

Year	Out-standing li-ability	Taxable in-come	Deduction as limited by taxable income	Amount at-tributable to part payment of \$200,000 in 1956	Amount at-tributable to release of lien in 1958
Total .....	.....	.....	.....	.....	850,000

(5)(i) If an amount has been included in undistributed personal holding company income of the personal holding company by reason of section 545(b)(9), any shareholder of the company may elect to compute his income tax with respect to such of his dividends as are attributable to such amount as though such dividends were received ratably over the period the lien was in effect.

(ii) For purposes of section 545(b)(9), the dividends paid during the taxable year of the personal holding company (computed as of the close of such year) shall be deemed attributable first to undistributed personal holding company income by reason of section 545(b)(9) (computed as of the close of the taxable year of the personal holding company). If the period over which the lien was in effect consists of several taxable years of the personal holding company, the dividend deemed received for any taxable year shall be deemed received on the last day of such taxable year of the personal holding company.

(iii) Such election shall be made in a statement showing the amount of the deduction under section 545(b)(9) for each taxable year of the period in which the lien was in effect, the amount of such deduction, if any, which was added to undistributed personal holding company income in a later year or years as a result of partial satisfaction or release of such lien, and the details thereof, the taxable year or years to which such dividends are allocable, and a computation of tax, on the basis of the election, for all taxable years affected by such ratable allocation of the dividends. Further, the statement shall show the district director's office in which the returns, for the years to which the dividends are allocable, were filed, the kind of returns which were filed (separate returns or joint returns), and the name and address under which the returns were filed. The statement shall be at-

tached to the shareholder's return for the taxable year for which the dividend would be reported but for such election.

(iv) The operation of this subparagraph may be illustrated as follows: If, in the example under subparagraph (4) of this paragraph, shareholder A owns 75 percent in value of the outstanding stock of the personal holding company, and receives a dividend of \$540,000 from such company during 1958 (the total dividend distribution being \$720,000) he may elect to compute his income tax with respect to the \$540,000 in dividends for 1958 as if he had received \$127,058.82 of such dividends for 1954 (\$200,000/850,000 of \$540,000), \$158,823.53 of such dividends for 1955 (\$250,000/850,000 of \$540,000), \$190,588.23 of such dividends for 1956 (\$300,000/850,000 of \$540,000), and \$63,529.41 of such dividends for 1957 (\$100,000/850,000 of \$540,000). Accordingly, the tax computed for 1958 with respect to such dividends shall be the aggregate of the taxes attributable to such amounts had they been distributed in the respective years.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6805, 30 FR 3209, Mar. 9, 1965; T.D. 6841, 30 FR 9305, July 27, 1965; T.D. 6949, 33 FR 5526, Apr. 9, 1968; T.D. 7207, 37 FR 20796, Oct. 5, 1972; T.D. 7429, 41 FR 35492, Aug. 23, 1976; T.D. 7649, 44 FR 60086, Oct. 18, 1979]

#### § 1.545-3 Special adjustment to taxable income.

(a) *In general.* In computing undistributed personal holding company income for any taxable year beginning after December 31, 1963, section 545(c) (1) provides that, except as otherwise provided in section 545(c), there shall be allowed as a deduction amounts used or amounts irrevocably set aside (to the extent reasonable with reference to the size and terms of the indebtedness) during such year to pay or retire qualified indebtedness (as defined in section 545(c)(3) and paragraph (d) of this section). The reasonableness

of amounts irrevocably set aside shall be determined under the rules of paragraph (g)(4) of § 1.545-2.

(b) *Amounts used or irrevocably set aside*—(1) *In general.* The deduction is allowable, in any taxable year, only for amounts used or irrevocably set aside in that year to extinguish or discharge qualified indebtedness. If amounts are set aside in 1 year, no deduction is allowable for a later year in which such amounts are actually paid. As long as all other conditions are satisfied, the aggregate amount allowable as a deduction for any taxable year includes all amounts (from whatever source) used and all amounts (from whatever source) irrevocably set aside, irrespective of whether in cash or other medium. The same item shall not be deducted more than once.

