

**§ 1.537-2 Grounds for accumulation of earnings and profits.**

(a) *In general.* Whether a particular ground or grounds for the accumulation of earnings and profits indicate that the earnings and profits have been accumulated for the reasonable needs of the business or beyond such needs is dependent upon the particular circumstances of the case. Listed below in paragraphs (b) and (c) of this section are some of the grounds which may be used as guides under ordinary circumstances.

(b) *Reasonable accumulation of earnings and profits.* Although the following grounds are not exclusive, one or more of such grounds, if supported by sufficient facts, may indicate that the earnings and profits of a corporation are being accumulated for the reasonable needs of the business provided the general requirements under §§ 1.537-1 and 1.537-3 are satisfied:

- (1) To provide for bona fide expansion of business or replacement of plant;
- (2) To acquire a business enterprise through purchasing stock or assets;
- (3) To provide for the retirement of bona fide indebtedness created in connection with the trade or business, such as the establishment of a sinking fund for the purpose of retiring bonds issued by the corporation in accordance with contract obligations incurred on issue;
- (4) To provide necessary working capital for the business, such as, for the procurement of inventories;
- (5) To provide for investments or loans to suppliers or customers if necessary in order to maintain the business of the corporation; or
- (6) To provide for the payment of reasonably anticipated product liability losses, as defined in section 172(j), § 1.172-13(b)(1), and § 1.537-1(f).

(c) *Unreasonable accumulations of earnings and profits.* Although the following purposes are not exclusive, accumulations of earnings and profits to meet any one of such objectives may indicate that the earnings and profits of a corporation are being accumulated beyond the reasonable needs of the business:

- (1) Loans to shareholders, or the expenditure of funds of the corporation

for the personal benefit of the shareholders;

(2) Loans having no reasonable relation to the conduct of the business made to relatives or friends of shareholders, or to other persons;

(3) Loans to another corporation, the business of which is not that of the taxpayer corporation, if the capital stock of such other corporation is owned, directly or indirectly, by the shareholder or shareholders of the taxpayer corporation and such shareholder or shareholders are in control of both corporations;

(4) Investments in properties, or securities which are unrelated to the activities of the business of the taxpayer corporation; or

(5) Retention of earnings and profits to provide against unrealistic hazards.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 8096, 51 FR 30484, Aug. 27, 1986]

**§ 1.537-3 Business of the corporation.**

(a) The business of a corporation is not merely that which it has previously carried on but includes, in general, any line of business which it may undertake.

(b) If one corporation owns the stock of another corporation and, in effect, operates the other corporation, the business of the latter corporation may be considered in substance, although not in legal form, the business of the first corporation. However, investment by a corporation of its earnings and profits in stock and securities of another corporation is not, of itself, to be regarded as employment of the earnings and profits in its business. Earnings and profits of the first corporation put into the second corporation through the purchase of stock or securities or otherwise, may, if a subsidiary relationship is established, constitute employment of the earnings and profits in its own business. Thus, the business of one corporation may be regarded as including the business of another corporation if such other corporation is a mere instrumentality of the first corporation; that may be established by showing that the first corporation owns at least 80 percent of the voting stock of the second corporation. If the taxpayer's ownership of stock is less