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activities in Mexico. FX is a QBU under paragraph (b)(2)(i) of this section. The activities of FX in Mexico also constitute a QBU under paragraph (b)(2)(ii) of this section.

Example 10. F, a foreign corporation, computes a gain of $100 from the disposition of a United States real property interest (as defined in section 897(c)). The gain is taken into account as if F were engaged in a trade or business in the United States and as if such gain were effectively connected with such trade or business. F is a QBU under paragraph (b)(2)(i) of this section because of its corporate status. F's disposition activity constitutes a separate QBU under paragraph (b)(3) of this section.

[T.D. 8279, 55 FR 284, Jan. 4, 1990, as amended by T.D. 9794, 81 FR 88851, Dec. 8, 2016]

§ 1.989(b)–1 Definition of weighted average exchange rate.

For purposes of section 989(b)(3) and (4), the term ''weighted average exchange rate'' means the simple average of the daily exchange rates (determined by reference to a qualified source of exchange rates described in §1.988–1(d)(1)), excluding weekends, holidays and any other nonbusiness days for the taxable year.

[T.D. 8263, 54 FR 38664, Sept. 20, 1989. Redesignated by T.D. 8367, 56 FR 48437, Sept. 25, 1991; 57 FR 6060, Feb. 18, 1992; T.D. 9452, 74 FR 27890, June 11, 2009]

DOMESTIC INTERNATIONAL SALES CORPORATIONS

§ 1.991–1 Taxation of a domestic international sales corporation.

(a) *In general.* A corporation which is a DISC for a taxable year is not subject to any tax imposed by subtitle A of the Code (sections 1 through 1564) for such taxable year, except for the tax imposed by chapter 5 thereof (sections 1491 through 1494) on certain transfers to avoid tax. Thus, for example, a corporation which is a DISC for a taxable year is not subject for such year to the corporate income tax (section 11), the minimum tax on tax preferences (sections 56 through 58), or the accumulated earnings tax (sections 531 through 537). A DISC is liable for the payment of all taxes payable by corporations under other subtitles of the Code, such as, for example, income taxes withheld at the source and other employment taxes under subtitle C and the interest equalization tax and other miscellaneous excise taxes imposed by subtitle D. In addition, a DISC is subject to the provisions of chapter 3 of subtitle A (including section 1461), relating to withholding of tax on nonresident aliens and foreign corporations and tax-free covenant bonds. See §1.992–1 for the definition of the term ''DISC.''

(b) *Determination of taxable income*—(1) *In general.* Although a DISC is not subject to tax under subtitle A of the Code (other than chapter 5 thereof), a DISC's taxable income shall be determined for each taxable year in order to determine, for example, the amount deemed distributed for that taxable year to its shareholders pursuant to §1.995–2. Except as otherwise provided in the Code and the regulations thereunder, the taxable income of a DISC shall be determined in the same manner as if the DISC were a domestic corporation which had not elected to be treated as a DISC. Thus, for example, a DISC chooses its method of depreciation, inventory method, and annual accounting period in the same manner as if it were a corporation which had not elected to be treated as a DISC. Any elections affecting the determination of taxable income shall be made by the DISC. Thus, as a further example, a DISC which makes an installment sale described in section 453 is able to avail itself of the benefits of section 453: *Provided,* The DISC complies with the election requirements of such section. See §1.995–2(e) and §1.996–8 and the regulations thereunder for rules relating to the application for a taxable year of a DISC of a deduction under section 172 for a net operating loss carryback or carryover or of a capital loss carryback or carryover under section 1212.

(2) *Choice of method of accounting.* A DISC may, generally, choose any method of accounting permissible under section 446(c) and the regulations thereunder. However, if a DISC is a member of a controlled group (as defined in §1.993–1(k)), the DISC may not choose a method of accounting which, when applied to transactions between the DISC and other members of the controlled group, will result in a material distortion of the income of the DISC or any other member of the controlled group. Such a material distortion of income

would occur, for example, if a DISC chooses to use the cash method of accounting where the DISC acts as commission agent in a substantial volume of sales of property by a related corporation which uses the accrual method of accounting and which customarily pays commissions to the DISC more than 2 months after such sales. As a further example, a material distortion of income would occur if a DISC chooses to use the accrual method of accounting where the DISC leases a substantial amount of property from a related corporation which uses the cash method of accounting, if the DISC customarily accrues any portion of the rent on such property more than 2 months before the rent is paid. Changes in the method of accounting of a DISC are subject to the requirements of section 446(e) and the regulations thereunder.

(3) *Choice of annual accounting period*—(i) *In general.* A DISC may choose its annual accounting period without regard to the annual accounting period of any of its stockholders. In general, changes in the annual accounting period of a DISC are subject to the requirements of section 442 and the regulations thereunder.

(ii) *Transition rule for change in taxable year in order to become a DISC.* A corporation may, without the consent of the Commissioner, change its annual accounting period and adopt a new taxable year beginning on the first day of any month in 1972: *Provided*, That—

(*a*) Such change has the effect of accelerating the time as of which such corporation can become a DISC,

(*b*) The Commissioner is notified of such change by means of a statement filed (with the regional service center with which such corporation files its election to be treated as a DISC) not later than the end of the period during which such corporation may file an election to be treated as a DISC for such new taxable year, and

(*c*) The short period required to effect such change is not a taxable year in which such corporation has a net operating loss as defined in section 172.

Thus, for example, if a corporation which uses the calendar year for its taxable year does not complete arrangements to become a DISC until May 15, 1972, such corporation can, pursuant to this subdivision, change its annual accounting period and adopt a taxable year beginning on the first day of any month in 1972 after May. A change to a new annual accounting period made pursuant to this subdivision is effective only if the corporation which makes such change qualifies as a DISC for such new period. A corporation may change its annual accounting period and adopt a new taxable year pursuant to this subdivision without regard to the provisions of §1.1502–76 (relating to the taxable year of members of a group). A copy of the statement described in (*b*) of this subdivision shall be attached to the return of a corporation for the new taxable year to which such corporation changes pursuant to this subdivision. A corporation which changes its annual accounting period pursuant to this subparagraph will not be permitted under section 442 to change its annual accounting period at any time before 1982, except with the consent of the Commissioner as provided in §1.442–1(b)(1) or pursuant to subparagraph (4) of this paragraph.

(4) *Transition rule for change of taxable year of certain DISC's.* In the case of a DISC all of the shares of which are held by a single shareholder or by members of a group who file a consolidated return, such DISC may (without the consent of the Commissioner) change its annual accounting period and adopt a taxable year beginning in 1972 which is the same as the taxable year of such shareholder or the members of such group. A change to a new annual accounting period may be made by a DISC pursuant to this subparagraph even if such DISC has changed its annual accounting period pursuant to subparagraph (3)(ii) of this paragraph.

(5) *Transition rule for beginning of first taxable year of certain corporations.* If a corporation organized before January 1, 1972, neither acquires assets (other than cash or other property acquired as consideration for the issuance of stock) nor begins doing business prior to January 1, 1972, the first taxable year of such corporation is deemed to begin at the time such corporation acquires any asset (other than cash or other property acquired as consideration for the

issuance of stock) or begins doing business, whichever is earlier: *Provided*, That such corporation is a DISC for such first taxable year. For purposes of §1.6012–2(a), such corporation is treated as not coming into existence until the beginning of such first taxable year.