(2) *Refunding, etc., of qualified indebtedness.* (i) A refunding, renewal or mere change in the form of a qualified indebtedness which does not involve a substantial change in the economic terms of the indebtedness will not result in an allowable deduction whether or not funds are obtained from such refunding, renewal, or change in form, and whether or not such funds are applied on the prior obligation, and will not constitute a reduction in the amount of such qualified indebtedness. For purposes of this section, if, in connection with a refunding, renewal, or other change in the form of an indebtedness, the rate of interest or principal amount of such debt, or the date when payment is due with respect to such debt or significantly changed, or if, after the refunding, renewal, or other change in the form of such debt, the creditor to whom such debt is owed is neither the creditor to whom such debt was owed before such refunding, renewal, or other change, nor a person standing in a relationship to such creditor described in section 267(b), then a substantial change in the economic terms of such indebtedness will normally have occurred.

(ii) The application of this subparagraph may be illustrated by the following examples:

*Example 1.* On December 31, 1963, M owes \$10,000 to X represented by a 6-percent, 90-day note payable on January 31, 1964. On January 31, 1964, M renews the debt, giving X

a new 6-percent, 90-day note (payable on Apr. 30, 1964) and paying the accrued interest on the old note. Since the date when payment is due has been significantly changed, a substantial change in the economic terms of the indebtedness has occurred.

*Example 2.* On December 31, 1963, S owes \$5,000 to T represented by a 6-percent note payable on January 1, 1965. On December 23, 1964, S liquidates the note, giving T a new note for \$5,000 due on January 2, 1965, and bearing interest at 6 percent. Since the transaction does not involve a substantial change in the economic terms of the indebtedness, the transaction will not result in an allowable deduction, and the amount of the qualified indebtedness will not be reduced.

*Example 3.* (i) On December 31, 1963, Q owes \$45,000 to R represented by a demand note. On July 1, 1964, Q renews \$30,000 of the indebtedness by issuing a new demand note to R and liquidates \$15,000 of the debt. Since the principal amount of the debt has been significantly changed, there has been a substantial change in the economic terms of the indebtedness.

(ii) If Q had issued renewal notes for \$44,000 and had paid only \$1,000 of the total indebtedness, then a significant change in the principal amount of the debt would not have occurred and Q would have been entitled to only a \$1,000 deduction (the amount actually paid during the taxable year). In addition, the amount of qualified indebtedness would have been reduced to \$44,000.

(c) *Corporations to which applicable.* Section 545(c)(2) describes the corporations to which section 545(c) applies. In order to qualify under section 545(c)(2), the corporation must be one:

(1) Which for at least one of its two most recent taxable years ending before February 26, 1964, was not a personal holding company under section 542, but which would have been a personal holding company under section 542 for such taxable year if the law applicable for the first taxable year beginning after December 31, 1963, had been applicable to such taxable year; or

(2) Which is an acquiring corporation treated as a corporation described in subparagraph (1) of this paragraph by reason of section 381(c)(15) (relating to the carryover of certain indebtedness in corporate acquisitions), but only to the extent of the qualified indebtedness to which it has succeeded under section 381(c)(15) and the indebtedness referred to in paragraph (d)(1)(ii) of this section incurred to replace qualified indebtedness to which it has succeeded under section 381(c)(15).

The law applicable for the first taxable year beginning after December 31, 1963, for purposes of this paragraph means part II (section 541 and following), subchapter G, chapter 1 of the Code as applicable to such year but does not include amendments to other parts of the Code first applicable with respect to such year. For an example of a corporation described in subparagraph (1) of this paragraph see paragraph (f)(1) of § 1.333-5.

(d) *Qualified indebtedness*—(1) *General definition.* Except as provided in subparagraphs (2), (3), and (4) of this paragraph the term *qualified indebtedness* means:

(i) The outstanding indebtedness (as defined in subparagraph (6) of this paragraph) incurred after December 31, 1933, and before January 1, 1964, by the taxpayer (or to which the taxpayer succeeded in a transaction to which section 381(c)(15) applies), and

(ii) The outstanding indebtedness (as defined in subparagraph (6) of this paragraph) incurred after December 31, 1963, by the taxpayer (or to which the taxpayer succeeded in a transaction to which section 381(c)(15) applies) for the purpose of making a payment or set-aside referred to in paragraph (a) of this section in the same taxable year of the debtor in which such indebtedness was incurred. An indebtedness shall be deemed not to have been incurred for the purpose of making a payment or set-aside referred to in paragraph (a) of this section when such indebtedness is a consequence of a refunding, renewal or mere change in the form of a qualified indebtedness which does not involve a substantial change in the economic terms of the qualified indebtedness. (See paragraph (b)(2) of this section for the meaning of *substantial change in the economic terms of the indebtedness*.) In the case of such a payment or set-aside which is made on or after the first day of the first taxable year beginning after December 31, 1963, such indebtedness incurred after December 31, 1963, is treated as qualified indebtedness only to the extent that the deduction from taxable income otherwise allowed by section 545(c)(1) with respect to such payment or set-aside is treated as non-deductible by

reason of the election referred to in paragraph (e) of this section.

