to avoid certain lia-

64. See generally Weiler & Erickson, Purchase and Sale of Business Assets: Contract Failing to Allocate Purchase Price, 56 Taxes 143 (1978).

65. Id.
bilities. There may also be reasons why the sellers do not want buyers to assume certain liabilities. For example, the seller may prefer to retain low interest rate indebtedness and receive more cash for the assets. On the other hand, there are certain liabilities which the seller who intends to continue as a PHC should insist the buyer assume. One of these is the potential for subsequent products liabilities claims. In most states statutes of limitation for bodily injury caused by defective products do not start to run until injury is sustained. Thus, the corporate seller remains exposed to suit indefinitely on products sold prior to the assets sale. The corporate seller can maintain products liability insurance coverage, but it will substantially reduce the investment income expected after the assets sale. Accordingly, it is preferable to avoid the cost of insurance and have the buyer assume such liability.

Throughout the foregoing discussion it has been assumed that the consideration received by the corporate seller will be cash. It is possible that some or all of the consideration paid will be the buyer’s stock or debt. It may be the only available payment or it may provide an advantage to the seller to receive other consideration rather than cash. If the seller accepts the buyer’s debt, he may want an assurance that it can be handled to qualify for installment sale treatment. Any gain realized by the seller on non-inventory assets can be spread over the years of payment of the debt, and this may, if the gain is small enough, provide the opportunity to utilize the low corporate rates (i.e., 17% on first $25,000; 20% on next $25,000) applicable to the first $50,000 of taxable corporate income, as well as deferring payment of tax on the gain. Of course, interest on the remaining debt will have to be paid or it will be imputed, and will be both PHCI and income included in the computation of taxable corporate income. This income could push total corporate income beyond the $50,000 barrier so that the normal 28% capital gain rate on corporations would apply to the gain.

More concrete reasons exist for the seller to consider accepting the buyer’s voting stock as part or all of the consideration. If properly handled, acceptance of solely buyer’s voting stock would qualify the

68. I.R.C. § 453(b).
69. However, if the corporate installment seller liquidates before full payment of the debt, the debt may be deemed disposed of and the remaining gain taxed immediately. See J. Herz & C. Baller, Business Acquisitions: Planning & Practice § 7.402c (1971).
70. Cf., Lake Gerar Dev. Co. v. Commissioner, 71 T.C. No. 78 (February 20, 1979) (interest received by a corporation on purchase money mortgage notes is PHCI).
assets transaction as a non-taxable "C" reorganization. In such instances it is common for the seller corporation to liquidate and distribute the buyer’s stock to its shareholders since this can be done without tax consequences to these shareholders. On occasion, however, the shareholders may find it preferable to maintain the corporation and allow it to continue as a PHC. This has been advocated primarily for estate planning reasons. However, if reliance can be placed on the cited tax rulings, there also appears to be some potential income tax benefits which derive from the fact that according to the rulings the buyer in such a "C" reorganization assumes, and the corporate seller loses, the accumulated earnings and profits of the seller. Following the reorganization, the seller-corporation will have a tax basis in the buyer’s stock equal to its former adjusted basis in the assets sold and, if the revenue rulings are accurate, no accumulated earnings and profits. Under such circumstances, in subsequent years the seller could make distributions each year to its shareholders in excess of the amount necessary to bring UPHCl to zero for the year without having the excess treated as dividends. The excess would be treated as a return of capital and not taxable to the recipient shareholders until the adjusted basis in their respective shares was reduced to zero. This assumes, of course, that in the meantime, certain types of non-PHCl such as tax exempt interest and net capital gains have not been realized, resulting in increased accumulated earnings and profits.

There may also be distinct advantages to the corporate seller, and to the buyer, to have the buyer’s stock constitute part of the consideration even if the transaction is intentionally structured so that it will not qualify as a "C" reorganization. From the seller’s standpoint, the buyer’s stock may be acquired subject to restrictions on resale, transfer or voting. The most common restriction would arise because of the