(c) *Effective date.* The provisions of this section and the regulations under sections 992 through 997 apply with respect to taxable years ending after December 31, 1971, except that a corporation may not be a DISC for any taxable year beginning before January 1, 1972.

(d) *Related statutes.* For rules relating to the transfer, during a taxable year beginning before January 1, 1976, to a DISC of assets of an export trade corporation (as defined in section 971), where a parent owns all the outstanding stock of both such DISC and such export trade corporation, see section 505(b) of the Revenue Act of 1971 (85 Stat. 551). For rules regarding limitations on the qualification of a corporation as an export trade corporation for any taxable year beginning after October 31, 1971, see section 971(a)(3).

[T.D. 7323, 39 FR 34402, Sept. 25, 1974, as amended by T.D. 7854, 47 FR 51738, Nov. 17, 1982]

§1.992–1 Requirements of a DISC.

(a) *''DISC'' defined.* The term ''DISC'' refers to a domestic international sales corporation. The term ''DISC'' means a corporation which, for a taxable year—

(1) Is duly incorporated and existing under the laws of any State or the District of Columbia,

(2) Satisfies the gross receipts test described in paragraph (b) of this section,

(3) Satisfies the assets test described in paragraph (c) of this section,

(4) Satisfies the capitalization requirement described in paragraph (d) of this section,

(5) Satisfies the requirement that an election to be treated as a DISC be in effect for such year, as described in paragraph (e) of this section,

(6) [Reserved]

(7) Maintains separate books and records, and

(8) Is not an ineligible corporation described in paragraph (f) of this section.

A corporation which satisfies the requirements described in subparagraphs (1) through (8) of this paragraph for a taxable year is treated as a separate corporation for Federal tax purposes and qualifies as a DISC, even though such corporation would not be treated (if it were not a DISC) as a corporate entity for Federal income tax purposes. An association cannot qualify as a DISC even if such association is taxable as a corporation pursuant to section 7701(a)(3). In addition, a corporation created or organized in, or under the law of, a possession of the United States cannot qualify as a DISC. The rules contained in this paragraph constitute a relaxation of the general rules of corporate substance otherwise applicable under the Code. The separate incorporation of a DISC is required under section 992(a)(1) to make it possible to keep a better record of the income which is subject to the special treatment provided by sections 991 through 996, but this does not necessitate in all other respects the separate relationships which otherwise would be required between a parent corporation and its subsidiary. However, this relaxation of the general rules of corporate substance does not apply with respect to other corporations in other contexts. In the case of a transaction between a DISC and a person related to such DISC for purposes of section 482, see §1.993–1(l) for rules for determining whether income is income of a DISC to which the intercompany pricing rules authorized by section 994 apply.

(b) *Gross receipts test.* In order for a corporation described in paragraph (a)(1) of this section to be a DISC for a taxable year, 95 percent or more of its gross receipts (as defined in §1.993–6) for such year must consist of qualified export receipts (as defined in §1.993–1). Gross receipts for a taxable year are determined in accordance with the method of accounting adopted by the corporation pursuant to §1.991–1(b)(2). However, for rules regarding gross receipts in the case of a commission sale by such corporation, see §1.993–6.

(c) *Assets test*—(1) *In general.* In order for a corporation described in paragraph (a)(1) of this section to be a DISC for a taxable year, the adjusted basis (determined under section 1011) of its

qualified export assets at the close of such year must equal or exceed 95 percent of the sum of the adjusted bases (determined under section 1011) of all assets of such corporation at the close of such year.

(2) *Assets acquired to meet assets test.* For purposes of determining whether the requirements of subparagraph (1) of this paragraph are satisfied by a corporation at the end of a taxable year, an asset which is a qualified export asset is treated as not being an asset of such corporation at such time if such asset is held for a total of 60 days or less and is acquired directly or indirectly through borrowing, unless the acquisition of such asset is established to the satisfaction of the Commissioner or his delegate to have been for bona fide purposes. Such acquisition is deemed to have been for bona fide purposes if, for example, it is made in the usual course of the corporation's trade or business.

(d) *Capitalization requirement*—(1) *In general.* To qualify as a DISC for a taxable year, a corporation must have, on each day of that taxable year, only one class of stock. The par value (or, in the case of stock without par value, the stated value) of the corporation's outstanding stock must be on each day of the taxable year at least $2,500. In the case of a corporation which elects to be treated as a DISC for its first taxable year, the requirements of this paragraph (d)(1) are satisfied if the corporation has no more than one class of stock at any time during the year and if the par value (or, in the case of stock without par value, the stated value) of the corporation's outstanding stock is at least $2,500 on the last day of the period within which the election must be made and on each succeeding day of the year. For purposes of this paragraph (d)(1), the stated value of shares is the aggregate amount of the consideration paid for such shares which is not allotted to paid in surplus, or other surplus. The law of the State of incorporation of the DISC determines what consideration may be used to capitalize the DISC. A corporation will not be a qualified DISC unless at least $2,500 of valid consideration was used for this purpose. If a corporation has a realized or unrealized loss during a taxable year which results in the impairment of all or part of the capital required under this paragraph (d)(1), that impairment does not result in disqualification under this paragraph (d)(1), provided that the corporation does not take any legal or formal action under State law to reduce capital for that year below the amount required under this paragraph (d)(1).

(2) *Treatment of debt payable to shareholders*—(i) *In general.* Purported debt of a DISC payable to any person, whether or not such person is a shareholder or a member of a controlled group (as defined in §1.993–1(k)) of which such DISC is a member, is treated as debt for all purposes of the Code, provided that such purported debt—

(*a*) Would qualify as debt for purposes of the Code if the DISC were a corporation which did not qualify as a DISC,

(*b*) Qualifies under subdivision (ii) of this subparagraph, or

(*c*) Are trade accounts payable described in subdivision (iii) of this subparagraph.

Such debt is not treated as stock, and interest payable by the DISC on such debt is treated as interest by both the DISC and the holder of such debt. Payment of the principal of such debt by a DISC does not constitute the payment of a dividend by such DISC. The provisions of this subparagraph apply for a taxable year of a DISC, even though debt described in this subparagraph would be treated as stock of the corporation if such corporation did not qualify as a DISC for such year.

(ii) *Safe harbor rule.* Purported debt of a DISC will in no event be treated as other than debt for purposes of subdivision (i) of this subparagraph if—

(*a*) It is a written obligation to pay a sum certain on or before a fixed maturity date,

(*b*) Interest is payable on such purported debt at an arm's length interest rate (as determined under §1.482–2(a)(2)), expressed as a fixed dollar amount or a fixed percentage of principal,

(*c*) Such purported debt is not convertible into stock or into other purported debt unless such other purported debt qualifies under this subparagraph as debt of the DISC,

(*d*) Such purported debt does not confer voting rights upon its holder, except in the event of default thereon, and

(*e*) Interest and principal are paid in accordance with the terms of such purported debt or with any modification of such terms consistent with (*a*) through (*d*) of this subdivision.

The determination of whether purported debt of a DISC constitutes debt described in this subdivision is made without regard to the proportion of debt of the DISC held by any of its shareholders, to the ratio of the outstanding debt of the DISC to its equity, or to the amount of outstanding debt of such DISC. The provisions of (*e*) of this subdivision do not prevent the modification of the terms of debt of a DISC where, for example, a DISC becomes unable to make timely payments of principal required under such terms, provided that such modification is consistent with (*a*) through (*d*) of this subdivision.

