



Instructions for Schedule PH (Form 1120)

U.S. Personal Holding Company (PHC) Tax

Section references are to the Internal Revenue Code unless otherwise noted.

General Instructions

A Change To Note

Effective for any tax year beginning in 2002, the tax rate applicable to undistributed personal holding company income is decreased to 38.6%.

Purpose of Schedule

Corporations use this schedule to figure the personal holding company (PHC) tax.

Who Must File

A corporation that is a PHC must file Schedule PH by attaching it to the corporation's income tax return.

Personal Holding Company

Generally, a corporation is a PHC if it meets **both** of the following requirements (also, see **Important** under **Specific Instructions**).

1. PHC Income Test. At least 60% of the corporation's adjusted ordinary gross income for the tax year is PHC income. See section 543(b)(2) for the definition of adjusted ordinary gross income and section 543(a) for the definition of PHC income.

2. Stock Ownership

Requirement. At any time during the last half of the tax year, more than 50% in value of the corporation's outstanding stock is owned, directly or indirectly, by five or fewer individuals. See section 542(a)(2) for details.

For purposes of this requirement, the following organizations are considered individuals:

- A qualified pension, profit-sharing, and stock bonus plan described in section 401(a).
- A trust that provides for the payment of supplemental unemployment compensation under

certain conditions (section 501(c)(17)).

- A private foundation (section 509(a)).
- A part of a trust permanently set aside or used exclusively for the purpose described in section 642(c).

Exceptions. The term "personal holding company" does not include the following corporations, even if the two requirements above are met.

- Tax-exempt corporations.
 - Banks, domestic building and loan associations, and certain lending or finance companies.
 - Life insurance and surety companies.
 - Certain small business investment companies operating under the Small Business Investment Act of 1958.
 - Corporations under the jurisdiction of the court in a title 11 or similar case.
 - Foreign personal holding companies (as defined in section 552).
 - Foreign corporations that do not have income under section 543(a)(7), if, during the last half of the tax year, all of the corporation's stock is owned by nonresident alien individuals.
 - Passive foreign investment companies (as defined in section 1297).
- See section 542(c) for more information.

At-risk, passive activities, and earnings stripping rules. A corporation that has an activity subject to the at-risk or passive activity rules or interest expense subject to the earnings stripping rules (or both) may have deductions and losses suspended or limited under these rules. As a result, do not use deductions and losses limited or suspended in any of the PHC computations. Treat any prior year deductions and losses allowed under the at-risk, passive activity, and earnings stripping rules as current year deductions and losses.

Foreign corporations. If a foreign corporation that is a PHC does not file Schedule PH as required, it may be penalized, unless it can show that the failure to file was due to reasonable cause. The penalty is 10% of the corporation's Federal income taxes (including the PHC tax) and is in addition to any other penalties charged the corporation. See section 6683.

Specific Instructions

Important: To determine if a corporation is a PHC, follow the steps below to complete Schedule PH and the Worksheet on page 4.

1. Complete Part I of Schedule PH. Then, complete lines 1 through 5 of the Worksheet.
2. Complete Part II of Schedule PH and then line 6 of the Worksheet.
3. Generally, if line 6 of the Worksheet is 60% or more and the Stock Ownership Requirement (Part IV of Schedule PH) is met, the corporation must file Schedule PH and pay the PHC tax. However, see **Exceptions** above.
4. If the corporation determines that it must file Schedule PH and pay the PHC tax, it must complete line 26, Part III, to figure the amount of the PHC tax.

Part I—Undistributed Personal Holding Company Income

Additions

Line 1—Taxable income before net operating loss deduction and special deductions. Enter the amount from Form 1120, line 28, page 1. If the income on line 28 was figured using section 443(b) (placing the income on an annual basis), refigure it without using that section.

A foreign corporation figures line 1 by including only income derived from U.S. sources or effectively connected with a U.S. trade or business, reduced by deductions allowable in determining taxable income before the net operating loss deduction and special deductions.

If all of a foreign corporation's stock is owned during the last half of the tax year by nonresident alien individuals (directly or indirectly), taxable income for section 545(a) is only income received under a contract for personal services as described in section 543(a)(7), reduced by deductions attributable to that income, and adjusted as provided in section 545(b) with respect to that income.