(2) *Exception for indebtedness owed to certain shareholders.* For purposes of subparagraph (1) of this paragraph, qualified indebtedness does not include any amounts which were, at any time after December 31, 1963, and before the payment or set-aside to which this section applies, owed directly or indirectly to a person who at such time owned more than 10 percent in value of the taxpayer's outstanding stock. The rules of section 318(a) and the regulations thereunder apply for the purpose of determining ownership under this subparagraph. Amounts which cease to be qualified indebtedness by reason of this subparagraph may not subsequently become qualified indebtedness as a result of any change in the facts (for example, a subsequent sale of stock by the person to whom the amounts are directly or indirectly owed).

(3) *Reduction for amounts irrevocably set aside.* For purposes of subparagraph (1) of this paragraph, qualified indebtedness with respect to a particular contract is reduced when and to the extent that amounts are irrevocably set aside to pay or retire such indebtedness. An amount is not considered to be irrevocably set aside if any person could use such amount for any purpose other than the retirement of the qualified indebtedness with respect to which it was set aside. No deduction is allowed under section 545(c)(1) and this section for payments out of amounts previously set aside. Thus, for example, if a corporation, which is a June 30 fiscal year taxpayer, incurs indebtedness of \$1 million on February 1, 1962, and, in accordance with its contract of indebtedness, irrevocably sets aside \$50,000 in a sinking fund on February 1, of each of the years 1963, 1964, and 1965, then its qualified indebtedness on January 1, 1964, is \$950,000 (\$1 million less one set-aside of \$50,000 in 1963). The corporation is not allowed a deduction under section 545(c)(1) for the set-aside of \$50,000 made during its taxable year ending on June 30, 1964, since section 545(c) is applicable only to taxable years beginning after December 31, 1963, but the qualified indebtedness is nevertheless reduced by such amount.

The corporation is allowed a deduction of \$50,000 for its taxable year ending June 30, 1965, as a result of the set-aside made during such taxable year, and qualified indebtedness on July 1, 1965, is \$850,000. No deduction is allowed to the corporation for a payment in any subsequent taxable year from the amounts so set aside.

(4) *Reduction on disposition of certain property.* (i) Section 545(c)(6) provides that the total amount of the taxpayer's qualified indebtedness (as determined under subdivision (ii) of this subparagraph) shall be reduced if property of a character subject to the allowance for exhaustion, wear and tear, obsolescence, amortization, or depletion is disposed of after December 31, 1963. The reduction is made pro rata (in accordance with subdivision (iii) of this subparagraph) for the taxable year of such disposition and is equal in total amount to the excess, if any, of:

(a) The adjusted basis of the property disposed of (determined under section 1011 and the regulations thereunder) immediately before such disposition; over

(b) The amount of qualified indebtedness which ceased to be qualified indebtedness with respect to the taxpayer by reason of the assumption of indebtedness by the transferee of the property disposed of (whether or not such indebtedness was incurred by the taxpayer in connection with the property disposed of).

For purposes of (b) of this subdivision, the transferee will be treated as having assumed qualified indebtedness if such transferee acquires real estate of which the taxpayer is the legal or equitable owner immediately before the transfer and which is subject to indebtedness that, with respect to the taxpayer, is qualified indebtedness immediately before the transfer, provided the taxpayer shows to the satisfaction of the Commissioner that under all the facts and circumstances it no longer bears the burden of discharging such indebtedness.

(ii) The indebtedness reduced under the rule of this subparagraph is the qualified indebtedness which is outstanding with respect to the taxpayer immediately after the disposition re-

ferred to in subdivision (i) of this subparagraph.

(iii) The reduction with respect to any particular contract of indebtedness under the rules of this subparagraph shall be determined by multiplying the total reduction (determined under subdivision (i) of this subparagraph) by the ratio which the amount of the qualified indebtedness owed with respect to such contract by the taxpayer on the date referred to in subdivision (ii) of this subparagraph bears to the aggregate qualified indebtedness owed by the taxpayer with respect to all contracts on such date.