(iii) *Trade accounts payable.* Trade accounts payable of a DISC which arise in the normal course of its trade or business (such as in consideration for inventory or supplies) constitute debt of the DISC (whether or not such accounts payable are debt described in subdivision (i) (*a*) or (*b*) of this subparagraph), provided that such accounts are payable within 15 months after they arise. If such accounts are payable more than 15 months after they arise, they are debt of such DISC only if they are debt described in subdivision (i) (*a*) or (*b*) of this subparagraph.

(iv) *Relation of subparagraph to other corporations.* The provisions of this subparagraph generally constitute a relaxation of the ordinary rules used in determining whether purported debt of a corporation is debt or equity. This relaxation is in recognition of the principle that a corporation may qualify as a DISC even though it has relatively little capital. This relaxation does not apply with respect to purported debt of other corporations in other contexts. The provisions of subdivisions (i), (ii), and (iii) of this subparagraph apply only for taxable years for which a corporation qualifies (or is treated) as a DISC.

(3) *Classes of stock.* [Reserved]

(e) *Election in effect.* In order for a corporation to be a DISC for a taxable year, an election to be treated as a DISC must be made by such corporation pursuant to §1.992–2 and must be in effect for such taxable year. A corporation does not become or remain a DISC solely by making such an election. A corporation is a DISC for a taxable year only if such an election is in effect for that year and the corporation also satisfies the requirements of paragraphs (a) through (d) of this section. See §1.992–2 for rules regarding the time and manner of making such an election.

(f) *Ineligible corporations.* The following corporations shall not be eligible to be treated as a DISC—

(1) A corporation exempt from tax by reason of section 501,

(2) A personal holding company (as defined in section 542),

(3) A financial institution to which section 581 or 593 applies,

(4) An insurance company subject to the tax imposed by subchapter L,

(5) A regulated investment company (as defined in section 851(a)),

(6) A China Trade Act corporation receiving the special deduction provided in section 941(a), or

(7) An electing small business corporation (as defined in section 1371(b)).

(g) *Status as DISC after having filed return as a DISC.* Under section 992(a)(2), notwithstanding the failure of a corporation to meet the requirements of paragraph (a) of this section for a taxable year, such corporation will be treated as a DISC for purposes of the Code for such taxable year (and, thus, will not be able to claim that it is not eligible to be a DISC) if—

(1) Such corporation files a return as a DISC for such taxable year,

(2) Such corporation does not notify the district director, more than 30 days before the expiration of the period of limitation (including extensions thereof) on assessment for underpayment of tax for such taxable year (as determined under section 6501 and the regulations thereunder), that it is not a DISC for such taxable year, and

(3) The Internal Revenue Service has not issued, within such period of limitation (including extensions thereof) on assessment for underpayment of tax

for such taxable year, a notice of deficiency based on a determination that such corporation is not a DISC for such taxable year.

A corporation is treated as a DISC, for all purposes, pursuant to the provisions of this paragraph for any taxable year for which it meets the requirements of this paragraph, even if such corporation is an ineligible corporation described in paragraph (f) of this section for such taxable year. Thus, for example, a corporation which is treated as a DISC for a taxable year pursuant to this paragraph is treated as a DISC for that taxable year for purposes of §1.992–2(e)(3) (relating to the termination of a DISC election if a corporation is not a DISC for each of any 5 consecutive taxable years). If a corporation is treated as a DISC for a taxable year pursuant to this paragraph, persons who held stock of such corporation at any time during such taxable year are treated, with respect to such stock, as holders of stock in a DISC for the period or periods during which they held such stock within such taxable year.

(h) *Definition of ''former DISC''.* Under section 992(a)(3), the term ''former DISC'' refers to a corporation which is not a DISC for a taxable year but which was (or was treated as) a DISC for a prior taxable year. However, a corporation is not a former DISC for a taxable year unless such corporation has, at the beginning of such taxable year, undistributed previously taxed income (as defined in §1.996–3(c) or accumulated DISC income (as defined in §1.996–3(b)). A corporation which is a former DISC for a taxable year is a former DISC for all purposes of the Code.

(Secs. 385 and 7805 of the Internal Revenue Code of 1954 (83 Stat. 613 and 68A Stat. 917; 26 U.S.C. 385 and 7805))

[T.D. 7323, 39 FR 34403, Sept. 25, 1974, as amended by T.D. 7420, 41 FR 20654, May 20, 1976; 41 FR 22267, June 2, 1976; T.D. 7747, 45 FR 86459, Dec. 31, 1980; T.D. 7920, 48 FR 50712, Nov. 3, 1983; T.D. 8371, 56 FR 55234, Oct. 25, 1991]

§ 1.992–2 Election to be treated as a DISC.

(a) *Manner and time of election*—(1) *Manner*—(i) *In general.* A corporation can elect to be treated as a DISC for a taxable year beginning after December 31, 1971. Except as provided in paragraph (a)(1)(ii) of this section, the election is made by the corporation filing Form 4876 with the service center with which it would file its income tax return if it were subject for such taxable year to all the taxes imposed by subtitle A of the Internal Revenue Code of 1954. The form shall be signed by any person authorized to sign a corporation return under section 6062, and shall contain the information required by such form. Except as provided in paragraphs (b)(3) and (c) of this section, such election to be treated as a DISC shall be valid only if the consent of every person who is a shareholder of the corporation as of the beginning of the first taxable year for which such election is effective is on or attached to such Form 4876 when filed with the service center.

(ii) *Transitional rule for corporations electing during 1972.* If the first taxable year for which an election by a corporation to be treated as a DISC is a taxable year beginning after December 31, 1971, and on or before December 31, 1972, such election may be made either in the manner prescribed in subdivision (i) of this subparagraph or by filing, at the place prescribed in subdivision (i) of this subparagraph, a statement captioned ''Election to be Treated as a DISC.'' Such statement of election shall be valid only if the consent of each shareholder is filed with the service center in the form, and at the time, prescribed in paragraph (b) of this section. Such statement shall be signed by any person authorized to sign a corporation return under section 6062 and shall include the name, address, and employer identification number (if known) of the corporation, the beginning date of the first taxable year for which the election is effective, the number of shares of stock of the corporation issued and outstanding as of the earlier of the beginning of the first taxable year for which the election is effective or the time the statement is filed, the number of shares held by each shareholder as of the earlier of such dates, and the date and place of incorporation. As a condition of the election being effective, a corporation

which elects to become a DISC by filing a statement in accordance with this subdivision must furnish (to the service center with which the statement was filed) such additional information as is required by Form 4876 by March 31, 1973.

(2) *Time of making election*—(i) *In general.* In the case of a corporation making an election to be treated as a DISC for its first taxable year, such election shall be made within 90 days after the beginning of such taxable year. In the case of a corporation which makes an election to be treated as a DISC for any taxable year beginning after March 31, 1972 (other than the first taxable year of such corporation), the election shall be made during the 90-day period immediately preceding the first day of such taxable year.

(ii) *Transitional rules for certain corporations electing during 1972.* In the case of a corporation which makes an election to be treated as a DISC for a taxable year beginning after December 31, 1971, and on or before March 31, 1972 (other than its first taxable year), the election shall be made within 90 days after the beginning of such taxable year.

