paragraph, a nonresident foreign corporation will be considered to have filed a return for any taxable year ending before September 9, 1958, if the return for any such taxable year is filed on or before February 5, 1960.

[T.D. 6949, 33 FR 5525, Apr. 9, 1968]

### § 1.545–2 Adjustments to taxable income.

(a) *Taxes*—(1) *General rule.* (i) In computing undistributed personal holding company income for any taxable year, there shall be allowed as a deduction the amount by which Federal income and excess profits taxes accrued during the taxable year exceed the credit provided by section 33 (relating to taxes of foreign countries and possessions of the United States), and the income, war profits, and excess profits taxes of foreign countries and possessions of the United States accrued during the taxable year (to the extent provided by subparagraph (3) of this paragraph), except that no deduction shall be allowed for (*a*) the accumulated earnings tax imposed by section 531 (or a corresponding section of a prior law), (*b*) the personal holding company tax imposed by section 541 (or a corresponding section of a prior law), and (*c*) the excess profits tax imposed by subchapter E, chapter 2 of the Internal Revenue Code of 1939, for taxable years beginning after December 31, 1940. The deduction is for taxes for the taxable year, determined under the accrual method of accounting, regardless of whether the corporation uses an accrual method of accounting, the cash receipts and disbursement method, or any other allowable method of accounting. In computing the amount of taxes accrued, an unpaid tax which is being contested is not considered accrued until the contest is resolved.

(ii) However, the taxpayer shall deduct taxes paid, rather than taxes accrued, if it used that method with respect to Federal taxes for each taxable year for which it was subject to the tax imposed by section 500 of the Internal Revenue Code of 1939, unless an election is made under subparagraph (2) of this paragraph to deduct taxes accrued.

(2) *Election by taxpayer which deducted taxes paid.* (i) If the corporation was subject to the personal holding company tax imposed by section 500 of the Internal Revenue Code of 1939 and, for the purpose of that tax, deducted Federal taxes paid rather than such taxes accrued for each taxable year for which it was subject to such taxes, the corporation may elect for any taxable year ending after June 30, 1954, to deduct taxes accrued, including taxes of foreign countries and possessions of the United States, rather than taxes paid, for the purposes of the tax imposed by section 541 of the Internal Revenue Code of 1954. The election shall be made by deducting such taxes accrued on Schedule PH, Form 1120, to be filed with the return. The schedule shall, in addition, contain a statement that the corporation has made such election and shall set forth the year to which such election was first applicable. The deduction of taxes accrued in the year of election precludes the deduction of taxes paid during such year. The election, if made, shall be irrevocable and the deduction for taxes accrued shall be allowed for the year of election and for all subsequent taxable years.

(ii) Pursuant to section 7851(a)(1)(C), the election provided for in subdivision (i) of this subparagraph may be made with respect to a taxable year ending after June 30, 1954, even though such taxable year is subject to the Internal Revenue Code of 1939.

(3) *Taxes of foreign countries and United States possessions.* In determining undistributed personal holding company income for any taxable year, if the taxpayer chooses the benefits of section 901 for such taxable year, a deduction shall be allowed for:

(i) The income, war profits, and excess profits taxes imposed by foreign countries or possessions of the United States and accrued (or paid, if required under subparagraph (1)(ii) of this paragraph) during such taxable year, and

(ii) In the case of a domestic corporation, the foreign income taxes deemed to be paid for such taxable year under section 902(a) in accordance with §§ 1.902–1 and 1.902–2 or section 960(a)(1) in accordance with § 1.960–7.

In no event shall the amount under subdivision (ii) of this subparagraph exceed the amount includible in gross income with respect to such taxes under section 78 and § 1.78–1. The credit for

such taxes provided by section 901 shall not be allowed against the personal holding company tax imposed by section 541. See section 901(a).

(b) *Charitable contributions*—(1) *Taxable years beginning before January 1, 1970.* (i) Section 545(b)(2) provides that, in computing the deduction for charitable contributions for purposes of determining undistributed personal holding company income of a corporation for taxable years beginning before January 1, 1970, the limitations in section 170(b)(1) (A) and (B), relating to charitable contributions by individuals, shall apply and section 170(b) (2) and (5), relating to charitable contributions by corporations and carryover of certain excess charitable contributions made by individuals, respectively, shall not apply.