(5) *Total debt consisting of both qualified and nonqualified indebtedness.* In any case where, with respect to a particular contract of indebtedness, a part of the total indebtedness owed with respect to such contract is qualified indebtedness and the other part is indebtedness which is not qualified indebtedness, then, any amount paid or irrevocably set aside with respect to such contract shall be allocated between both such parts pro rata unless the taxpayer clearly indicates in its return the part of the payment or set-aside which shall be allocated to the qualified indebtedness.

(6) *Outstanding indebtedness.* For purposes of determining qualified indebtedness, the term *indebtedness* has the same meaning that it has under section 545(b)(7) and paragraph (g)(2) of § 1.545-2. Indebtedness ceases to be outstanding when the taxpayer no longer has an obligation absolute and not contingent with respect to the payment of such debt. An indebtedness evidenced by bonds, notes, or other obligations issued by a corporation is ordinarily incurred as of the date such obligations are issued, and the amount of such indebtedness is the amount represented by the face value of the obligations. However, a refunding, renewal, or mere change in the form of an indebtedness which does not involve a substantial change in the economic terms of the indebtedness will not have the effect of changing the date the indebtedness was incurred. (See paragraph(b)(2) of this section for the meaning of *substantial change in the economic terms of the indebtedness*.) For purposes of this section, the outstanding indebtedness of a

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taxpayer includes a mortgage or other security interest on real estate of which such taxpayer is the legal or equitable owner (even though the taxpayer is not directly liable on the underlying evidence of indebtedness secured by such mortgage or security interest) provided such taxpayer shows to the satisfaction of the Commissioner that under all of the facts and circumstances it bears the burden of discharging such indebtedness. Thus, for example, if X acquires from Y property which is subject to a mortgage (X not assuming the indebtedness underlying such mortgage) and if X actually bears the burden of discharging the indebtedness, then, after the date of acquisition, such underlying indebtedness is outstanding indebtedness with respect to X, and, since Y's obligation to pay is in fact contingent upon X failing to discharge the indebtedness, such indebtedness is not outstanding indebtedness with respect to Y.

(7) *Examples.* The application of this paragraph may be illustrated by the following examples:

*Example 1.* M Corporation, a calendar year taxpayer has \$600,000 of indebtedness outstanding on December 31, 1963 (which was incurred after 1933), represented by three demand notes. Individuals A and B (who are not shareholders) each hold one of M Corporation's notes in the amount of \$150,000 and N Corporation (which is not a shareholder) holds M Corporation's note in the amount of \$300,000. The note held by N Corporation is secured by a mortgage on certain depreciable real estate owned by M Corporation which has an adjusted basis to it on July 1, 1964, of \$500,000. On July 1, 1964, M Corporation sells the depreciable real estate to O Corporation in consideration for \$200,000 in cash and the assumption by O Corporation of the indebtedness on the note held by N Corporation. M Corporation borrows \$200,000 on September 30, 1964, of which amount \$150,000 is simultaneously applied to liquidate the note held by B. M Corporation's qualified indebtedness is reduced on July 1, 1964, by \$300,000, the qualified indebtedness which ceased to be outstanding by reason of the transfer. In addition, the reduction (computed under section 545(c)(6) and subparagraph (4) of this paragraph) of M Corporation's qualified indebtedness by reason of the disposition of depreciable property on July 1, 1964, is as follows:

Outstanding qualified indebtedness after reduction of qualified indebtedness which ceased to be outstanding by reason of the transfer but before the sec. 545(c)(6) reduction .....	\$300,000
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Reduced by:	
The excess of the adjusted basis of depreciable real estate disposed of on July 1, 1964 (\$500,000), over the amount of qualified indebtedness assumed by O Corporation (\$300,000) .....	200,000
Qualified indebtedness after reductions from transfer and assumption of indebtedness .....	100,000

The pro-rata share of the reduction with respect to each debt is computed as follows:

Note held by A:	
Qualified indebtedness owed by taxpayer on the note held by A before the disposition of depreciable property .....	\$150,000
Less the pro-rata share of the total reduction computed under subparagraph (4) of this paragraph allocable to such note $\$200,000 \times (\$150,000 + \$300,000)$ .....	100,000
Qualified indebtedness owed on the note held by A after the transfer .....	50,000
Note held by B:	
Qualified indebtedness owed by taxpayer on the note held by B before the transfer of depreciable property .....	\$150,000
Less the pro-rata share of the total reduction computed under subparagraph (4) of this paragraph allocable to such note $\$200,000 \times (\$150,000 + \$300,000)$ .....	100,000
Qualified indebtedness owed on the note held by B after the transfer .....	50,000

Of the \$150,000 paid by M Corporation on September 30, 1964, to retire the note held by B only \$50,000 qualified as a use of an amount to pay or retire qualified indebtedness and, thus, only \$50,000 is allowable as a deduction for purposes of computing undistributed personal holding company income for 1964.

