

## Internal Revenue Service, Treasury

## § 1.542-4

542(a)(1) and §1.542-2 it will be a personal holding company.

(b) *Changes in stock outstanding.* It is necessary to consider any change in the stock outstanding during the last half of the taxable year, whether in the number of shares or classes of stock, or in the ownership thereof. Stock subscribed and paid for will be considered as stock outstanding, whether or not such stock is evidenced by issued certificates. Treasury stock shall not be considered as stock outstanding.

(c) *Value of stock outstanding.* The value of the stock outstanding shall be determined in the light of all the circumstances. The value may be determined upon the basis of the company's net worth, earning and dividend paying capacity, appreciation of assets, together with such other factors as have a bearing upon the value of the stock. If the value of the stock is greatly at variance with that reflected by the corporate books, the evidence of such value should be filed with the return. In any case where there are two or more classes of stock outstanding, the total value of all the stock should be allocated among the different classes according to the relative value of each class.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6739, 29 FR 7713, June 17, 1964]

### § 1.542-4 Corporations filing consolidated returns.

(a) *General rule.* A consolidated return under section 1501 shall determine the application of the personal holding company tax to the group and to any member thereof on the basis of the consolidated gross income and consolidated personal holding company income of the group, as determined under the regulations prescribed pursuant to section 1502 (relating to consolidated returns); however, this rule shall not apply to either (1) an ineligible affiliated group as defined in section 542(b)(2) and paragraph (b) of this section, or (2) an affiliated group of corporations a member of which is excluded from the definition of a personal holding company under section 542(c) and paragraph (c) of this section. Thus, in the latter two instances the gross income requirement provided in sec-

tion 542(a)(1) and §1.542-2 shall apply to each individual member of the affiliated group of corporations.

(b) *Ineligible affiliated group.* (1) Except for certain affiliated railroad corporations, as provided in subparagraph (2) of this paragraph, an affiliated group of corporations is an ineligible affiliated group and therefore may not use its consolidated gross income and consolidated personal holding company income to determine the liability of the group or any member thereof for personal holding company tax (as provided in paragraph (a) of this section), if (i) any member of such group, including the common parent, derived gross income from sources outside the affiliated group for the taxable year in an amount equal to 10 percent or more of its gross income from all sources for that year and (ii) 80 percent or more of the gross income from sources outside the affiliated group consists of personal holding company income as defined in section 543 and §§1.543-1 and 1.543-2. For purposes of subdivision (i) of this subparagraph gross income shall not include certain dividend income received by a common parent from a corporation not a member of the affiliated group which qualifies under section 542(b)(4) and paragraph (d) of this section. See particularly the examples contained in paragraph (d)(2) of this section. Intercorporate dividends received by members of the affiliated group (including the common parent) are to be included in the gross income from all sources for purposes of the test in subdivision (i) of this subparagraph. For purposes of subdivision (ii) of this subparagraph, section 543 and paragraph (a) of §1.543-1 shall be applied as if the amount of gross income derived from sources outside the affiliated group by a corporation which is a member of such group is the gross income of such corporation.

(2) An affiliated group of railroad corporations shall not be considered to be an ineligible affiliated group, notwithstanding any other provisions of section 542(b)(2) and this paragraph, if the common parent of such group would be eligible to file a consolidated return

under section 141 of the Internal Revenue Code of 1939 prior to its amendment by the Revenue Act of 1942 (56 Stat. 798).

(3) See section 562(d) and § 1.562-3 for dividends paid deduction in the case of a distribution by a member of an ineligible affiliated group.

(4) The determination of whether an affiliated group of corporations is an ineligible group under section 542(b)(2) and this paragraph, may be illustrated by the following examples:

*Example 1.* Corporations X, Y, and Z constitute an affiliated group of corporations which files a consolidated return for the calendar year 1954; Corporations Y and Z are wholly-owned subsidiaries of Corporation X and derive no gross income from sources outside the affiliated group; Corporation X, the common parent, has gross income in the amount of \$250,000 for the taxable year 1954. \$200,000 of such gross income consists of dividends received from Corporations Y and Z. The remaining \$50,000 was derived from sources outside the affiliated group, \$40,000 of which represents personal holding company income as defined in section 543. The \$50,000 included in the gross income of Corporation X and derived from sources outside the affiliated group is more than 10 percent of X's gross income (\$50,000/\$250,000) and the \$40,000 which represents personal holding company income is 80 percent of \$50,000 (the amount considered to be the gross income of Corporation X). Accordingly, Corporations X, Y, and Z would be an ineligible affiliated group and the gross income requirement under section 542(a)(1) and § 1.542-2 would be applied to each corporation individually.

*Example 2.* If, in the above example, only \$30,000 of the \$50,000 derived from sources outside the affiliated group by Corporation X represented personal holding company income, this group of affiliated corporations would not be an ineligible affiliated group. Although the \$50,000 representing the gross income of Corporation X from sources outside the affiliated group is more than 10 percent of its total gross income, the amount of \$30,000 representing personal holding company income is not 80 percent or more of the amount considered to be gross income for the purpose of this test. Under section 542(b)(2) and subparagraph (1) of this paragraph both the gross income and the personal holding company income requirements must be satisfied in determining that an affiliated group constitutes an ineligible group. Since both of these requirements have not been satisfied in this example this group of affiliated corporations would not be an ineligible group.