(b) *Consent by shareholders*—(1) *In general*—(i) *Time and manner of consent.* Under paragraph (a)(1)(i) of this section, subject to certain exceptions, the election to be treated as a DISC is not valid unless each person who is a shareholder as of the beginning of the first taxable year for which the election is effective signs either the statement of consent on Form 4876 or a separate statement of consent attached to such form. A shareholder's consent is binding on such shareholder and all transferees of his shares and may not be withdrawn after a valid election is made by the corporation. In the case of a corporation which files an election to become a DISC for a taxable year beginning after December 31, 1972, if a person who is a shareholder as of the beginning of the first taxable year for which the election is effective does not consent by signing the statement of consent set forth on Form 4876, such election shall be valid (except in the case of an extension of the time for filing granted under the provisions of subparagraph (3) of this paragraph or paragraph (c) of this section) only if the consent of such shareholder is attached to the Form 4876 upon which such election is made.

(ii) *Form of consent.* A consent other than the statement of consent set forth on Form 4876 shall be in the form of a statement which is signed by the shareholder and which sets forth (*a*) the name and address of the corporation and of the shareholder and (*b*) the number of shares held by each such shareholder as of the time the consent is made and (if the consent is made after the beginning of the corporation's taxable year for which the election is effective) as of the beginning of such year. If the consent is made by a recipient of transferred shares pursuant to paragraph (c) of this section, the statement of consent shall also set forth the name and address of the person who held such shares as of the beginning of such taxable year and the number of such shares. Consent shall be made in the following form: ''I (insert name of shareholder), a shareholder of (insert name of corporation seeking to make the election) consent to the election of (insert name of corporation seeking to make the election) to be treated as a DISC under section 992(b) of the Internal Revenue Code. The consent so made by me is irrevocable and is binding upon all transferees of my shares in (insert name of corporation seeking to make the election).'' The consents of all shareholders may be incorporated in one statement.

(iii) *Who may consent.* Where stock of the corporation is owned by a husband and wife as community property (or the income from such stock is community property), or is owned by tenants in common, joint tenants, or tenants by the entirety, each person having a community interest in such stock or the income therefrom and each tenant in common, joint tenant, and tenant by the entirety must consent to the election. The consent of a minor shall be made by his legal guardian or by his natural guardian if no legal guardian has been appointed. The consent of an estate shall be made by the executor or administrator thereof. The consent of a trust shall be made by the trustee thereof. The consent of an estate or trust having more than one executor,

administrator, or trustee, may be made by any executor, administrator, or trustee, authorized to make a return of such estate or trust pursuant to section 6012(b)(5). The consent of a corporation or partnership shall be made by an officer or partner authorized pursuant to section 6062 or 6063, as the case may be, to sign the return of such corporation or partnership. In the case of a foreign person, the consent may be signed by any individual (whether or not a U.S. person) who would be authorized under sections 6061 through 6063 to sign the return of such foreign person if he were a U.S. person.

(2) *Transitional rule for corporations electing during 1972.* In the case of a corporation which files an election to be treated as a DISC for a taxable year beginning after December 31, 1971, and on or before December 31, 1972, such election shall be valid only if the consent of each person who is a shareholder as of the beginning of the first taxable year for which such election is effective is filed with the service center with which the election was filed within 90 days after the first day of such taxable year or within the time granted for an extension of time for filing such consent. The form of such consent shall be the same as that prescribed in subparagraph (1) of this paragraph. Such consent shall be attached to the statement of election or shall be filed separately (with such service center) with a copy of the statement of election. An extension of time for filing a consent may be granted in the manner, and subject to the conditions, described in subparagraph (3) of this paragraph.

(3) *Extension of time to consent.* An election which is timely filed and would be valid except for the failure to attach the consent of any shareholder to the Form 4876 upon which the election was made or to comply with the 90-day requirement in subparagraph (2) of this paragraph or paragraph (c)(1) of this section, as the case may be, will not be invalid for such reason if it is shown to the satisfaction of the service center that there was reasonable cause for the failure to file such consent, and if such shareholder files a proper consent to the election within such extended period of time as may be granted by the Internal Revenue Service. In the case of a late filing of a consent, a copy of the Form 4876 or statement of election shall be attached to such consent and shall be filed with the same service center as the election. The form of such consent shall be the same as that set forth in paragraph (b)(1)(ii) of this section. In no event can any consent be made pursuant to this paragraph on or after the last day of the first taxable year for which a corporation elects to be treated as a DISC.

(c) *Consent by holder of transferred shares*—(1) *In general.* If a shareholder of a corporation transfers—

(i) Prior to the first day of the first taxable year for which such corporation elects to be treated as a DISC, some or all of the shares held by him without having consented to such election, or

(ii) On or before the 90th day after the first day of the first taxable year for which such corporation elects to be treated as a DISC, some or all of the shares held by him as of the first day of such year (or if later, held by him as of the time such shares are issued) without having consented to such election, then consent may be made by any recipient of such shares on or before the 90th day after the first day of such first taxable year. If such recipient fails to file his consent on or before such 90th day, an extension of time for filing such consent may be granted in the manner, and subject to the conditions, described in paragraph (b)(3) of this section. In addition, if the transfer occurs more than 90 days after the first day of such taxable year, an extension of time for filing such consent may be granted to such recipient only if it is determined under paragraph (b)(3) of this section that an extension of time would have been granted the transferor for the filing of such consent if the transfer had not occurred. A consent which is not attached to the original Form 4876 or statement of election (as the case may be) shall be filed with the same service center as the original Form 4876 or statement of election and shall have attached a copy of such original form or statement of election. The form of such consent shall be the same as that set forth in paragraph (b)(1)(ii) of this section. For the purposes of this paragraph, a transfer of

shares includes any sale, exchange, or other disposition, including a transfer by gift or at death.

(2) *Requirement for the filing of an amended Form 4876 or statement of election.* In any case in which a consent to a corporation's election to be treated as a DISC is made pursuant to subparagraph (1) of this paragraph, such corporation must file an amended Form 4876 or statement of election (as the case may be) reflecting all changes in ownership of shares. Such form must be filed with the same service center with which the original Form 4876 or statement of election was filed by such corporation.

(d) *Effect of election*—(1) *Effect on corporation.* A valid election to be treated as a DISC remains in effect (without regard to whether the electing corporation qualifies as a DISC for a particular year) until terminated by any of the methods provided in paragraph (e) of this section. While such election is in effect, the electing corporation is subject to sections 991 through 997 and other provisions of the Code applicable to DISC's for any taxable year for which it qualifies as a DISC (or is treated as qualifying as a DISC pursuant to §1.992–1(g)). Such corporation is also subject to such provisions for any taxable year for which it is treated as a former DISC as a result of qualifying or being treated as a DISC for any taxable year for which such election was in effect.

(2) *Effect on shareholders.* A valid election by a corporation to be treated as a DISC subjects the shareholders of such corporation to the provisions of section 995 (relating to the taxation of the shareholders of a DISC or former DISC) and to all other provisions of the Code relating to the shareholders of a DISC or former DISC. Such provisions of the Code apply to any person who is a shareholder of a DISC or former DISC whether or not such person was a shareholder at the time the corporation elected to become a DISC.

(e) *Termination of election*—(1) *In general.* An election to be treated as a DISC is terminated only as provided in subparagraph (2) or (3) of this paragraph.