*Example 2.* The facts are the same as in example 1 except that M Corporation elects in accordance with paragraph (e) of this section not to deduct \$25,000 of the \$50,000 amount otherwise deductible. Then \$25,000 of the \$200,000 of new indebtedness incurred by M Corporation is qualified indebtedness. If the payment on the note held by B had not been made until January 1, 1965, then the new indebtedness would not be qualified indebtedness since the payment was not made in the taxable year in which the new indebtedness was incurred. If M Corporation pays \$40,000 on April 1 and July 1, 1965, on the indebtedness incurred September 30, 1964, then (unless M indicates otherwise in its return for 1965 in accordance with subparagraph (5) of this paragraph) the payments made on such dates must be allocated between qualified and nonqualified indebtedness in the following manner:

	Qualified	Non-qualified
<i>April 1 payment:</i>		
\$40,000 × 25,000 (qualified) + \$200,000 (total indebtedness) .....	\$5,000	

	Qualified	Non-qualified
\$40,000×\$175,000 (non-qualified)+\$200,000 (total indebtedness) .....		\$35,000
<i>July 1 payment:</i>		
\$40,000×\$20,000 (qualified)+\$160,000 (total indebtedness) .....	5,000	
\$40,000×\$140,000 (non-qualified)+\$160,000 (total indebtedness) .....		35,000
<b>Total</b> .....	<b>10,000</b>	<b>70,000</b>

Thus, a total of \$10,000 of the two payments would be considered used to pay or retire qualified indebtedness. The results in examples 1 and 2 would be the same if O Corporation purchased the real estate subject to the indebtedness (not assuming the indebtedness) on the note held by N Corporation, provided M Corporation does not bear the burden of discharging such indebtedness after July 1, 1964.

*Example 3.* C owns all of the 1000 shares of outstanding capital stock of P Corporation. On December 31, 1963, P Corporation, a calendar year taxpayer, owes \$200,000 of outstanding indebtedness to D and \$500,000 of outstanding indebtedness to E. These debts were incurred after 1933. On January 15, 1964, P Corporation pays \$100,000 in partial liquidation of the \$500,000 indebtedness. On March 15, 1964, P Corporation pays \$50,000 into a sinking fund with respect to the \$200,000 indebtedness owed to D. On April 15, 1964, D purchases one-half of the shares owned by C, constituting 50 percent in value of P Corporation's outstanding stock. P Corporation, on June 15, 1964, pays \$50,000 into a sinking fund with respect to the indebtedness owed to D. For purposes of the March 15, 1964, set-aside, the indebtedness owed to D (\$200,000) is qualified indebtedness. However, the indebtedness owed to D is not qualified indebtedness for purposes of the June set-aside with respect to such indebtedness since D is a person who after December 31, 1963, and before the June set-aside, owned more than 10 percent in value of P Corporation's outstanding stock. Moreover, any subsequent set-asides made with respect to the indebtedness owed to D will not be made with respect to qualified indebtedness even if the shares owned by D are subsequently sold. Assuming no payments or set-asides are made by P Corporation after June 15, 1964, the P Corporation is entitled to a deduction of \$150,000 under section 545(c)(1) for the calendar year 1964 for amounts paid and for amounts irrevocably set aside to pay or retire qualified indebtedness, and the total qualified indebtedness at the end of 1964 is \$400,000. No additional deduction is allowed in subsequent taxable years for amounts paid out of the amounts set aside in 1964.

(e) *Election not to deduct*—(1) *In general.* Section 545(c)(4) provides that a taxpayer may elect to treat as non-deductible amounts otherwise deductible under section 545(c)(1) for the taxable year. The election shall be in the form of a statement of election filed on or before the 15th day of the third month following the close of the taxable year with respect to which the election applies. The election shall be irrevocable after such date.