Line 3—Excess expenses and depreciation (section 545(b)(6)). If the corporation earned rent or other compensation for the use of, or right to use, property and that rent or compensation was less than the total allowable expenses and depreciation, complete Part V in most cases and enter the excess on line 3. However, if the corporation can establish that it meets **all three** of the requirements listed below, it may attach a statement instead of completing Part V. The statement must include **(a)** a list of the deductions, with the complete facts, circumstances, and arguments supporting them and **(b)** the information required by Regulations section 1.545-2(h)(2).

To qualify, the corporation must establish that:

1. The rent or other compensation it received was the highest obtainable (if none was received, it must show that none was obtainable),
2. The property was held in the course of a business carried on for profit, and
3. There was a reasonable expectation that the property's operation would result in a profit, or that the property was necessary to conduct the business.

Deductions

Line 5—Federal and foreign income, war profits, and excess profits taxes not deducted in figuring line 1. The corporation can deduct:

- Federal income taxes accrued during the tax year and
- Income, war profits, and excess profits taxes accrued (or deemed paid) during the tax year to foreign countries and U.S. possessions.*

The corporation cannot deduct:

- The accumulated earnings tax under section 531 or
- The PHC tax under section 541.

*The foreign tax credit is not allowed against PHC tax. But, as described above, the corporation may take a deduction for taxes paid to foreign countries and U.S. possessions even if a credit was claimed when figuring the corporation's income tax.

Attach a schedule showing the type of tax, the tax year, and the amount. For more information, see section 545(b)(1).

Line 6—Contributions (section 545(b)(2)). Figure the deduction using the limitations under sections 170(b)(1)(A), (B), and (D), but without sections 170(b)(2) and (d)(1). When figuring the limitations under section 170(b)(1), use taxable income figured with the adjustments (other than the 10% limitation) provided in sections 170(b)(2) and (d)(1) and without any expenses and depreciation disallowed under section 545(b)(6).

Line 7—Net operating loss (section 545(b)(4)). Instead of the net operating loss deduction provided in section 172, a deduction is allowed for the net operating loss (as defined in section 172(c)) for the preceding tax year figured without the deductions provided in Part VIII (except section 248) of subchapter B.

Line 8—Net capital gain. Net capital gain for a foreign corporation is determined by taking into account only gains and losses that are effectively connected with the conduct of a trade or business within the United States that are not exempt from tax under treaty.

Line 10—Total. Include in the total for line 10 any deduction for amounts used or irrevocably set aside to pay or retire qualified indebtedness under section 545(c) (as in effect before November 5, 1990). See Regulations section 1.545-3. Write the amount and "Section 545(c)" on the dotted line next to line 10.

Line 12—Dividends paid after the end of the tax year. The corporation may elect to treat dividends (other than deficiency dividends) paid after the end of the year and before the 16th day of the 3rd month following the end of the tax year as paid during the tax year. Enter these dividends on line 12 but not in Part VI.

Line 13—Undistributed PHC income. If 10% or less in value of the outstanding stock of a foreign

corporation is owned (see section 958(a)) during the last half of the tax year by U.S. persons, undistributed PHC income is determined by multiplying the undistributed PHC income (determined without this instruction) by a percentage in value of the corporation's outstanding stock. This percentage is figured by using the greatest percentage in value of its outstanding stock owned by the U.S. persons on any day during the period.

Part II—Personal Holding Company Income

Note: The term "ordinary gross income" (used below) means line 3 of the Worksheet on page 4. The term "adjusted ordinary gross income" means line 5 of the Worksheet.

A corporation may be subject to the PHC tax if at least 60% of its adjusted ordinary gross income for the tax year is PHC income. Use Part II to figure the amount of the corporation's PHC income. Then, complete line 6 of the Worksheet to determine if the corporation is a PHC.

Line 15b—Amounts excluded. Enter the total of interest excluded on line 15b. The following interest may be excluded from PHC income.

- Interest constituting rent.
- Interest on amounts set aside in a reserve fund under section 511 or 607 of the Merchant Marine Act of 1936.
- Interest received by a broker or dealer (within the meaning of section 3(a)(4) or (5) of the Securities Exchange Act of 1934) in connection with **(a)** any securities or money market instruments held as property described in section 1221(a)(1), **(b)** margin accounts, or **(c)** any financing for a customer secured by securities or money market instruments.
- Interest from line 4d of the Worksheet.

See sections 543(a)(1) and 543(b)(2)(C) for more information.

Line 18—Rents. Rents may be excluded from PHC income if **both** of the following tests are met.

Test 1. The adjusted income from rents (line 18c) is at least 50% of adjusted ordinary gross income.