---

74. I.R.C. § 381(c)(2). Rev. Rul. 73-552, 1973-2 C.B. 117, states “the accumulated earnings and profits . . . of [the transferor] are no longer identified with [it] but become attached to [the transferee] under prescribed rules contained in section 1.381(c)(2)-1 of the Income Tax Regulations.” Unfortunately, a close reading of § 381(a), which governs all specific carryovers, and interrelated § 352(b)(1)(B), suggests this conclusion may have been hasty if the transferor corporation is not going to liquidate.
75. I.R.C. § 301(c). In addition, redemptions not qualifying for exchange under § 302(a) would nevertheless avoid dividend treatment.
76. Treas. Reg. § 1.312-6(b) (1955).
securities law limitations on resale except pursuant to a current registration.\textsuperscript{77} The net effect of such restrictions will be a discounted value.\textsuperscript{78} This may conveniently be used to limit the amount of gain that the corporate seller might otherwise have had to recognize at the time of sale. In addition, such restrictions will justify discounting the value of the PHC's portfolio and thus reduce the value of the shares of the PHC. This reduction will have estate and gift tax benefits for the shareholders. From the buyer's standpoint, structuring the assets purchase as a taxable transaction will allow it to make favorable allocations of the purchase price to depreciable assets\textsuperscript{79} whereas had the transaction been a "C" reorganization the buyer would have taken over the seller's adjusted basis in such assets.\textsuperscript{80} Finally, it may be desirable for the shareholders of the seller-corporation to have some investment (even indirectly) in the buyer, particularly if some or all of them are continuing in the employ of the buyer.

There are, however, several drawbacks to the acceptance of buyer's stock. One is the lack of diversification and a second is the diminished marketability, particularly if it represents a large block or is restricted in some way. A third factor is the possible application of section 368(a)(2)(F) of the Code, which prevents a tax-free reorganization with another investment company if the PHC is not sufficiently diversified.

B. Arranging Shareholder Relationships

Shareholders of the selling corporation may disagree on whether to adopt PHC Conversion or liquidate pursuant to a section 337 plan. If the majority of the shareholders desire PHC Conversion, presumably that will be done. However, there is no reason why the majority should not try to accommodate the wishes of the minority. Redemption of the minority shareholders' shares can usually be arranged without adverse consequences to the corporation or the non-redeeming shareholders. Conversely, if it is the majority that desires liquidation and the minority that desires PHC Conversion, it should be possible to redeem the majority's shares and leave the minority with the continuing corporation.

\textsuperscript{77} 17 C.F.R. 230.145(a)(3) (1972).
\textsuperscript{79} See note 64 supra.
\textsuperscript{80} I.R.C. § 362(b).
Assuming an accommodating majority, attention should be directed to two key issues: first, whether the redemption should take place before or after the acquisition is closed, and, second, how to approach the issue of valuation of the redeemed shares. There is no clear-cut answer to either question but certain considerations tend to suggest certain conclusions. For example, will the corporation have sufficient liquidity before the acquisition closing to make the redemption? In which tax year would the redeeming shareholders prefer to take their gain? Does the redemption make good sense whether the acquisition closes or not? Would it be unwise if there is any risk the acquisition might fall through? Might assets which neither the buyer nor the continuing corporation want, be used to consummate part or all of the redemption, and, if so, can the corporation select assets which will take advantage of the opportunities presented by section 311 (d)(2)?

On the issue of valuation, if the majority shareholders are being redeemed, their views ought to prevail subject, of course, to fiduciary considerations. If the seller-corporation will realize taxable gain on the sale, such a fact should be taken into consideration regardless of who is being redeemed or when the redemption takes place. However, it is the majority who should dictate the effect on valuation. For example, if the majority prefers total liquidation, but to accommodate the minority, it permits PHC Conversion combined with a subsequent redemption of its shares, the majority will relinquish the benefits of a section 337 plan. Under such circumstances, tax paid on the corporation's gain, if any, should not be reflected in valuing the majority's shares. Sometimes the parties may all desire a low valuation because of estate or gift planning considerations. The Internal Revenue Service is likely to take a stricter position on the value after a PHC Conversion because of the liquid (and therefore easier to value) position of the PHC after sale. 81 However, a recent revenue ruling states that the estate tax value of a closely-held corporation's stock must take into account the effect of a tentative agreement for the acquisition of the corporation; 82 this development should be kept in mind.

C. Immediate Post-Acquisition Considerations and Timing

1. Accumulated Earnings Tax

The sale of a closely-held corporation's operating assets in exchange for cash, followed by reinvestment in income-producing passive

81. See notes 20 and 49 supra.
investments, does not immediately make the corporate seller a personal holding company. This is because the sale will not ordinarily affect the fiscal year of the asset-selling corporation and the corporation will only be a PHC in the fiscal year of sale if PHCI exceeds sixty percent of total adjusted ordinary gross income for the year. During the part of the fiscal year of sale which precedes the closing the corporation will realize primarily “trade or business” gross income and during the balance of the year the corporation will realize primarily PHCI. In most businesses one to two months trade or business gross income is likely to exceed the amount of PHCI generated during the rest of the year. Thus, most continuing corporations are not likely to be PHCs in the year of sale and will continue to be subject to the accumulated earnings tax provisions of the Code.