(ii) Although the limitations of section 170(b)(1) (A) and (B) are 10 and 20 percent, respectively, of the individual's adjusted gross income, the limitations are applied for purposes of section 545(b)(2) by using 10 and 20 percent, respectively, of the corporation's taxable income as adjusted for purposes of section 170(b)(2), that is, the same amount of taxable income to which the 5-percent limitation applied. Thus, the term *adjusted gross income* when used in section 170(b)(1) means the corporation's taxable income computed with the adjustments, other than the 5-percent limitation, provided in the first sentence of section 170(b)(2). However, a further adjustment for this purpose is that the taxable income shall also be computed without the deduction of the amount disallowed under section 545(b)(8), relating to expenses and depreciation applicable to property of the taxpayer. The carryover of charitable contributions made in a prior year, otherwise allowable as a deduction in computing taxable income to the extent provided in section 170(b)(2) and, with respect to contributions paid in taxable years beginning after December 31, 1963, in section 170(b)(5), shall not be allowed as a deduction in computing undistributed personal holding company income for any taxable year.

(iii) See §1.170–2 with respect to the charitable contributions to which the 10-percent limitation is applicable and the charitable contributions to which the 20-percent limitation is applicable.

(2) *Taxable years beginning after December 31, 1969.* (i) Section 545(b)(2) provides that, in computing the deduction allowable for charitable contributions for purposes of determining undistributed personal holding company income of a corporation for taxable years beginning after December 31, 1969, the limitations in section 170(b)(1) (A), (B), and (D)(i) (relating to charitable contributions by individuals) shall apply, and section 170(b)(1)(D)(ii) (relating to excess charitable contributions by individuals of certain capital gain property, section 170(b)(2) (relating to the 5-percent limitation on charitable contributions by corporations), and section 170(d) (relating to carryovers of excess contributions of individuals and corporations) shall not apply.

(ii) Although the limitations of section 170(b)(1) (A), (B), and (D)(i) are 50, 20, and 30 percent, respectively, of an individual's contribution base, these limitations are applied for purposes of section 545(b)(2) by using 50, 20, and 30 percent, respectively, of the corporation's taxable income as adjusted for purposes of section 170(b)(2), that is, the same amount of taxable income to which the 5-percent limitation applies. Thus, the term *contribution base* when used in section 170(b)(1) means the corporation's taxable income computed with the adjustments, other than the 5-percent limitation, provided in section 170(b)(2). However, a further adjustment for this purpose is that the taxable income shall also be computed without the deduction of the amount disallowed under section 545(b)(8), relating to expenses and depreciation applicable to property of the taxpayer. The carryover of charitable contributions made in a prior year, otherwise allowable as a deduction in computing taxable income to the extent provided in section 170(b)(1)(D)(ii) and (d), shall not be allowed as a deduction in computing undistributed personal holding company income for any taxable year.

(iii) See §1.170A–8 for the rules with respect to the charitable contributions to which the 50-, 20-, and 30-percent limitations apply.

(c) *Special deductions disallowed.* Part VIII, subchapter B, chapter 1 of the

Code, allows corporations, in computing taxable income, special deductions for such matters as partially tax-exempt interest, certain dividends received, dividends paid on certain preferred stock of public utilities, organizational expenses, etc. See section 241. Such special deductions, except the deduction provided by section 248 (relating to organizational expenses) shall be disallowed in computing undistributed personal holding company income.

(d) *Net operating loss.* The net operating loss deduction provided in section 172 is not allowed for purposes of the computation of undistributed personal holding company income. For purposes of such a computation, however, there is allowed as a deduction the amount of the net operating loss (as defined in section 172(c)) for the preceding taxable year, except that, in computing undistributed personal holding company income for a taxable year beginning after December 31, 1957, the amount of such net operating loss shall be computed without the deductions provided in part VIII (section 241 and following, except section 248), subchapter B, chapter 1 of the Code.

(e) *Long-term capital gains.* (1) There is allowed as a deduction the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year, minus the taxes attributable to such excess, as provided in section 545(b)(5).

(2) Section 631(c) (relating to gain or loss in the case of disposal of coal or domestic iron ore) shall have no application.

(f) *Bank affiliates.* There is allowed the deduction provided by section 601 in the case of bank affiliates (as defined in section 2 of the Banking Act of 1933; 12 U.S.C. 221a (c)).

(g) *Payment of indebtedness incurred prior to January 1, 1934*—(1) *General rule.* In computing undistributed personal holding company income, section 545(b)(7) provides that there shall be allowed as a deduction amounts used or irrevocably set aside to pay or to retire indebtedness of any kind incurred before January 1, 1934, if such amounts are reasonable with reference to the size and terms of such indebtedness. See § 1.545–3 for the deduction in computing undistributed personal holding company income of amounts used or irrevocably set aside to pay or retire qualified indebtedness (as defined in paragraph (d) of § 1.545–3).