Test 2. The sum of taxable distributions (Part VI, line 3) and the deduction for dividends paid after the end of the tax year (Part I, line 12) is at least equal to:

- The excess, if any, of PHC income over

- 10% of ordinary gross income.

For this purpose, PHC income includes copyright royalties and adjusted income from mineral, oil, and gas royalties, but does not include the amounts from lines 18c and 22.

If both of the above tests are met, rents may be excluded from PHC income. Do not complete lines 18a through 18c.

If the rents may not be excluded, enter rents (as defined in section 543(b)(3)) on line 18a. Enter the amount from line 4a of the Worksheet on line 18b and complete line 18c.

See section 543(a)(2) for more information.

Line 19—Mineral, oil, and gas royalties.

Mineral, oil, and gas royalties may be excluded from PHC income if **all three** of the tests below are met.

Test 1. The adjusted income from mineral, oil, and gas royalties (line 19c) is at least 50% of adjusted ordinary gross income.

Test 2. PHC income is not more than 10% of ordinary gross income.

For this purpose, PHC income includes copyright royalties and the adjusted income from rents, but does not include line 19c.

Test 3. The deductions allowable under section 162 (other than compensation for personal services rendered by a shareholder and deductions specifically allowable under other sections) are 15% or more of adjusted ordinary gross income.

If all of the above tests are met, mineral, oil, and gas royalties may be excluded from PHC income. Do not complete lines 19a through 19c.

If mineral, oil, and gas royalties are not excluded, enter the total mineral, oil, and gas royalties (including production payments and overriding royalties) on line 19a. Enter the amount from line 4b of the Worksheet on line 19b and complete line 19c.

See section 543(a)(3) for more information.

Line 20—Copyright royalties.

Note: For royalties received in connection with the licensing of computer software, see below.

Copyright royalties may be excluded from PHC income if **all three** of the tests below are met.

Test 1. Income from copyright royalties is at least 50% of ordinary gross income. For this purpose, copyright royalties do not include royalties received for the use of, or right to use, copyrights or interests in copyrights on works created in whole or in part by any shareholder.

Test 2. PHC income is not more than 10% of ordinary gross income.

For this purpose, PHC income includes:

- The adjusted income from rents (line 18c),
- The adjusted income from mineral, oil, and gas royalties (line 19c), and
- Copyright royalties received for the use of, or right to use, copyrights on works created in whole or in part by any shareholder owning more than 10% of the corporation's stock.

PHC income does **not** include:

- Copyright royalties (other than stated above) or
- Dividends from any corporation that meets Test 1 above and Test 3 below, and in which the corporation owns at least 50% (by vote and value) of the stock.

Test 3. Total allocable deductions under section 162 (other than deductions for compensation for personal services rendered by shareholders, deductions for royalties paid or accrued, and deductions specifically allowable under sections other than section 162) are at least 25% of the excess of:

- Ordinary gross income over
- The sum of royalties paid or accrued and depreciation for copyright royalties.

See section 543(a)(4) for more information.

Royalties received in connection with the licensing of computer software. Royalties received in connection with the licensing of computer software may be excluded from PHC income if **all four** of the tests below are met.

Test 1. The corporation is engaged in the active business of developing, manufacturing, or producing computer software.

Test 2. The royalties are at least 50% of ordinary gross income.

Test 3. Total allowable deductions under sections 162, 174, and 195 that are allocable to the computer software business are at least 25% of ordinary gross income (or, the

average of the deductions for the 5 tax years ending with the current tax year is at least 25% of the average ordinary gross income for that period).

Test 4. The sum of taxable distributions (Part VI, line 3), and the deduction for dividends paid after the end of the tax year (Part I, line 12), is at least equal to the excess, if any, of:

- PHC income (as defined in section 543(d)(5)(B)) over
- 10% of ordinary gross income.

See section 543(d) for more information.

Line 21—Produced film rents.

Produced film rents may be excluded from PHC income if the rents constitute at least 50% of ordinary gross income. See section 543(a)(5) for the definition of produced film rents.

Line 22—Compensation received for the use of corporation property by a 25% or more shareholder.

This line applies only to a corporation with other PHC income in excess of 10% of ordinary gross income. For purposes of this limitation, other PHC income is defined in section 543(a)(6)(C).

Enter on line 22 amounts received as compensation for the use of, or right to use, tangible property of the corporation by or for an individual, who at any time during the tax year owned, directly or indirectly, at least 25% in value of the corporation's outstanding stock.

Line 23—Amounts received under personal service contracts and from their sale.

