

§ 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

than 80 percent in the other corporation, the determination of whether the funds are employed in a business operated by the taxpayer will depend upon the particular circumstances of the case. Moreover, the business of one corporation does not include the business of another corporation if such other corporation is a personal holding company, an investment company, or a corporation not engaged in the active conduct of a trade or business.

PERSONAL HOLDING COMPANIES

§ 1.541-1 Imposition of tax.

(a) Section 541 imposes a graduated tax upon corporations classified as personal holding companies under section 542. This tax, if applicable, is in addition to the tax imposed upon corporations generally under section 11. Unless specifically excepted under section 542(c) the tax applies to domestic and foreign corporations and, to the extent provided by section 542(b), to an affiliated group of corporations filing a consolidated return. Corporations classified as personal holding companies are exempt from the accumulated earnings tax imposed under section 531 but are not exempt from other income taxes imposed upon corporations, generally, under any other provisions of the Code. Unlike the accumulated earnings tax imposed under section 531, the personal holding company tax imposed by section 541 applies to all personal holding companies as defined in section 542, whether or not they were formed or availed of to avoid income tax upon shareholders. See section 6501(f) and §301.6501(f)-1 of this chapter (Regulations on Procedure and Administration) with respect to the period of limitation on assessment of personal holding company tax upon failure to file a schedule of personal holding company income.

(b) A foreign corporation, whether resident or nonresident, which is classified as a personal holding company is subject to the tax imposed under section 541 with respect to its income from sources within the United States, even though such income is not fixed or determinable annual or periodical income specified in section 881. A foreign corporation is not classified as a

personal holding company subject to tax under section 541 if it is a foreign personal holding company as defined in section 552 or if it meets the requirements of the exception provided in section 542(c)(10).

§ 1.542-1 General rule.

A personal holding company is any corporation (other than one specifically excepted under section 542(c)) which, for the taxable year, meets:

- (a) The gross income requirement specified in section 542(a)(1) and §1.542-2, and
- (b) The stock ownership requirement specified in section 542(a)(2) and §1.542-3.

Both requirements must be satisfied with respect to each taxable year.

§ 1.542-2 Gross income requirement.

To meet the gross income requirement it is necessary that at least 80 percent of the total gross income of the corporation for the taxable year be personal holding company income as defined in section 543 and §§1.543-1 and 1.543-2. For the definition of *gross income* see section 61 and §§1.61-1 through 1.61-14. Under such provisions gross income is not necessarily synonymous with gross receipts. Further, in the case of transactions in stocks and securities and in commodities transactions, gross income for personal holding company tax purposes shall include only the excess of gains over losses from such transactions. See section 543(b), paragraph (b) (5) and (6) of §1.543-1 and §1.543-2. For determining the character of the amount includible in gross income under section 951(a), see paragraph (a) of §1.951-1.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6795, 30 FR 934, Jan. 29, 1965]

§ 1.542-3 Stock ownership requirement.

(a) *General rule.* To meet the stock ownership requirement, it is necessary that at some time during the last half of the taxable year more than 50 percent in value of the outstanding stock of the corporation be owned, directly or indirectly, by or for not more than 5 individuals. Any organization or trust