(2) *Indebtedness.* The term *indebtedness* means an obligation absolute and not contingent, to pay on demand or within a given time, in cash or other medium, a fixed amount. The term *indebtedness* does not include the obligation of a corporation on its capital stock. The indebtedness must have been incurred (or, if incurred by assumption, assumed) by the taxpayer before January 1, 1934. 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. In the case of refunding, renewal, or other change in the form of an indebtedness, the giving of a new promise to pay by the taxpayer will not have the effect of changing the date the indebtedness was incurred.

(3) *Amounts used or irrevocably set aside.* The deduction is allowable, in any taxable year, only for amounts used or irrevocably set aside in that year. The use or irrevocable setting aside must be to effect the extinguishment or discharge of indebtedness. In the case of refunding, renewal, or other change in the form of an indebtedness, the mere giving of a new promise to pay by the taxpayer will not result in an allowable deduction. If amounts are set aside in one year, no deduction is allowable for such amounts for a later year in which 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. Double deductions shall not be allowed.

(4) *Reasonableness of the amounts with reference to the size and terms of the indebtedness.* (i) The reasonableness of the amounts used or irrevocably set aside must be determined by reference to the size and terms of the particular indebtedness. Hence, all the facts and

circumstances with respect to the nature, scope, conditions, amount, maturity, and other terms of the particular indebtedness must be shown in each case.

(ii) Ordinarily an amount used to pay or retire an indebtedness, in whole or in part, at or prior to the maturity and in accordance with the terms thereof will be considered reasonable, and may be allowable as a deduction for the year in which so used. However, if an amount has been set aside in a prior year for payment or retirement of the same indebtedness, the amount so set aside shall not be allowed as a deduction in the year of the payment.

(iii) All amounts irrevocably set aside for the payment or retirement of an indebtedness in accordance with and pursuant to the terms of the obligation, for example, the annual contribution to trustees required by the provisions of a mandatory sinking fund agreement, will be considered as complying with the requirement of reasonableness. To be considered reasonable, it is not necessary that the plan of retirement provide for a retroactive setting aside of amounts for years prior to that in which the plan is adopted. However, if a voluntary plan was adopted before 1934, no adjustment is allowable in respect of the amounts set aside in the years prior to 1934.

(5) *Burden of proof.* The burden of proof will rest upon the taxpayer to sustain the deduction claimed. Therefore, 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.

(6) *Allowance to a successor corporation.* For allowance of deduction for pre-1934 indebtedness to a successor corporation, see section 381(c)(15).

(h) *Expenses and depreciation applicable to property of the taxpayer.* (1) In computing undistributed personal holding company income in the case of a personal holding company which owns or operates property, section 545(b)(8) provides a specific limitation with respect to the allowance of deductions for trade or business expenses and depreciation allocable to the operation or maintenance of such property. Under this limitation, these deductions shall not be allowed in an amount in excess of the aggregate amount of the rent or other compensation received for the use of, or the right to use, the property, unless it is established to the satisfaction of the Commissioner:

(i) That the rent or other compensation received was the highest obtainable, or if none was received, that none was obtainable;

(ii) That the property was held in the course of a business carried on bona fide for profit; and

(iii) Either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business.

(2) The burden of proof will rest upon the taxpayer to sustain the deduction claimed. If, in computing undistributed personal holding company income, a personal holding company claims deductions for expenses and depreciation allocable to the operation and maintenance of property owned or operated by the company, in an aggregate amount in excess of the rent or other compensation received for the use of, or the right to use, the property, it shall attach to its income tax return a statement setting forth its claim for allowance of the additional deductions, together with a complete statement of the facts and circumstances pertinent to its claim and the arguments on which it relies. Such statement shall set forth:

(i) A description of the property;

(ii) The cost or other basis to the corporation and the nature and value of the consideration paid for the property;

(iii) The name and address of the person from whom the property was acquired and the date the property was acquired;

(iv) The name and address of the person to whom the property is leased or rented, or the person permitted to use the property, and the number of shares of stock, if any, held by such person and the members of his family;

(v) The nature and gross amount of the rent or other compensation received for the use of, or the right to use, the property during the taxable year and for each of the five preceding years and the amount of the expenses

incurred with respect to, and the depreciation sustained on, the property for such years;

(vi) Evidence that the rent or other compensation was the highest obtainable or, if none was received, a statement of the reasons therefore;

(vii) A copy of the contract, lease or rental agreement;

(viii) The purpose for which the property was used;

(ix) The business, carried on by the corporation, with respect to which the property was held and the gross income, expenses, and taxable income derived from the conduct of such business for the taxable year and for each of the five preceding years;

(x) A statement of any reasons which existed for expectation that the operation of the property would be profitable, or a statement of the necessity for the use of the property in the business of the corporation, and the reasons why the property was acquired; and

(xi) Any other information pertinent to the taxpayer's claim.