(2) *Revocation of election*—(i) *Manner of revocation.* An election by a corporation to be treated as a DISC may be revoked by the corporation for any taxable year of the corporation after the first taxable year for which the election is effective. Such revocation shall be made by the corporation filing a statement that the corporation revokes its election under section 992(b) to be treated as a DISC. Such statement shall indicate the corporation's name, address, employer identification number, and the first taxable year of the corporation for which the revocation is to be effective. The statement shall be signed by any person authorized to sign a corporation return under section 6062. Such revocation shall be filed with the service center with which the corporation filed its election, except that, if it filed an annual information return under section 6011(e)(2), the revocation shall be filed with the service center with which it filed its last such return.

(ii) *Years for which revocation is effective.* If a corporation files a statement revoking its election to be treated as a DISC during the first 90 days of a taxable year (other than the first taxable year for which such election is effective), such revocation will be effective for such taxable year and all taxable years thereafter. If the corporation files a statement revoking its election to be treated as a DISC after the first 90 days of a taxable year, the revocation will be effective for all taxable years following such taxable year.

(3) *Continued failure to be a DISC.* If a corporation which has elected to be treated as a DISC does not qualify as a DISC (and is not treated as a DISC pursuant to §1.992–1(g)) for each of any 5 consecutive taxable years, such election terminates and will not be effective for any taxable year after such fifth taxable year. Such termination will be effective automatically, without notice to such corporation or to the Internal Revenue Service. If, during any 5-year period for which an election is effective, the corporation should qualify as a DISC (or be treated as a DISC pursuant to §1.992–1(g)) for a taxable year, a new 5-year period shall automatically start at the beginning of the following taxable year.

(4) *Election after termination.* If a corporation has made a valid election to

be treated as a DISC and such election terminates in either manner described in subparagraph (2) or (3) of this paragraph, such corporation is eligible to reelect to be treated as a DISC at any time by following the procedures described in paragraphs (a) through (c) of this section. If a corporation terminates its election and subsequently reelects to be treated as a DISC, the corporation and its shareholders continue to be subject to sections 995 and 996 with respect to the period during which its first election was in effect. Thus, for example, distributions upon disqualification includible in the gross incomes of shareholders of a corporation pursuant to section 995(b)(2) continue to be so includible for taxable years for which a second election of such corporation is in effect without regard to the second election.

[T.D. 7323, 39 FR 34405, Sept. 25, 1974, as amended by T.D. 7420, 41 FR 20655, May 20, 1976]

§ 1.992–3 Deficiency distributions to meet qualification requirements.

(a) *In general.* A corporation which meets the requirements described in § 1.992–1 for treatment as a DISC for a taxable year, other than the 95 percent of gross receipts test described in § 1.992–1(b) or the 95-percent assets test described in § 1.992–1(c), or both tests, may nevertheless qualify as a DISC for such year by making deficiency distributions (attributable to its gross receipts other than qualified export receipts and its assets other than qualified export assets) if all of the following requirements are satisfied:

(1) The corporation distributes the amount determined under paragraph (b) of this section as a deficiency distribution. The amount of a deficiency distribution is determined without regard to the amount by which the corporation fails to meet either test.

(2) The reasonable cause requirements prescribed in paragraph (c)(1) of this section are satisfied with respect to both the corporation's failure to meet either test and its failure to make a deficiency distribution prior to the time the distribution is made.

(3) The corporation makes such deficiency distribution pro rata to all its shareholders.

(4) The corporation designates the distribution, at the time of the distribution, as a deficiency distribution, pursuant to section 992(c), to meet the qualification requirements to be a DISC. Such designation shall be in the form of a communication sent at the time of such distribution to each shareholder and to the service center with which the corporation has filed or will file its return for the taxable year to which the distribution relates. A corporation may not retroactively designate a prior distribution as a deficiency distribution to meet qualification requirements. Subject to the limitation described in paragraph (c)(3) of this section, a corporation may make a deficiency distribution with respect to a taxable year at any time after the close of such taxable year or, in the case of a deficiency distribution made on or before September 29, 1975, at any time during or after such taxable year.

See sections 246(d), 904(f), 995, and 996 for rules regarding the treatment of a deficiency distribution to meet qualification requirements by the shareholders and the corporation.

(b) *Amount of deficiency distribution*—(1) *In general.* In order to meet the requirements of paragraph (a) of this section, the amount of a deficiency distribution must be, if the corporation fails to meet—

(i) The 95 percent of gross receipts test, the amount determined in subparagraph (2) of this paragraph,

(ii) The 95-percent assets test, the amount determined in subparagraph (3) of this paragraph, and

(iii) Both such tests, except as provided in subparagraph (4) of this paragraph, the sum of the amounts determined in subparagraphs (2) and (3) of this paragraph.

(2) *Computation of deficiency distribution to meet 95 percent of gross receipts test*—(i) *In general.* If a corporation fails to meet the 95 percent of gross receipts test described in § 1.992–1(b) for its taxable year, the amount of the deficiency distribution required by this subparagraph is an amount equal to the sum of its taxable income (if any) from each transaction giving rise to gross receipts (as defined in § 1.993–6) which are

not qualified export receipts (as defined in §1.993–1). A corporation's taxable income from a transaction shall be the amount of such gross receipts from such transaction reduced only by (*a*) its cost of goods sold attributable to such gross receipts, and by (*b*) its expenses, losses, and other deductions properly apportioned or allocated thereto in a manner consistent with the rules set forth in §1.861–8. For purposes of this subdivision, however, any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income in such manner shall not reduce such gross receipts. If the corporation is a commission agent for a principal in a transaction, the corporation's taxable income is the amount of the commission from such transaction reduced only by the amounts described in (*b*) of this subdivision.

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

Example. (*a*) X and Y are calendar year taxpayers. X, a domestic manufacturing company, owns all the stock of Y, which seeks to qualify as a DISC for 1973. During 1973, X manufactures a machine which is eligible to be export property as defined in §1.993–3. Y is made a commission agent with respect to exporting such machine. Thereafter, during 1973 Y is considered to receive gross receipts of $100,000, as determined under section 993(f), attributable to X's sale of the machine in a manner which causes the gross receipts to be excluded receipts pursuant to section 993(a)(2) and, therefore, not qualified export receipts. Y's total gross receipts for 1973 are $1 million of which $900,000 (*i.e.*, 90 percent) are qualified export receipts. Therefore, Y does not satisfy the 95 percent of gross receipts test for 1973 because less than 95 percent of its gross receipts are qualified export receipts. Y has $9,000 of expenses properly apportioned or allocated to its gross income from such sale and $1,000 of other expenses which cannot definitely be allocated to some item or class of gross income, determined in a manner consistent with the rules set forth in §1.861–8. In order to satisfy the 95 percent of gross receipts test for 1973, if the commission due from X to Y were $15,000, Y must make a deficiency distribution of $6,000 computed as follows:

Y's commission (gross income) from the transaction	$15,000
Less: Y's expenses apportioned or allocated to its gross income from the transaction	9,000
Required deficiency distribution by reason of $100,000 of gross receipts which are not qualified export receipts	6,000

(*b*) If the commission due from X to Y were $9,400, resulting in a net loss of $600 to Y ($9,400 to $10,000), Y must make a deficiency distribution of $400 computed as follows:

Y's commissions (gross income) from the transaction	$9,400
Less: Y's expenses apportioned or allocated to its gross income from the transaction	9,000
Required deficiency distribution by reason of $100,000 of gross receipts which are not qualified export receipts	400

(*c*) If the commission due from X to Y were $8,500, Y would not be required to make a deficiency distribution since, under this subparagraph, there would be no taxable income attributable to gross receipts from the sale.