In the rare case where the corporation is a PHC for the year of sale it will presumably pay dividends during the year approximately equal to the amount necessary to bring the UPHCI to zero. But in the more common case where the corporation is not a PHC in the year of sale, the shareholders, especially if they are in high income tax brackets, predictably will oppose the payment of dividends. A corporation owning principally liquid assets and intending to continue as a holding or investment company has little chance of defense against a claim of unreasonable accumulation in the year of sale if it fails to pay dividends approximately equal to earnings of that year. But contrary to what might be supposed, failure to pay dividends in the year of sale, if not a PHC that year, will not result in insurmountable accumulated earnings tax problems. Section 563(a) of the Code (relating to accumulated earnings) provides that any dividends paid within two and one-half months after “the close of (a fiscal) year shall be considered as paid during such (fiscal) year.” Fortunately for the corporation in transition to PHC status, these same post-fiscal year dividends will be considered for PHC purposes as dividends of the fiscal year in which actually paid out. Thus the distribution of a single dividend within a proper time period literally “kills two birds with one stone.” In addition, should it be necessary to pay a larger dividend in respect of the year of sale than what would otherwise have to be paid in the first PHC year to avoid a penalty tax on UPHCI, e.g., year of sale earnings $200,000, first PHC year UPHCI (prior to any dividend) of

83. I.R.C. § 542(a) (1).
84. Unless the corporation has been, and for the year of sale continues to be, a subchapter S corporation.
85. See Rev. Rul. 72-152, 1972-1 C.B. 272. The dividend is taxable to the recipient-shareholders in the year of actual distribution.
$150,000, the PHC will be able to use any excess as a dividend carry-over in the following two fiscal years.\textsuperscript{66}

To some degree corporations can control whether they are or are not PHCs in the year of sale. One method to assure PHC status in the year of sale is to change the fiscal year of the corporation just before the closing of the assets sale. This should minimize trade or business gross income for the year of sale and increase the probability that PHCI for the year will exceed sixty percent of adjusted ordinary gross income. Careful examination of regulation section 1.442-1(c) should reveal whether the corporation meets all the conditions necessary to make the change without the Commissioner's prior consent.

If the sale takes place early in the fiscal year and the corporation is uncertain about, or wishes to avoid, PHC status for the year of sale, it may arrange its investment income in such a way as to minimize PHCI. The best method is to invest in tax-exempt securities, which will provide interest income but will not be PHCI. This raises the question of accumulated earnings tax concerns for the corporation's fiscal year preceding the year of sale. If negotiations on the asset-sale took place during the year prior to the year of sale, and dividends roughly equal to the earlier year's earnings and profits were never distributed, the IRS can be expected to maintain that the corporation was pursuing a tax avoidance purpose to benefit the shareholders, since in light of the planned sale of assets, the corporation could not have needed the year's earnings for the reasonable needs of the business. Naturally the corporation would have an excellent defense if its working capital position prior to sale would not have permitted the payment of dividends without borrowing. However, even a corporation that had satisfactory liquidity should not be defenseless against an Internal Revenue Service attack. The corporation should be able to contend that it was concerned, \textit{on a parallel basis}, with both its reasonable needs for reinvestment (assuming there were some) and the possible sale of its assets. Until a sale was agreed to and closed on a basis satisfactory to all parties, the corporate seller had to assume that no sale would ever occur. Having to conduct itself as if a sale would not occur, the corporation could rationally maintain that it continued to consider its reasonable reinvestment needs.

A recent court of claims decision, \textit{J JJ Corp. v. Commissioner},\textsuperscript{67} provides several useful insights into the accumulated earnings tax provisions as applied to asset-selling corporations. In that case the sole shareholder of JJJ Corp. arranged for the corporation to sell its assets

\textsuperscript{66} I.R.C. §564.

\textsuperscript{67} 576 F.2d 327 (Cl. Cl. 1978).
for cash but did not adopt any plan to liquidate. At the time of sale the shareholder had not yet decided whether to continue the corporation as an investment vehicle or to use the proceeds to acquire another business. Several months later, but prior to the end of the fiscal year in which the assets sale took place, the sole shareholder died. For the next four months (and into the next fiscal year, beyond the time where post-tax year dividends under Code section 563(a) could be made), the corporation's board, which included the sole shareholder's surviving spouse and also his testamentary trustee, made no final investment decisions. Although the court of claims affirmed the district court's finding of unreasonable accumulation, it made several observations which could be valuable to parties in similar undecided positions. First, it held that the fact that JJJ Corp. owned only passive investments during the latter half of the fiscal year in question did not automatically make it a "mere holding or investment company" for purposes of section 533(b) which provides that "the fact that a corporation is (such a) company shall be prima facie evidence of the purpose to (unreasonably accumulate earnings)." Second, the court stated that a corporate assets seller and its shareholders are entitled to a "breathing spell" after the sale, allowing time to decide on the future direction of the corporation, including how to best utilize accumulated earnings. Presumably the court also believes that the corporation should be allowed a reasonable time to locate and negotiate the purchase of new businesses if that is the corporation's plan.

