§ 1.996-1 Rules for actual distributions and certain deemed distributions.

(a) General rule. Under section 996(a)(1), any actual distribution (other than a distribution described in paragraph (b) of this section or to which § 1.995-4 applies) to a shareholder by a DISC, or former DISC, which is made out of earnings and profits shall be treated as made—

(1) First, out of "previously taxed income" (as defined in § 1.996-3(c)) to the extent thereof,

(2) Second, out of "accumulated DISC income" (as defined in § 1.996-3(b)) to the extent thereof, and

(3) Third, out of "other earnings and profits" (as defined in § 1.996-3(d)) to the extent thereof.

(b) Rules for qualifying distributions and deemed distributions under section 995(b)(1)(G)—(1) In general. Except as provided in subparagraph (2), any actual distribution to meet qualification requirements made pursuant to § 1.992-3 and any deemed distribution pursuant to § 1.995-2(a)(5) (relating to foreign investment attributable to producer's loans) which is made out of earnings and profits shall be treated as made—

(i) First, out of "accumulated DISC income" (as defined in § 1.996-3(b)) to the extent thereof,

(ii) Second, out of "other earnings and profits" (as defined in § 1.996-3(d)) to the extent thereof, and

(iii) Third, out of "previously taxed income" (as defined in § 1.996-3(c)) to the extent thereof.

(2) Special rule. For taxable years beginning after December 31, 1975, paragraph (b)(1) of this section shall apply to one-half of the amount of an actual distribution made pursuant to § 1.992-3 to satisfy the condition of § 1.992-1(b) (the gross receipts test) and paragraph (a) of this section shall apply to the remaining one-half of such amount.

(c) Exclusion from gross income. Under section 996(a)(3), amounts distributed out of previously taxed income shall be excluded by the distributee from gross income. However, see § 1.996-5(b) for treatment as gain from the sale or exchange of property of the portion of an actual distribution out of previously taxed income to the extent it exceeds the adjusted basis of the stock with respect to which the distribution is made.

(d) Priority of distributions. Under section 996(c), for purposes of determining their treatment under paragraphs (a), (b), and (c) of this section, distributions made during a taxable year shall be treated as being made in the following order—

(1) Deemed distributions under §§ 1.995-2 and 1.995-3.

(2) Actual distributions to meet qualification requirements made pursuant to § 1.992-3 in the order in which they are made, and

(3) Other actual distributions in the order in which they are made.

Thus, the treatment of any distribution shall be determined after the divisions of earnings and profits have been properly adjusted by taking into account distributions of higher priority which are made or deemed made during the same taxable year.

(e) Examples. The provisions of this section may be illustrated by the following examples:

Example 1. Y Corporation, which uses the calendar year as its taxable year, elects to be treated as a DISC beginning with 1972. During 1973, Y makes a cash distribution of $100 to X Corporation, Y’s sole shareholder. For 1973, Y has no earnings and profits. As of the beginning of 1973, Y has $300 of accumulated earnings and profits which consist of $70 of accumulated DISC income, $40 of previously taxed income, and $190 of other earnings and profits. The entire $100 distribution is a dividend under section 316. However, $40 thereof is treated as made out of previously taxed income and is thus excluded from gross income. Accordingly, only $60 is treated as distributed out of accumulated DISC income and includable in gross income. See § 1.246-4 for the inapplicability of the dividend received deduction with respect to the entire distribution of $100.

Example 2. Assume the same facts as in example 1, except that the cash distribution is designated as a distribution to meet qualification requirements made pursuant to § 1.992-3. Under these facts, X includes the entire distribution in its gross income as a dividend. Of the $100 distributed, $70 is treated as made out of accumulated DISC income and the remaining $30 is treated as made out of other earnings and profits. The dividend...
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Rules for losses.

(a) In general. Under section 996(b), if for any taxable year a DISC, or a former DISC, incurs a deficit in earnings and profits, such deficit shall be charged—

(1) First, to other earnings and profits (as defined in §1.996–3(d)) to the extent thereof,

(2) Second, to accumulated DISC income (as defined in §1.996–3(b)) to the extent thereof, subject to the special rule in paragraph (b) of this section,

(3) Third, to previously taxed income (as defined in §1.996–3(c)) to the extent thereof, and

(4) To the extent that the amount of such deficit exceeds the sum of the amounts charged in accordance with subparagraphs (1), (2), and (3) of this paragraph, to other earnings and profits (as defined in §1.996–3(d)).

Thus, the excess deficit charged to other earnings and profits under subparagraph (4) of this paragraph will create a deficit therein in the amount of such excess. To determine the amount of any division of earnings and profits for the purpose of determining under §1.996–1 the treatment of any actual and certain deemed distributions, the portion of a deficit in earnings and profits chargeable under this paragraph to such division prior to such distribution shall be determined in a manner consistent with the rules in §1.316–2(b) for determining the amount of earnings and profits available on the date of any distribution.

(b) Deficits subsequent to a disqualification. A deficit in earnings and profits of a DISC, or former DISC, shall not be charged to accumulated DISC income which has been determined is to be deemed distributed to the shareholders pursuant to §1.995–3 as a result of a revocation of election or other disqualification. Thus, in accordance with paragraph (a) of this section as modified by this paragraph, a deficit incurred by a former DISC following such a revocation or disqualification shall be charged first to other earnings and profits and then to previously taxed income with any balance being charged to other earnings and profits and creating a deficit therein. The preceding sentence shall also apply in the case of a deficit incurred by a DISC which has no accumulated DISC income accumulated during its current taxable year and all immediately preceding consecutive taxable years for which it was a DISC. If as a result of the application of this paragraph the amount of a deficit in other earnings and profits exceeds the amount of a deficit in accumulated earnings and profits, then upon any subsequent actual distribution the deficit in other earnings and profits shall be reduced by the lower of (1) the amount of such actual distribution chargeable to accumulated DISC income or previously taxed income or (2) the amount of such excess.

(c) Examples. The provisions of this section may be illustrated by the following examples:

Example 1. X Corporation, which uses the calendar year as its taxable year, becomes a DISC beginning with 1976. In addition to other facts assumed in the table below, X incurs a deficit in earnings and profits for 1979...