(2) *Statement of election.* The statement of election referred to in subparagraph (1) of this paragraph shall be attached to the taxpayer's Schedule PH (Form 1120) for the year with respect to which such election applies, if such schedule is filed on or before the date referred to in subparagraph (1) of this paragraph. If the taxpayer's Schedule PH (Form 1120) is not filed on or before such date, then the statement of election shall clearly set forth the taxpayer's name, address, and employer identification number, shall be signed by an officer of the taxpayer who is authorized to sign a return of the taxpayer with respect to income, and shall be filed with the district director for the internal revenue district in which the taxpayer's income tax return (for the year with respect to which the election is applicable) would be filed. The following information shall be included in the statement of election:

(i) A statement that the taxpayer wishes to elect in accordance with section 545(c)(4);

(ii) The amounts paid or set aside which are to be treated as nondeductible under section 545(c)(4) and this section;

(iii) All information necessary to identify the qualified indebtedness with respect to which such amounts were paid or set aside;

(iv) The date on which such payments or set-asides were made; and

(v) All information necessary to identify the indebtedness (referred to in section 545(c)(3)(A)(ii) and paragraph (d)(1)(ii) of this section) incurred for the purpose of making the payments or set-asides which the taxpayer elects to treat as nondeductible, including:

(a) The date on which such indebtedness was incurred;

(b) The amount of such indebtedness;

(c) The person or persons to whom such indebtedness is owed; and

(d) A statement that such person or persons do not own more than 10 percent in value of the taxpayer's outstanding stock.

(f) *Limitation on deduction*—(1) *In general.* Section 545(c)(5) provides certain limitations on the deduction otherwise allowed by section 545(c)(1). Such deduction is reduced by the sum of the following amounts:

(i) The amount, if any, by which:

(a) The deductions allowed for the taxable year and all preceding taxable years beginning after December 31, 1963, for exhaustion, wear and tear, obsolescence, amortization, or depletion (other than such deductions which are disallowed in computing undistributed personal holding company income under the rule of paragraph (h) of §1.545-2), exceed

(b) Any reduction, by reason of section 545(c)(5)(A) and this subdivision (i), of the deductions otherwise allowed by section 545(c)(1) for such preceding years; and

(ii) The amount, if any, by which:

(a) The deductions allowed under section 545(b)(5) (relating to long-term capital gain deduction) in computing undistributed personal holding company income for the taxable year and all preceding taxable years beginning after December 31, 1963, exceed

(b) Any reduction, by reason of section 545(c)(5)(B) and this subdivision (ii), of the deductions otherwise allowed by section 545(c)(1) for such preceding years.

(2) *Allocation of reduction.* If the total reduction required by subparagraph (1) of this paragraph is greater than the amount of the payment or set-aside made in respect of qualified indebtedness in a taxable year, then the portion

of the reduction which is attributable to either section 545(c)(5)(A) or section 545(c)(5)(B), as the case may be, is that portion which bears the same ratio to the total reduction as the total reduction available under either section 545(c)(5)(A) or section 545(c)(5)(B), respectively, bears to the total reduction available under both such sections.

(3) *Example.* The provisions of this paragraph may be illustrated by the following example:

*Example.* (i) Q Corporation, a calendar year taxpayer, has qualified indebtedness of \$400,000 on January 1, 1964, with respect to which payments of \$50,000 are made on April 15, 1964, and 1965, and \$300,000 on April 15, 1966. In the years 1964 and 1966, Q Corporation is allowed a deduction under section 545(b)(5) of \$50,000 for the excess of its net long-term capital gain over its net short-term capital loss, minus the taxes attributable to such excess. Q Corporation is allowed a depreciation deduction of \$50,000 for each of its taxable years 1964 through 1966. Q Corporation is a personal holding company with taxable income of \$200,000 in each of the years 1964 and 1966.

(ii) For 1964, in computing undistributed personal holding company income, Q Corporation's taxable income is reduced by \$50,000 by reason of the deduction under section 545(b)(5). No part of the depreciation deduction is disallowed under the rule of paragraph (h) of §1.545-2. Q Corporation's deduction for payment of qualified indebtedness otherwise allowable under section 545(c)(1) and this section is reduced to zero by reason of the depreciation deduction and the capital gains deduction. The reduction by reason of section 545(c)(5)(A) and subparagraph (1)(i) of this paragraph (depreciation) is \$25,000 [(\$50,000 + \$100,000) × \$50,000], and the reduction by reason of section 545(c)(5)(B) and subparagraph (1)(ii) of this paragraph (capital gain) is \$25,000 [(\$50,000 + \$100,000) × \$50,000].

