

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 ineli-

gible 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 of interest or participation in any profit-sharing agreement, or in any oil, gas, or other mineral property, or

lease, collateral trust certificates, voting trust certificates, bonds, debentures, certificates of indebtedness, notes, car trust certificates, bills of exchange, obligations issued by or on behalf of a State, Territory, or political subdivision thereof.

(ii) In the case of *regular dealers in stock or securities* there shall not be included gains or losses derived from the sale or exchange of stock or securities made in the normal course of business. The term *regular dealer in stock or securities* means a corporation with an established place of business regularly engaged in the purchase of stock or securities and their resale to customers. However, such corporations shall not be considered as regular dealers with respect to stock or securities which are held for investment. See section 1236 and § 1.1236-1.

(6) *Gains from futures transactions in commodities*. Gross income and personal holding company income include the amount by which the gains exceed the losses from futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange. See § 1.543-2 for provisions relating to this limitation. In general, for the purpose of determining such excess, there are included all gains and losses on futures contracts which are speculative. However, for the purpose of determining such excess, there shall not be included gains or losses from cash transactions, or gains or losses by a producer, processor, merchant, or handler of the commodity, which arise out of bona fide hedging transactions reasonably necessary to the conduct of its business in the manner in which such business is customarily and usually conducted by others. See section 1233 and § 1.1233-1.

(7) *Estates and trusts*. Under section 543(a)(4) personal holding company income includes amounts includible in computing the taxable income of the corporation under part I, subchapter J, chapter 1 of the Code (relating to estates, trusts, and beneficiaries); and any gain derived by the corporation from the sale or other disposition of any interest in an estate or trust.

(8) *Personal service contracts*. (i) Under section 543(a)(5) amounts received

under a contract under which the corporation is to furnish personal services, as well as amounts received from the sale or other disposition of such contract, shall be included as personal holding company income if:

(a) Some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract; and

(b) At any time during the taxable year 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform, such services. For this purpose, the amount of stock outstanding and its value shall be determined in accordance with the rules set forth in the last two sentences of paragraph (b) and in paragraph (c) of § 1.542-3. It should be noted that the stock ownership requirement of section 543(a)(5) and this subparagraph relates to the stock ownership at any time during the taxable year. For rules relating to the determination of stock ownership, see section 544 and §§ 1.544-1 through 1.544-7.

(ii) If the contract, in addition to requiring the performance of services by a 25-percent stockholder who is designated or who could be designated (as specified in section 543(a)(5) and subdivision (i) of this subparagraph), requires the performance of services by other persons which are important and essential, then only that portion of the amount received under such contract which is attributable to the personal services of the 25-percent stockholder shall constitute personal holding company income. Incidental personal services of other persons employed by the corporation to facilitate the performance of the services by the 25-percent stockholder, however, shall not constitute important or essential services. Under section 482 gross income, deductions, credits, or allowances between or among organizations, trades, or businesses may be allocated if it is determined that allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any

such organizations, trades, or businesses.

(iii) The application of section 543(a)(5) and this subparagraph may be illustrated by the following examples:

Example 1. A, whose profession is that of an actor, owns all of the outstanding capital stock of the M Corporation. The M Corporation entered into a contract with A under which A was to perform personal services for the person or persons whom the M Corporation might designate, in consideration of which A was to receive \$10,000 a year from the M Corporation. The M Corporation entered into a contract with the O Corporation in which A was designated to perform personal services for the O Corporation in consideration of which the O Corporation was to pay the M Corporation \$500,000 a year. The \$500,000 received by the M Corporation from the O Corporation constitutes personal holding company income.

Example 2. Assume the same facts as in example 1, except that, in addition to A's contract with the M Corporation, B, whose profession is that of a dancer and C, whose profession is that of a singer, were also under contract to the M Corporation to perform personal services for the person or persons whom the M Corporation might designate, in consideration of which they were each to receive \$25,000 a year from the M Corporation. Neither B nor C were stockholders of the M Corporation. The contract entered into by the M Corporation with the O Corporation, in addition to designating that A was to perform personal services for the O Corporation, designated that B and C were also to perform personal services for the O Corporation. Although the O Corporation particularly desired the services of A for an entertainment program it planned, it also desired the services of B and C, who were prominent in their fields, to provide a good supporting cast for the program. The services of B and C required under the contract are determined to be important and essential; therefore, only that portion of the \$500,000 received by the M Corporation which is attributable to the personal services of A constitutes personal holding company income. The same result would obtain although the dancer and the singer required by the contract were not designated by name but the contract gave the M Corporation discretion to select and provide the services of a singer and a dancer for the program and such services were provided.

Example 3. The N Corporation is engaged in engineering. Its entire outstanding capital stock is owned by four individuals. The N Corporation entered into a contract with the R Corporation to perform engineering services in consideration of which the R Corporation was to pay the N Corporation \$50,000.

The individual who was to perform the services was not designated (by name or by description) in the contract and no one but the N Corporation had the right to designate (by name or by description) such individual. The \$50,000 received by the N Corporation from the R Corporation does not constitute personal holding company income.