2. Preferred State of Incorporation for PHCs

Closely-held corporations typically incorporate in the state where their principal place of business is located. Consequently, initial incorporation in more accommodating states such as Delaware is unlikely. If after becoming a PHC the corporation remains domiciled in the same state, it is likely to pay income or franchise taxes to that state in amounts not unlike what it paid prior to the sale of its operating assets. Unless the shareholders plan substantial activities for the PHC beyond mere investing and reinvesting in passive investments, modest to significant savings can be realized by forming a new Delaware corporation and merging the PHC into it. Delaware has special exemptions for

88. Id. at 332, the court relates the shareholder's process of making a decision whether or not to liquidate the corporation following its sale of assets.
89. Id. at 333.
90. Id. at 337.
91. Id. at 340. See also id. at 339 n.10.
92. Id. at 344.
93. This redomestication should be accomplished as a non-taxable reorganization under § 369(a) (1) (F) of the Code.
investment holding corporations so that neither income nor net worth, no matter how large, determine the amount of tax in Delaware.\textsuperscript{94} If certain added precautions are taken, the redomesticated Delaware PHC should not need to qualify as a foreign corporation in the state or states where its shareholders reside.\textsuperscript{95} In addition, and again regardless of income or net worth, the Delaware initial filing tax and annual franchise tax can be kept to a minimum by having a low number of shares of authorized par value stock.\textsuperscript{96}

3. PHC Operating Expenses and Deduction Opportunities

In most instances there is no reason why PHC operating expenses cannot be kept to a minimum, particularly if steps are taken to minimize state franchise or income taxes. Unless the investment portfolio or the number of shareholders is large, there should be little necessity for offices or clerical help. The principal expenses will then be phones, postage, stationery, modest state franchise taxes, annual registered agent fees, custodian fees, and, if the portfolio is properly structured, a modest amount of federal income tax. Beyond these expenses, the possibility of salary expense remains. However, rather than being thought of as an expensive outlay it may be an opportunity for tax savings, if, as will generally be the case, parties to whom salaries may be paid are also shareholders of the PHC. If that is the case, and such parties actually perform services in connection with the selection, supervision and administration of the PHC's investments, their salaries will be deductible by the PHC with resulting modest savings in federal income tax payable by the corporation. More important, however, may be the lower rates payable by the salaried shareholder on the salary income than he would pay on the same amount if distributed as dividend income. This assumes the shareholder has sufficiently high personal service income to place him in the maximum tax bracket.\textsuperscript{97} Finally, salaried employees of the PHC will be eligible

\textsuperscript{94} DEL. CODE ANN. tit. 30, §1902(b)(8) (1975). Shares of stock of Delaware corporations owned by non-residents of Delaware are not subject to taxation by the state of Delaware, DEL. CONST. art. 9, §6.

\textsuperscript{95} Business of the corporation in any state other than Delaware should be kept to the minimum contacts feasible. At least one Wilmington, Delaware, bank and several local Wilmington accounting firms provide a variety of services for holding PHC property and conducting PHC business as much as possible in Delaware. If the PHC has one or more investments requiring shareholders' attention "locally," domiciliation of the parent PHC in Delaware and formation of a wholly-owned subsidiary to conduct the local affairs may be desirable.

\textsuperscript{96} DEL. CODE ANN. tit. 8, §391(a)(1) (1975).

\textsuperscript{97} I.R.C. §1348. However, at the least the PHC will have to pay FICA taxes on the amount paid as salaries. This will diminish, although not eliminate, the apparent savings. Furthermore, the salary must be reasonable or it will be treated as a dividend to the recipient. See Heim v. Commissioner, 37 T.C.M. 584 (1978). In addition, if the salary is set aside and also found to be a preferential dividend, further complications may arise under §562(c) of the Code.
for various fringe benefits, which, if paid by the PHC, may result in meaningful after-tax savings.\textsuperscript{98}

\textbf{Conclusion}

In appropriate cases PHC Conversions can yield substantial tax savings. At the very least these savings can be retained for an indefinite period of time, and if PHC shares are held by a shareholder until death, the savings realized at the time of PHC Conversion may become permanent in the hands of the deceased shareholder's successor. PHC Conversions are not without limitations or disadvantages, but then neither are the other common ways of selling an incorporated business. The critical point to keep in mind is that PHC Conversion may have sufficient advantages that it should be the preferred way to sell an incorporated business in a given instance.\textsuperscript{98}

\textsuperscript{98} See Milefsky, \textit{supra} note 20, at 203.