(c) *Excluded corporations.* The general rule for determining liability of an affiliated group under paragraph (a) of this section shall not apply if any member thereof is a corporation which is excluded, under section 542(c), from the definition of a personal holding company.

(d) *Certain dividend income received by a common parent.* (1) Dividends received by the common parent of an affiliated group from a corporation which is not a member of the affiliated group shall not be included in gross income or personal holding company income, for the purpose of the test under section 542(b)(2):

(i) If such common parent owned, directly or indirectly, more than 50 percent of the outstanding voting stock of the dividend paying corporation at the time such common parent became entitled to the dividend, and

(ii) If the dividend paying corporation is not a personal holding company for the taxable year in which the dividends are paid.

Thus, if the tests in subdivisions (i) and (ii) of this subparagraph are met, the dividend income received by the common parent from such other corporation will not be considered gross income for purposes of the test in section 542(b)(2)(A) (paragraph (b) of this section), that is, either to determine gross income from sources outside the affiliated group or to determine gross income from all sources.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

*Example 1.* Corporation X is the common parent of Corporation Y and Corporation Z and together they constitute an affiliated group which files a consolidated return under section 1501. Corporation Y and Corporation Z derived no income from sources outside the affiliated group. Corporation X, the common parent, had gross income of \$100,000 for the calendar year 1954 of which amount \$20,000 represented a dividend received from Corporation W, and \$4,000 represented interest from Corporation T. The remaining gross income of X, \$76,000, was received from Corporations Y and Z. Corporation X, for its entire taxable year, owned 60 percent of the voting stock of Corporation W which was not a personal holding company for the calendar year 1954. For the purpose of the gross income and personal holding company income test under section 542(b)(2) and

paragraph (b) of this section, the \$20,000 dividend received from Corporation W would not be included in the gross income or personal holding company income of Corporation X. The affiliated group would not be an ineligible group under section 542(b)(2) because 10 percent or more of its gross income was not from sources outside the affiliated group as required by section 542(b)(2)(A). Inasmuch as the \$20,000 dividend from Corporation W is not included in the gross income of Corporation X for purposes of section 542(b)(2) Corporation X only has \$4,000 gross income from sources outside the affiliated group which is only 5 percent of its gross income from all sources, \$80,000.

*Example 2.* If, in example 1, Corporation X owned 50 percent or less of the voting stock of Corporation W at the time X became entitled to the dividend, or if Corporation W had been a personal holding company for the taxable year in which the dividends were paid, the \$20,000 dividends received by Corporation X would be included in gross income and personal holding company income of Corporation X for the purpose of the test under section 542(b)(2) and paragraph (b) of this section. Thus, the affiliated group would be an ineligible affiliated group under section 542(b)(2) because 24 percent of its gross income was from sources outside the affiliated group (\$24,000/\$100,000) and 100 percent of this \$24,000 was personal holding company income.

#### § 1.543-1 Personal holding company income.

(a) *General rule.* The term *personal holding company income* means the portion of the gross income which consists of the classes of gross income described in paragraph (b) of this section. See section 543(b) and § 1.543-2 for special limitations on gross income and personal holding company income in cases of gains from stocks', securities', and commodities' transactions.

(b) *Definitions—(1) Dividends.* The term *dividends* includes dividends as defined in section 316 and amounts required to be included in gross income under section 551 and §§ 1.551-1—1.551-2 (relating to foreign personal holding company income taxed to United States shareholders).

(2) *Interest.* The term *interest* means any amounts, includible in gross income, received for the use of money loaned. However, (i) interest which constitutes *rent* shall not be classified as interest but shall be classified as *rents* (see subparagraph (10) of this paragraph) and (ii) interest on amounts

set aside in a reserve fund under section 511 or 607 of the Merchant Marine Act, 1936 (46 U.S.C. 1161 or 1177), shall not be included in personal holding company income.

(3) *Royalties (other than mineral, oil, or gas royalties or certain copyright royalties).* The term *royalties* (other than mineral, oil, or gas royalties or certain copyright royalties) includes amounts received for the privilege of using patents, copyrights, secret processes and formulas, good will, trade marks, trade brands, franchises, and other like property. It does not, however, include rents. For rules relating to rents see section 543(a)(7) and subparagraph (10) of this paragraph. For rules relating to mineral, oil, or gas royalties, see section 543(a)(8) and subparagraph (11) of this paragraph. For rules relating to certain copyright royalties for taxable years beginning after December 31, 1959, see section 543(a)(9) and subparagraph (12) of this paragraph.

(4) *Annuities.* The term *annuities* includes annuities only to the extent includible in the computation of gross income. See section 72 and §§ 1.72-1—1.72-14 for rules relating to the inclusion of annuities in gross income.

(5) *Gains from the sale or exchange of stock or securities.* (i) Except in the case of regular dealers in stock or securities as provided in subdivision (ii) of this subparagraph, gross income and personal holding company income include the amount by which the gains exceed the losses from the sale or exchange of stock or securities. See section 543(b)(1) and § 1.543-2 for provisions relating to this limitation. For this purpose, there shall be taken into account all those gains includible in gross income (including gains from liquidating dividends and other distributions from capital) and all those losses deductible from gross income which are considered under chapter 1 of the Code to be gains or losses from the sale or exchange of stock or securities. The term *stock or securities* as used in section 543(a)(2) and this subparagraph includes shares or certificates of stock, stock rights or warrants, or interest in any corporation (including any joint stock company, insurance company, association, or other organization classified as a corporation by the Code), certificates