(i) *Amount of a lien in favor of the United States.* (1) If notices of lien are filed in the manner provided in section 6323(f), the amount of the liability to the United States outstanding at the close of the taxable year, and secured by such liens which are in effect at that time, shall be allowed as a deduction in computing undistributed personal holding company income. However, the amount of such deduction which may be allowed for any taxable year shall not exceed the taxable income (as adjusted for purposes of determining the undistributed personal holding company income, but without regard to the deduction under section 545(b)(9)) for such year. The fact that the amount of, or any part of, the outstanding obligation to the United States was deducted for one taxable year does not prevent its deduction for a subsequent taxable year to the extent the obligation is still outstanding at the close of the subsequent taxable year and is secured by a lien, notice of which has been filed.

(2) Subparagraph (1) of this paragraph may be illustrated by the following example:

*Example.* If the taxpayer (on the calendar year basis) is subject to a lien (notice of which has been properly filed) in the amount of $500,000 at the close of the calendar year 1954 and has taxable income of $400,000 for such taxable year, the deduction allowable by reason of the lien for the calendar year 1954 is $400,000. If, at the close of the taxable year ended December 31, 1955, the taxpayer is still subject to the same lien of $500,000 and it has taxable income of $450,000, a deduction is allowed by reason of such lien in the amount of $450,000.

(3) When the obligation secured by the lien in favor of the United States has been satisfied or released, the sum of the amounts which have been allowed as deductions under section 545(b)(9) in respect of such obligation shall be restored to taxable income for the year in which such lien is satisfied or released. If only a part of the obligation secured by the lien has been satisfied, the sum of the amounts which have been allowed as deductions under section 545(b)(9) in respect of such part shall be included in taxable income for the year of the satisfaction for the purpose of determining undistributed personal holding company income. It should be noted, however, that only the sum of the amounts which have been allowed as deductions under section 545(b)(9) and subparagraph (1) of this paragraph shall be included in taxable income. Thus, any amounts which were allowed as deductions under section 504(e) of the Internal Revenue Code of 1939 shall not be included as taxable income for any taxable year under section 545(b)(9) and subparagraph (1) of this paragraph.

(4) The application of subparagraph (3) of this paragraph may be illustrated by the following example:

*Example.* Assume the same facts as in the example in subparagraph (2) of this paragraph, and assume further that the corporation has $100,000 taxable income both for 1956 (before including the $400,000 described below) and for 1957. In 1956, the corporation pays $200,000 of the obligation, thereby reducing its liability from $500,000 to $300,000. In such case, $400,000 is included in taxable income in computing its undistributed personal holding company income for 1956, that is, the sum of the $200,000 deduction for 1954 and the $200,000 deduction for 1955 in respect of the liability which is paid in 1956. In 1957, property of the corporation is discharged from the lien by reason of the fact that the

value of the remaining property of the corporation exceeds double the outstanding liability. (See section 6325(b)(1).) Since this was not a release or satisfaction of the lien, no amount is added to taxable income for 1957 with respect to the property discharged from the lien. In 1958, the remaining property is released from the lien by reason of a bond being accepted under section 6325(a)(2). There is added to taxable income in computing undistributed personal holding company income for 1958, $850,000, that is, the sum of the deductions allowed for 1954, 1955, 1956, and 1957 in respect of the $300,000 liability, the lien for which was released in 1958. This amount of $850,000, is computed as follows:

| Year | Outstanding liability | Taxable income | Deduction as limited by taxable income | Amount attributable to part payment of $200,000 in 1956 | Amount attributable to release of lien in 1958 |
|---|---|---|---|---|---|
| 1954 | $500,000 | $400,000 | $400,000 | $200,000 | $200,000 |
| 1955 | 500,000 | 450,000 | 450,000 | 200,000 | 250,000 |
| 1956 | 300,000 | 500,000 | 300,000 | ..... | 300,000 |
| 1957 | 300,000 | 100,000 | 100,000 | ..... | 100,000 |
| 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 attached 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.