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From:

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To:

Cc:

Subject: Appeals Issue involving IRC sections 541 thru 543

Taxpayer:

TIN:

Tax Years:

Date 1:

Date 2:

Date 3:

This is in response to your request for advice concerning the adjustments set forth in the IRS Revenue Agent Report (RAR) dated Date 1, for tax years of Taxpayer ending Date 2, and Date 3. According to the RAR, Taxpayer, the parent company of an affiliated group of corporations (Taxpayer Group) excluded dividends from its adjusted ordinary gross income (AOGI) received from a member of Taxpayer Group (Sub). The RAR concludes that Taxpayer is not a personal holding company because Taxpayer must include the dividends in its AOGI. Including the dividends in Taxpayer's AOGI reduces Taxpayer's personal holding company income to less than 60 percent of its AOGI. As a result, the RAR proposes that Taxpayer Group is subject to the accumulated earnings tax.

For the following reasons, we believe that Taxpayer properly excluded the intercompany dividends it received from Sub from its AOGI.

Section 531 of the Code imposes for each taxable year on the accumulated taxable income (as defined in § 535) of each corporation described in § 532, an accumulated earnings tax equal to 15 percent of the accumulated taxable income. Under § 532(a), the accumulated earnings tax imposed by § 531 shall apply to every corporation (other than those described in § 532(b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

Section 532(b)(1) provides that the accumulated earnings tax imposed by § 531 shall not apply to a personal holding company (as defined in § 542).

Under § 541 of the Code, in addition to other taxes imposed under the Internal Revenue Code, there is imposed for each taxable year on the undistributed personal holding company income (as defined in § 545) of every personal holding company (as defined in § 542) a personal holding company tax equal to 15 percent of the undistributed personal holding company income.

Section 542(a) defines the term "personal holding company" as any corporation (other than a corporation described in 542(c)) if at least 60 percent of its adjusted ordinary gross income (AOGI) (as defined in § 543 (b)(2)) for the taxable year is personal holding company income (as defined in § 543 (a)), and 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.

Under § 542(b)(1), in the case of an affiliated group of corporations filing or required to file a consolidated return under § 1501 for any taxable year, the AOGI requirement of § 542(a)(1) shall, except as provided in § 542(b)(2) and (3), be applied for such year with respect to the consolidated AOGI and the consolidated personal holding company income of the affiliated group. No member of such an affiliated group shall be considered to meet the AOGI requirement unless the affiliated group meets the requirement.

Under § 542(b)(2), however, § 542(b)(1) does not apply to an affiliated group of corporations if any member of the affiliated group of corporations (including the common parent corporation) derived 10 percent or more of its adjusted ordinary gross income for the taxable year from sources outside the affiliated group, and 80 percent or more of the amount described in § 542(b)(2)(A) consists of personal holding company income (as defined in § 543) (an ineligible affiliated group).

Section 543(b)(1) defines the term "ordinary gross income" as the gross income determined by excluding (A) all gains from the sale or other disposition of capital assets, and (B) all gains (other than those referred to in subparagraph (A)) from the sale or other disposition of property described in § 1231(b).

Under § 543(b)(2) the term "adjusted ordinary gross income" means the ordinary gross income determined by excluding the specific costs described in § 543(b)(2)(A), (B), (C), and (D). Intercompany dividends are not specifically excluded from ordinary gross income under those subparagraphs.

Section 61(a) provides that except as otherwise provided, gross income means all income from whatever source derived.

Rev. Rul. 79-60, 1979-1 CB 211, held that a dividend paid by a subsidiary to its parent is eliminated for purposes of determining the parent's separate personal holding company income under § 543 and its separate undistributed personal holding company income under § 545 since the subsidiary did not avail itself of a dividends paid deduction under §§ 561 and 562(d). The revenue ruling cites to former § 1.1502-14(a)(1) of the Income Tax Regulations, which eliminates intercompany dividends from affiliated group members from the computation of separate taxable income. Section 1.1502-14(a)(1) was subsequently replaced by current § 1.1502-13(f)(2)(ii) and "excludes" rather than "eliminates" dividend income. Rev. Rul. 79-60 also cites to Rev. Rul. 74-131, 1974-1 C.B. 145, in which the Service noted that intercompany dividends paid by a non-PHC member "are eliminated for all purposes in determining the personal holding company income of the recipient member."

We believe that those revenue rulings support Taxpayer's conclusion that the intercompany dividend it received from Sub, which is not a PHC, is excluded for all purposes of the PHC calculations including AOGI.

Please note that the personal holding company rules are purely mechanical, and not subjective. Therefore, the intent of a taxpayer is irrelevant when determining whether or not the taxpayer is a personal holding company. Further, see § 547, which provides that if a determination with respect to a taxpayer establishes liability for personal holding company tax imposed by § 541 for any taxable year, a deduction shall be allowed to the taxpayer for the amount of the deficiency dividends for the purpose of determining the personal holding company tax for the year, but not for the purpose of determining interest, additional amounts, or assessable penalties computed with respect to the personal holding company tax.

Finally, we recommend that you contact
concerning the accumulated earnings tax.

if you would like assistance