(3) *Computation of deficiency distribution to meet 95 percent assets test*—(i) *In general.* If a corporation fails to meet the 95 percent assets test described in §1.992–1(c) for its taxable year, the amount of the deficiency distribution required by this subparagraph is an amount equal to the fair market value as of the last day of such taxable year of the assets which are not qualified export assets held by such corporation on such last day.

(ii) *Asset held for more than 1 year.* In the case of a corporation which holds continuously an asset which is not a qualified export asset at the close of more than 1 taxable year, it must distribute an amount equal to its fair market value (or, if greater, the amount determined under subparagraph (4) of this paragraph) only once if, at the close of the first such taxable year, such corporation reasonably believed that such asset was a qualified export asset. This subdivision shall not apply for any taxable year beginning after the date the corporation knows (or a reasonable man would have known) that an asset is not a qualified export asset and in order to qualify for each such year, the corporation must distribute the fair market value of such asset for each such year.

(4) *Computation in the case of a failure to meet both tests as a result of a single transaction.* If a corporation fails to meet both the 95 percent of gross receipts test and the 95 percent assets test for a taxable year, and if the corporation holds at the end of such year

assets (other than cash or qualified export assets) which were received as proceeds of a sale or exchange during such year which resulted in gross receipts other than qualified export receipts, then the amount of the deficiency distribution required by this paragraph with respect to such sale or exchange and assets held is the larger of the amount required by subparagraph (2) of this paragraph with respect to the sale or exchange or the amount required by subparagraph (3) of this paragraph with respect to such assets held. Thus, for example, if a corporation sells property which is not a qualified export asset for $100, receives $85 in cash and a note for $15, and derives $25 of taxable income from the sale as determined under subparagraph (2) of this paragraph, it must distribute $25. If the provisions of this subparagraph are applied with respect to assets of a DISC (other than qualified export assets), such provisions do not apply to any property received as proceeds from a sale or exchange of such assets.

(c) *Reasonable cause for failure*—(1) *In general.* If for a taxable year, a corporation has failed to meet the 95 percent of gross receipts test, the 95 percent assets test, or both tests, such corporation may satisfy any such test for such year by means of a deficiency distribution in the amount determined under paragraph (b) of this section only if the reasonable cause requirements of this subparagraph are satisfied. Such reasonable cause requirements are satisfied if—

(i) There is reasonable cause (as determined in accordance with subparagraph (2) of this paragraph) for such corporation's failure to satisfy such test and to make such distribution prior to the date on which it was made, the time limit in subparagraph (3) of this paragraph for making the distribution is satisfied, and interest (if required) is paid in the amount and in the manner prescribed by subparagraph (4) of this paragraph, or

(ii) The time and ''70-percent'' requirements of the reasonable cause test of paragraph (d) of this section are satisfied.

(2) *Determination of reasonable cause.* In general, whether a corporation's failure to meet the 95 percent of gross receipts test, the 95 percent assets test, or both tests for a taxable year and its failure to make a pro rata distribution prior to the date on which it was made will be considered for reasonable cause where the action or inaction which resulted in such failure occurred in good faith, such as failure to meet the 95 percent assets test resulting from blocked currency or expropriation, or failure to meet either test because of reasonable uncertainty as to what constitutes a qualified export receipt or a qualified export asset. For further examples, if a corporation's reasonable determination of the percentage of its total gross receipts that are qualified export receipts is subsequently redetermined to be less than 95 percent as a result of a price adjustment by the Internal Revenue Service under section 482, or if the corporation has a casualty loss for which it receives an unanticipated insurance recovery which causes its qualified export receipts to be less than 95 percent of its total gross receipts, then the failure to satisfy the 95 percent of gross receipts test is considered to be due to reasonable cause.

(3) *Time limit for deficiency distribution.* Except as otherwise provided in this subparagraph, the time limit prescribed by this subparagraph for making a deficiency distribution is satisfied if the amount of the distribution required by paragraph (b) of this section is made within 90 days from the date of the first written notification to the corporation by the Internal Revenue Service that it had not satisfied the 95 percent of gross receipts test or the 95 percent assets test or both tests, for a taxable year. Upon a showing by the corporation that an extension of the 90-day time limit is reasonable and necessary, the Commissioner may grant such extension of such time limit. In any case in which a corporation contests the decision of the Internal Revenue Service that such corporation has not met the 95 percent of gross receipts test, the 95 percent assets test, or both tests, an extension of the 90-day time limit will be allowed until 30 days after the final determination of such contest. The date of the final determination of such contest shall, for

purposes of section 992(c), be established in the manner specified in subdivisions (i) through (iv) of this subparagraph:

(i) The date of final determination by a decision of the United States Tax Court is the date upon which such decision becomes final, as prescribed in section 7481.

(ii) The date of final determination in a case which is contested in a court (and upon which there is a judgment) other than the Tax Court is the date upon which the judgment becomes final and will be determined on the basis of the facts and circumstances of each particular case. For example, ordinarily a judgment of a United States district court becomes final upon the expiration of the time allowed for taking an appeal, if no such appeal is duly taken within such time; and a judgment of the United States Court of Claims becomes final upon the expiration of the time allowed for filing a petition for certiorari if no such petition is duly filed within such time.

(iii) The date of a final determination by a closing agreement, made under section 7121, is the date such agreement is approved by the Commissioner.

(iv) A final determination under section 992(c) may be made by an agreement signed by the district director or director of the service center with which the corporation files its annual return or by such other official to which authority to sign has been delegated, and by or on behalf of the taxpayer. The agreement shall set forth the total amount of the deficiency distribution to be paid to the shareholders of the DISC for the taxable year or years. An agreement under this subdivision shall be sent to the taxpayer at his last known address by either registered or certified mail. For further guidance regarding the definition of last known address, see §301.6212–2 of this chapter. If registered mail is used for such purpose, the date of registration is considered the date of final determination; if certified mail is used for such purpose, the date of postmark on the sender's receipt for such mail is considered the date of final determination. If the corporation makes a deficiency distribution before such registration or postmark date but on or after the date the district director or director of the service center or other official has signed the agreement, the date of signature by the district director or director of the service center or other official is considered the date of final determination. If the corporation makes a deficiency distribution before the district director or director of the service center or other official signs the agreement, the date of final determination is considered to be the date of the making of the deficiency distribution. During any extension of time the interest charge provided in subparagraph (4) of this paragraph will continue to accrue at the rate provided for in such subparagraph.

(4) *Payment of interest for delayed distribution*—(i) *In general.* If a corporation makes a deficiency distribution after the 15th day of the ninth month after the close of the taxable year with respect to which such distribution is made, such distribution will not be deemed to satisfy the 95 percent of gross receipts test or the 95 percent assets test for such year unless such corporation pays to the Internal Revenue Service a charge determined by multiplying (a) an amount equal to 4½ percent of such distribution by (*b*) the number of its taxable years which begin (*1*) after the taxable year with respect to which the distribution is made and (*2*) before such distribution is made. Such charge must be paid, within the 30-day period beginning with the day on which such distribution is made, to the service center with which the corporation files its annual information return for its taxable year in which the distribution is made. For purposes of the Internal Revenue Code, such charge is considered interest.