(9) *Compensation for use of property.* Under section 543(a)(6) amounts received as compensation for the use of, or right to use, property of the corporation shall be included as personal holding company income if, at any time during the taxable year, 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property. Thus, if a shareholder who meets the stock ownership requirement of section 543(a)(6) and this subparagraph uses, or has the right to use, a yacht, residence, or other property owned by the corporation, the compensation to the corporation for such use, or right to use, the property constitutes personal holding company income. This is true even though the shareholder may acquire the use of, or the right to use, the property by means of a sublease or under any other arrangement involving parties other than the corporation and the shareholder. However, if the personal holding company income of the corporation (after excluding any such income described in section 543(a)(6) and this subparagraph, relating to compensation for use of property, and after excluding any such income described in section 543(a)(7) and subparagraph (10) of this paragraph, relating to rents) is not more than 10 percent of its gross income, compensation for the use of property shall not constitute personal holding company income. For purposes of the preceding sentence, in determining whether personal holding company income is more than 10 percent of gross income, copyright royalties constitute personal holding company income, regardless of whether such copyright royalties are excluded from personal holding company income under section 543(a)(9) and subparagraph (12)(ii) of this paragraph. For purposes of applying section 543(a)(6) and this subparagraph, the amount of stock outstanding and its value shall be deter-

mined in accordance with the rules set forth in the last two sentences of paragraph (b) and in paragraph (c) of § 1.542-3. It should be noted that the stock ownership requirement of section 543(a)(6) and this subparagraph relates to the stock outstanding at any time during the entire taxable year. For rules relating to the determination of stock ownership, see section 544 and §§ 1.544-1 through 1.544-7.

(10) *Rents (including interest constituting rents).* Rents which are to be included as personal holding company income consist of compensation (however designated) for the use, or right to use, property of the corporation. The term *rents* does not include amounts includible in personal holding company income under section 543(a)(6) and subparagraph (9) of this paragraph. The amounts considered as rents include charter fees, etc., for the use of, or the right to use, property, as well as interest on debts owed to the corporation (to the extent such debts represent the price for which real property held primarily for sale to customers in the ordinary course of the corporation's trade or business was sold or exchanged by the corporation). However, if the amount of the rents includible under section 543(a)(7) and this subparagraph constitutes 50 percent or more of the gross income of the corporation, such rents shall not be considered to be personal holding company income.

(11) *Mineral, oil, or gas royalties.* (i) The income from mineral, oil, or gas royalties is to be included as personal holding company income, unless (a) the aggregate amount of such royalties constitutes 50 percent or more of the gross income of the corporation for the taxable year and (b) the aggregate amount of deductions allowable under section 162 (other than compensation for personal services rendered by the shareholders of the corporation) equals 15 percent or more of the gross income of the corporation for the taxable year.

(ii) The term *mineral, oil, or gas royalties* means all royalties, including overriding royalties and, to the extent not treated as loans under section 636, mineral production payments, received from any interest in mineral, oil, or

gas properties. The term *mineral* includes those minerals which are included within the meaning of the term *minerals* in the regulations under section 611.

(iii) The first sentence of subdivision (ii) of this subparagraph shall apply to overriding royalties received from the sublessee by the operating company which originally leased and developed the natural resource property in respect of which such overriding royalties are paid, and to mineral, oil, or gas production payments, only with respect to amounts received after September 30, 1958.

(12) *Copyright royalties*—(i) *In general.* The income from copyright royalties constitutes, generally, personal holding company income. However, for taxable years beginning after December 31, 1959, those copyright royalties which come within the definition of *copyright royalties* in section 543(a)(9) and subdivision (iv) of this subparagraph shall be excluded from personal holding company income only if the conditions set forth in subdivision (ii) of this subparagraph are satisfied.

(ii) *Exclusion from personal holding company income.* For taxable years beginning after December 31, 1959, copyright royalties (as defined in section 543(a)(9) and subdivision (iv) of this subparagraph) shall be excluded from personal holding company income only if the conditions set forth in (a), (b), and (c) of this subdivision are met.

(a) Such copyright royalties for the taxable year must constitute 50 percent or more of the corporation's gross income. For this purpose, copyright royalties shall be computed by excluding royalties received for the use of, or the right to use, copyrights or interests in copyrights in works created, in whole or in part, by any person who, at any time during the corporation's taxable year, is a shareholder.

(b) Personal holding company income for the taxable year must be 10 percent or less of the corporation's gross income. For this purpose, personal holding company income shall be computed by excluding (1) copyright royalties (except that there shall be included royalties received for the use of, or the right to use, copyrights or interests in copyrights in works created, in whole

or in part, by any shareholder owning, at any time during the corporation's taxable year, more than 10 percent in value of the outstanding stock of the corporation), and (2) dividends from any corporation in which the taxpayer owns, on the date the taxpayer becomes entitled to the dividends, at least 50 percent of all classes of stock entitled to vote and at least 50 percent of the total value of all classes of stock, provided the corporation which pays the dividends meets the requirements of subparagraphs (A), (B), and (C) of section 543(a)(9).