This line applies only if the individual who has performed, is to perform, or may be designated to perform such services owned at any time during the tax year 25% or more in value of the corporation's outstanding stock.

Enter amounts received under a contract that requires the corporation to furnish personal services if any person other than the corporation has the right to designate the individual who is to perform the services (or if the individual who is to perform the services is designated in the contract). Also include amounts received from the sale or other disposition of such a contract.

Worksheet for Figuring Ordinary Gross Income, Adjusted Ordinary Gross Income, and PHC Income Test
(See instructions below.) (Keep for your records.)

| | | |
|---|----|-----------|
| 1. Gross income. Insurance companies, other than life insurance companies, see section 543(c). | 1 | _____ |
| 2. Less: Gains from the sale or disposition of capital assets and section 1231(b) property | 2 | (_____) |
| 3. Ordinary gross income. Combine lines 1 and 2. (Foreign corporations, see instructions.) | 3 | _____ |
| 4. Adjustments: | | |
| a Deductions allocable to rents. | 4a | _____ |
| b Deductions allocable to certain royalties and working interests in oil and gas wells. | 4b | _____ |
| c Deductions allocable to compensation described in section 543(b)(3)(D) | 4c | _____ |
| d Certain excluded interest income under section 543(b)(2)(C) | 4d | _____ |
| e Total adjustments. Add lines 4a through 4d | 4e | _____ |
| 5. Adjusted ordinary gross income. Subtract line 4e from line 3 | 5 | _____ |
| 6. Complete Part II of Schedule PH. Divide line 25, Part II, by line 5 above. Enter the result as a percentage. | 6 | _____ % |

Important: If line 6 is **less than 60%**, the corporation is not a PHC. Do not file Schedule PH.

Generally, if line 6 is **60% or more** and the **Stock Ownership Requirement** of section 542(a) is met, the corporation is a PHC. Complete Parts III and IV. For details and exceptions, see **Who Must File** and **Personal Holding Company** on page 1.

Worksheet Instructions

Line 1–Gross income. Enter gross income as defined in section 61 and the related regulations. Foreign corporations (if not exempt under section 542(c)(7)) should only include gross income subject to U.S. tax.

Line 3–Ordinary gross income. A foreign corporation that is owned (directly or indirectly) by nonresident aliens for the last half of the tax year should enter ordinary gross income, reduced by all items of income that would normally be PHC income, except for amounts received for personal service contracts or the sale of personal service contracts (Part II, line 23). See section 543(b)(1).

Line 4–Adjustments. Ordinary gross income on line 3 must be adjusted as described below. Each type of income (rents, royalties, income from working interests in oil and gas wells, and certain excluded rents) is separately adjusted by the deductions allocable to it. Enter the allocable deductions on lines 4a, 4b, and 4c to the extent of the gross income (e.g., enter deductions allocable to royalties on line 4b, but do not enter more than the gross income from royalties).

Also, in figuring adjusted ordinary gross income, certain interest income

is excluded (see the instructions for line 4d below).

See section 543(b)(2) for more information.

Line 4a–Deductions allocable to rents. Enter deductions (listed below) allocable to rents (as defined in section 543(b)(3)).

- Depreciation and amortization of property (other than certain tangible personal property not customarily retained by any lessee for more than 3 years).
- Property taxes.
- Interest.
- Rent.

See section 543(b)(2)(A) for more information.

Line 4b–Deductions allocable to certain royalties and working interests in oil and gas wells. Enter deductions (listed below) allocable to mineral, oil, and gas royalties (including production payments and overriding royalties) and to gross income from a working interest in an oil or gas well.

- Depreciation and amortization.
- Depletion.
- Property and severance taxes.
- Interest.
- Rent.

See section 543(b)(2)(B) for more information.

Line 4c–Deductions allocable to compensation (section 543(b)(3)(D)). Compensation for the use of, or right to use, tangible

personal property manufactured or produced by the corporation does not count as rents if the corporation is engaged in substantial manufacturing or production of the same type of property during the tax year. Enter deductions (listed below) allocable to this type of compensation.

- Depreciation and amortization of property (other than certain tangible personal property).
- Property taxes.
- Interest.
- Rent.

See sections 543(b)(2)(D) and 543(b)(3)(D) for more information.

Line 4d–Certain excluded interest income (section 543(b)(2)(C)). Include:

- Interest on a direct obligation of the United States held for sale by a dealer who is making a primary market for these obligations and
- Interest on condemnation awards, judgments, and tax refunds.

See section 543(b)(2)(C) for more information.