Sidestep tax on personal holding companies

A tax that is often thought to be a remnant of days long gone by can still come back to haunt business owners.

Strategy: Don't trigger the personal holding company tax. This additional tax can be assessed against a closely held company if it receives excess investment income.

However, with some careful tax planning, you may be able to avoid any dire tax consequences.

Here's the whole story: A personal holding company (PHC) is a C corporation in which more than 50% of the value of its outstanding stock is owned—either directly or indirectly—by no more than five individuals and at least 60% of its adjusted ordinary gross income comes from passive sources. The PHC tax is imposed on the undistributed income of these C corporations. In other words, the tax targets closely held corporations deriving substantial investment income such as royalties, interest, dividends and rents.

Currently, a PHC must pay a corporate tax equal to 20% of the undistributed PHC income. From 2003 to 2012, the tax rate was 15%, but the American Taxpayer Relief Act of 2012 (ATRA) raised it by 5%.

The PHC tax can strike when least expected.

New ruling: XYZ Corp., a closely held company, owned land surrounding a commercial building of a related corporation. XYZ agreed to place building restrictions on the land to provide a "buffer zone." But the IRS ruled that payments received by XYZ for this privilege should be treated as rents, pushing it over the 60% passive income threshold. *(IRS Chief Counsel Memorandum, No. 20152012F, 5/22/15)*

To avoid the PHC tax, you might increase the number of shareholders. But be aware that stock gifted to other family members will be considered to be owned indirectly by you.

- Alternatively, you may be able to increase adjusted ordinary income or decrease PHC income. A few ideas are to:
- Accelerate billing for business services or sales near year-end
- Decrease cost of goods sold by deferral of purchases or other expenses at year-end
- Invest in business activities that result in additional gross receipts that are not PHC income
- Cash in securities and reinvest the funds in stocks that have growth potential but do not regularly pay dividends
- Pay out dividends to shareholders
- Limit your passive investments

Tip: Certain businesses, such as banks and life insurance companies, are specifically exempted from the PHC tax.

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