(iii) For 1966, Q Corporation is allowed a deduction for payment of qualified indebtedness of \$100,000 computed as follows:

Amount paid in 1966 to retire qualified indebtedness .....				\$300,000
Less the sum of:				
(a) Depreciation deductions allowed for 1964 through 1966 (3×\$50,000) .....	\$150,000			
Reduction of deductions in preceding taxable years (1964) .....	25,000	\$125,000		
(b) Deduction allowed under section 545(b)(5) (relating to long-term capital gains) for 1964 through 1966 .....	100,000			
Reduction of deductions in preceding taxable years (1964) .....	25,000	75,000	200,000	
Deduction after reduction .....				100,000

(iv) If, in the year 1966, Q Corporation's depreciation deduction had been limited for

purposes of computing undistributed personal holding company income to \$25,000 by

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reason of section 545(b)(8), then Q Corporation's deduction for payment of qualified in-

debtedness would be \$125,000, computed as follows:

Amounts paid in 1966 to retire qualified indebtedness .....				\$300,000
Less the sum of:				
(a) Depreciation deductions allowed for 1964 through 1966 .....	\$125,000			
Reduction of deductions in preceding taxable year (1964) .....	25,000			
				\$100,000
(b) Deduction allowed under section 545(b)(5) (relating to long-term capital gains) for 1964 through 1966 .....	100,000			
Reduction of deductions in preceding taxable years (1964) .....	25,000	75,000	175,000	
				125,000
Deduction after reduction .....				125,000

(g) *Burden of proof.* The burden of proof rests upon the taxpayer to sustain the deduction claimed under this section. In addition to any information required by this section, the taxpayer must furnish the information required by the return, and such other information as the district director may require in substantiation of the deduction claimed.

(h) *Application of section 381(c)(15).* Under section 381(c)(15), if an acquiring corporation assumes liability for qualified indebtedness in a transaction to which section 381(a) applies, then the acquiring corporation is considered to be the distributor or transferor corporation for purposes of section 545(c). Paragraph (c)(2) of this section reflects the application of section 381(c)(15) by including an acquiring corporation within the definition of corporation to which this section applies. Thus, the acquiring corporation is not required to meet the requirements of paragraph (c)(1) or paragraph (d)(1) of this section with respect to such acquired qualified indebtedness to which section 381(c)(15) is applicable. All the other provisions of this section apply in full to the acquiring corporation with respect to such acquired indebtedness.

[T.D. 6949, 33 FR 5526, Apr. 9, 1968; 33 FR 6091, Apr. 20, 1968]

**§ 1.547-1 General rule.**

Section 547 provides a method under which, by virtue of dividend distributions, a corporation may be relieved from the payment of a deficiency in the personal holding company tax imposed by section 541 (or by a corresponding provision of a prior income tax law), or may be entitled to a credit or refund of a part or all of any such deficiency which has been paid. The method pro-

vided by section 547 is to allow an additional deduction for a dividend distribution (which meets the requirements of this section) in computing undistributed personal holding company income for the taxable year for which a deficiency in personal holding company tax is determined. The additional deduction for deficiency dividends will not, however, be allowed for the purpose of determining interest, additional amounts, or assessable penalties, computed with respect to the personal holding company tax prior to the allowance of the additional deduction for deficiency dividends. Such amounts remain payable as if section 547 had not been enacted.

**§ 1.547-2 Requirements for deficiency dividends.**

(a) *In general.* There are certain requirements which must be fulfilled before a deduction is allowed for a deficiency dividend under section 547 and this section. These are:

(1) The taxpayer's liability for personal holding company tax shall be determined only in the manner provided in section 547(c) and paragraph (b)(1) of this section.

(2) The deficiency dividend shall be paid by the corporation on, or within 90 days after, the date of such determination and prior to the filing of a claim under section 547(e) and paragraph (b)(2) of this section for deduction for deficiency dividends. This claim must be filed within 120 days after such determination.

(3) The deficiency dividend must be of such a nature as would have permitted its inclusion in the computation of a deduction for dividends paid under section 561 for the taxable year with respect to which the liability for