(c) The aggregate amount of the deductions allowable under section 162 must constitute 50 percent or more of the corporation's gross income for the taxable year. For this purpose, the deductions allowable under section 162 shall be computed by excluding deductions for compensation for personal services rendered by, and deductions for copyright and other royalties to, shareholders of the corporation.

(iii) *Determination of stock value and stock ownership.* For purposes of section 543(a)(9) and this subparagraph, the following rules shall apply:

(a) The amount and value of the outstanding stock of a corporation shall be determined in accordance with the rules set forth in the last two sentences of paragraph (b) and in paragraph (c) of § 1.542-3.

(b) The ownership of stock shall be determined in accordance with the rules set forth in section 544 and §§ 1.544-1 through 1.544-7.

(c) Any person who is considered to own stock within the meaning of section 544 and §§ 1.544-1 through 1.544-7 shall be a shareholder.

(iv) *Copyright royalties defined.* For purposes of section 543(a)(9) and this subparagraph, the term *copyright royalties* means compensation, however designated, for the use of, or the right to use, copyrights in works protected by copyright issued under title 17 of the United States Code (other than by reason of section 2 or 6 thereof), and to which copyright protection is also extended by the laws of any foreign country as a result of any international treaty, convention, or agreement to which the United States is a signatory. Thus, *copyright royalties* includes not

only royalties from sources within the United States under protection of United States laws relating to statutory copyrights but also royalties from sources within a foreign country with respect to United States statutory copyrights protected in such foreign country by any international treaty, convention, or agreement to which the United States is a signatory. The term *copyright royalties* includes compensation for the use of, or right to use, an interest in any such copyrighted works as well as payments from any person for performing rights in any such copyrighted works.

(v) *Compensation which is rent.* Section 543(a)(9) and subdivisions (i) through (iv) of this subparagraph shall not apply to compensation which is *rent* within the meaning of the second sentence of section 543(a)(7).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6739, 29 FR 7713, June 17, 1964; T.D. 7261, 38 FR 5467, Mar. 1, 1973]

§ 1.543-2 Limitation on gross income and personal holding company income in transactions involving stocks, securities, and commodities.

(a) Under section 543(b)(1) the gains which are to be included in gross income, and in personal holding company income with respect to transactions described in section 543(a)(2) and paragraph (b)(5) of § 1.543-1, shall be the net gains from the sale or exchange of stock or securities. If there is an excess of losses over gains from such transactions, such excess (or net loss) shall not be used to reduce gross income or personal holding company income for purposes of the personal holding company tax. Similarly, under section 543(b)(2) the gains which are to be included in gross income, and in personal holding company income with respect to transactions described in section 543(a)(3) and paragraph (b)(6) of § 1.543-1, shall be the net gains from commodity transactions which reflect personal holding company income. Any excess of losses over gains from such transactions (resulting in a net loss) shall not be used to reduce gross income or personal holding company income. The capital loss carryover under section 1212 shall not be taken into account.

(b) The application of section 543(b) may be illustrated by the following examples:

Example 1. The P Corporation, not a regular dealer in stocks and securities, received rentals of \$250,000 for its property from a 25-percent shareholder, and also had gains of \$50,000 during the taxable year from the sale of stocks and securities. It also had losses on the sale of stocks and securities in the amount of \$30,000. Accordingly, P Corporation had gross income during the taxable year of \$270,000 (\$250,000 plus \$20,000 net gain from the sales of stocks and securities). It had personal holding company income of \$20,000. (The rentals of \$250,000 would not be personal holding company income under section 543(a)(6) since the personal holding company income of the corporation, \$20,000 (after excluding any such income described in section 543(a)(6)), is not more than 10 percent of its gross income.)

Example 2. The R Corporation, not a regular dealer in stocks or securities, realized total gains during the taxable year of \$900,000 from commodity futures transactions and \$200,000 from the sales of stocks and securities. It also sustained total losses of \$1,000,000 on such commodity futures transactions, resulting in a net gain for the taxable year of \$100,000. None of the commodity futures transactions are hedging or other types of futures transactions excluded from the application of section 543(a)(3). No part of the loss on commodity futures transactions is to be taken into account in determining personal holding company income and gross income for personal holding company tax purposes for the taxable year. The full amount of the \$200,000 in gains from the sales of stocks and securities is to be included in personal holding company income and in gross income for personal holding company tax purposes for the taxable year.

§ 1.544-1 Constructive ownership.

(a) Rules relating to the constructive ownership of stock are provided by section 544 for the purpose of determining whether the stock ownership requirements of the following sections are satisfied:

(1) Section 542(a)(2), relating to ownership of stock by five or fewer individuals.

(2) Section 543(a)(5), relating to personal holding company income derived from personal service contracts.

(3) Section 543(a)(6), relating to personal holding company income derived from property used by shareholders.