(ii) *Example.* The provisions of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. X corporation, which uses the calendar year as its taxable year, meets the 95 percent assets test but fails to meet the 95 percent of gross receipts test for 1972 and does not by September 15, 1973, make the deficiency distribution required by reason of its failure to meet such test. Assume that reasonable cause exists for the corporation's failure to meet the 95 percent of gross receipts test and failure to make the required

deficiency distribution. If X makes the required deficiency distribution, in the amount of $10,000, on April 1, 1976, X must pay on or before April 30, 1976, to the service center with which it files its annual information return a charge of $1,800, computed as follows:

Deficiency distribution made by X	$10,000
Multiplied by 4½ percent	.045
Intermediate product	450
Multiplied by: Number of X's taxable years beginning after 1972 and before April 1, 1976	4
Charge to be paid service center because of late deficiency distribution (which is considered interest)	1,800

(d) *Certain distributions deemed for reasonable cause.* If a corporation makes a distribution in the amount required by paragraph (b) of this section with respect to a taxable year on or before the 15th day of the ninth month after the close of such year, it will be deemed to have acted with reasonable cause with respect to its failure to satisfy the 95 percent of gross receipts test, the 95 percent assets test, or both tests, for such year and its failure to make such distribution prior to the date on which the distribution was made if—

(1) At least 70 percent of the gross receipts of such corporation for such taxable year consist of qualified export receipts, and

(2) The sum of the adjusted bases of the qualified export assets held by such corporation on the last day of each month of the taxable year equals or exceeds 70 percent of the sum of the adjusted bases of all assets held by the corporation on each such day.

[T.D. 7323, 39 FR 34407, Sept. 25, 1974; 39 FR 36009, Oct. 7, 1974, as amended by T.D. 7420, 41 FR 20655, May 20, 1976; T.D. 7854, 47 FR 51739, Nov. 17, 1982; T.D. 8939, 66 FR 2819, Jan. 12, 2001]

§ 1.992–4 Coordination with personal holding company provisions in case of certain produced film rents.

(a) *In general.* Section 992(d)(2) provides that a personal holding company is not eligible to be treated as a DISC. Section 543(a)(5)(B) provides that, for purposes of section 543, the term ''produced film rents'' means payments received with respect to an interest in a film for the use of, or the right to use, such film, but only to the extent that such interest was acquired before substantial completion of production of such film. Under section 992(e), if such produced film rents are included in the ordinary gross income (as defined in section 543(b)(1)) of a qualified subsidiary for a taxable year of such subsidiary, and such interest was acquired by such subsidiary from its parent, such interest is deemed (for purposes of the application of sections 541, 543(b)(1), and 992(d)(2), and §1.992–1(f) for such taxable year) to have been acquired by such subsidiary at the time such interest was acquired by such parent. Thus, for example, if a parent acquires an interest in a film before it is substantially completed, then substantially completes such film prior to transferring an interest in such motion picture to a qualified subsidiary, the qualified subsidiary is considered as having acquired such interest prior to substantial completion of such motion picture for purposes of determining whether payments from the rental of such motion picture will be classified as produced film rents of such subsidiary. The provisions of section 992(e) and this section are not applicable in determining whether payments received with respect to an interest in a film are included in the ordinary gross income of a parent or a qualified subsidiary. Thus, even though a qualified subsidiary is treated pursuant to this section as having acquired an interest in a film at the time such interest was acquired by such subsidiary's parent, payments received by such parent with respect to such interest prior to the transfer of such interest to such subsidiary are includible in the ordinary gross income of such parent and not includible in the ordinary gross income of such subsidiary.

(b) *Definitions*—(1) *Qualified subsidiary.* For purposes of this section, a corporation is a qualified subsidiary for a taxable year if—

(i) Such corporation was established for the purpose of becoming a DISC,

(ii) Such corporation would qualify (or be treated) as a DISC for such taxable year if it is not a personal holding company, and

(iii) On every day of such taxable year on which shares of such corporation are outstanding, at least 80 percent of such shares are held directly by a second corporation.

(2) *Parent.* For purposes of this section, the term ''parent'' means a second corporation referred to in subparagraph (1)(iii) of this paragraph.

[T.D. 7323, 39 FR 34409, Sept. 25, 1974]

§ 1.993–1 Definition of qualified export receipts.

(a) *In general.* For a corporation to qualify as a DISC, at least 95 percent of its gross receipts for a taxable year must consist of qualified export receipts. Under section 993(a), the term ''qualified export receipts'' means any of the eight amounts described in paragraphs (b) through (i) of this section, except to the extent that any of the eight amounts is an excluded receipt within the meaning of paragraph (j) of this section. For purposes of this section and §§ 1.993–2 through 1.993–6—

(1) *DISC.* All references to a DISC mean a DISC, except when the context indicates that such term means a corporation in the process of meeting the conditions necessary for that corporation to become a DISC, or a corporation being tested as to whether it qualifies as a DISC.

(2) *Sale, lease, and license.* The term ''sale'' includes an exchange or other disposition and the term ''lease'' includes a rental or a sublease. The term ''license'' includes a sublicense. All rules under this section and §§ 1.993–2 through 1.993–6 applicable to leases of export property apply in the same manner to licenses of export property. See § 1.993–3(f)(3) for a description of intangible property which cannot be export property.

(3) *Gross receipts.* The term ''gross receipts'' is defined by section 993(f) and § 1.993–6.

(4) *Qualified export assets.* The term ''qualified export assets'' is defined by section 993(b) and § 1.993–2.

(5) *Export property.* The term ''export property'' is defined by section 993(c) and § 1.993–3.

(6) *Related person.* The term ''related person'' means a person who is related to another person if either immediately before or after a transaction—

(i) The relationship between such persons would result in a disallowance of losses under section 267 (relating to disallowance of losses, etc., between related taxpayers), or section 707(b) (relating to losses disallowed, etc., between partners and controlled partnerships), and the regulations thereunder, or

(ii) Such persons are members of the same controlled group of corporations, as defined in section 1563(a) (relating to definition of controlled group of corporations), except that (*a*) ''more than 50 percent'' shall be substituted for ''at least 80 percent'' each place it appears in section 1563(a) and the regulations thereunder, and (*b*) the provisions of section 1563(b) shall not apply in determining whether such persons are members of the same controlled group.

(7) *Related supplier.* The term ''related supplier'' is defined by § 1.994–1(a)(3)(ii).

(8) *Controlled group.* The term ''controlled group'' is defined by paragraph (k) of this section.

(b) *Sales of export property.* Qualified export receipts of a DISC include gross receipts from the sale of export property by such DISC, or by any principal for whom such DISC acts as a commission agent (whether or not such principal is a related supplier), pursuant to the terms of a contract entered into with a purchaser by such DISC or by such principal at any time or by any other person and assigned to such DISC or such principal at any time prior to the shipment of such property to the purchaser. Any agreement, oral or written, which constitutes a contract at law, satisfies the contractual requirement of this paragraph. Gross receipts from the sale of export property, whenever received, do not constitute qualified export receipts unless the seller (or the corporation acting as commission agent for the seller) is a DISC at the time of the shipment of such property to the purchaser. For example, if a corporation which sells export property under the installment method is not a DISC for the taxable year in which the property is shipped to the purchaser, gross receipts from such sale do not constitute qualified export receipts for any taxable year of the corporation.

(c) *Leases of export property*—(1) *In general.* Qualified export receipts of a DISC include gross receipts from the lease of export property provided that—

(i) Such property is held by such DISC (or by a principal for whom such DISC acts as commission agent with respect to the lease) either as an owner or lessee at the beginning of the term of such lease, and

(ii) Such DISC qualified (or was treated) as a DISC for its taxable year in which the term of such lease began.

(2) *Prepayment of lease receipts.* If part or all of the gross receipts from a lease of property are prepaid, then—

(i) All such prepaid gross receipts are qualified export receipts of a DISC if it is reasonably expected at the time of such prepayment that throughout the term of such lease they would be qualified export receipts if received not as a prepayment; or

(ii) If it is reasonably expected at the time of such prepayment that throughout the term of such lease they would not be qualified export receipts if received not as a prepayment, then only those prepaid receipts, for the taxable years of the DISC for which they would be qualified export receipts, are qualified export receipts.

Thus, for example, if a lessee makes a prepayment of the first and last years' rent, and it is reasonably expected that the leased property will be export property for the first half of the lease period but not the second half of such period, the amount of the prepayment which represents the first year's rent will be considered qualified export receipts if it would otherwise qualify, whereas the amount of the prepayment which represents the last year's rent will not be considered qualified export receipts.

(d) *Related and subsidiary services*—(1) *In general.* Qualified export receipts of a DISC include gross receipts from services furnished by such DISC which are related and subsidiary to any sale or lease (as described in paragraph (b) or (c) of this section) of export property by such DISC or with respect to which such DISC acts as a commission agent, provided that such DISC derives qualified export receipts from such sale or lease. Such services may be performed within or without the United States.

(2) *Services furnished by DISC.* Services are considered to be furnished by a DISC for purposes of this paragraph if such services are provided by—

(i) The person who sold or lease the export property to which such services are related and subsidiary, provided that the DISC acts as a commission agent with respect to the sale or lease of such property and with respect to such services,

(ii) The DISC as principal, or any other person pursuant to a contract between such person and such DISC, provided the DISC acted as principal or commission agent with respect to the sale or lease of such property, or

(iii) A member of the same controlled group as the DISC where the sale or lease of the export property is made by another member of such controlled group provided, however, that the DISC act as principal or commission agent with respect to such sale or lease and as commission agent with respect to such services.

(3) *Related services.* A service is related to a sale or lease of export property if—

(i) Such service is of the type customarily and usually furnished with the type of transaction in the trade or business in which such sale or lease arose and

(ii) The contract to furnish such service—

(*a*) Is expressly provided for in or is provided for by implied warranty under the contract of sale or lease,

(*b*) Is entered into on or before the date which is 2 years after the date on which the contract under which such sale or lease was entered into, provided that the person described in subparagraph (2) of this paragraph which is to furnish such service delivers to the purchaser or lessor a written offer or option to furnish such services on or before the date on which the first shipment of goods with respect to which the service is to be performed is delivered, or

(*c*) Is a renewal of the services contract described in (*a*) or (*b*) of this subdivision. Services which may be related to a sale or lease of export property include but are not limited to warranty service, maintenance service, repair service, and installation service. Transportation (including insurance related to such transportation) may be related

to a sale or lease of export property, provided that the cost of such transportation is included in the sale price or rental of the property or, if such cost is separately stated, is paid by the DISC (or its principal) which sold or leased the property to the person furnishing the transportation service. Financing or the obtaining of financing for a sale or lease is not a related service for purposes of this paragraph.

(4) *Subsidiary services*—(i) *In general.* Services related to a sale or lease of export property are subsidiary to such sale or lease only if it is reasonably expected at the time of such sale or lease that the gross receipts from all related services furnished by the DISC (as defined in subparagraphs (2) and (3) of this paragraph) will not exceed 50 percent of the sum of (a) the gross receipts from such sale or lease and (b) the gross receipts from related services furnished by the DISC (as described in subparagraph (2) of this paragraph). In the case of a sale, reasonable expectations at the time of the sale are based on the gross receipts from all related services which may reasonably be expected to be performed at any time before the end of the 10-year period following the date of such-sale. In the case of a lease, reasonable expectations at the time of the lease are based on the gross receipts from all related services which may reasonably be expected to be performed at any time before the end of the term of such lease (determined without regard to renewal options).

(ii) *Allocation of gross receipts from services.* In determining whether the services related to a sale or lease of export property are subsidiary to such sale or lease, the gross receipts to be treated as derived from the furnishing of services may not be less than the amount of gross receipts reasonably allocated to such services as determined under the facts and circumstances of each case without regard to whether—

(*a*) Such services are furnished under a separate contract or under the same contract pursuant to which such sale or lease occurs or

(*b*) The cost of such services is specified in the contract of sale or lease.

(iii) *Transactions involving more than one item of export property.* If more than one item of export property is sold or leased in a single transaction pursuant to one contract, the total gross receipts from such transaction and the total gross receipts from all services related to such transaction are each taken into account in determining whether such services are subsidiary to such transaction. However, the provisions of this subdivision apply only if such items could be included in the same product line, as determined under §1.994–1(c)(7).

(iv) *Renewed service contracts.* If under the terms of a contract for related services, such contract is renewable within 10 years after a sale of export property, or during the term of a lease of export property, related services to be performed under the renewed contract are subsidiary to such sale or lease if it is reasonably expected at the time of such renewal that the gross receipts from all related services which have been and which are to be furnished by the DISC (as described in subparagraph (2) of this paragraph) will not exceed 50 percent of the sum of (*a*) the gross receipts from such sale or lease and (*b*) the gross receipts from related services furnished by the DISC (as so described). Reasonable expectations are determined as provided in subdivision (i) of this subparagraph.

(v) *Parts used in services.* In a services contract described in subparagraph (3) of this paragraph provides for the furnishing of parts in connection with the furnishing of related services, gross receipts from the furnishing of such parts are not taken into account in determining whether under this subparagraph the services are subsidiary. See paragraph (b) or (c) of this section to determine whether the gross receipts from the furnishing of parts consitute qualified export receipts. See §1.993–3(c)(2)(iv) and (e)(3) for rules regarding the treatment of such parts with respect to the manufacture of export property and the foreign content of such property, respectively.

(5) *Relation to leases.* If the gross receipts for services which are related and subsidiary to a lease of property have been prepaid at any time for all such services which are to be performed before the end of the term of such lease, then as of the time of the

prepayment the rules in paragraph (c)(2) of this section (relating to prepayment of lease receipts) will determine whether prepaid services under this subdivision are qualified export receipts. Thus, for example if it is reasonably expected that leased property will be export property for the first year of the term of the lease but will not be export property for the second year of the term, prepaid gross receipts for related and subsidiary services to be furnished in the first year may be qualified export receipts. However, any prepaid gross receipts for such services to be furnished in the second year cannot be qualified export receipts.

(6) *Relation with export property determination.* The determination as to whether gross receipts from the sale or lease of export property constitute qualified export receipts does not depend upon whether services connected with such sale or lease are related and subsidiary to such sale or lease. Thus, for example, assume that a DISC receives gross receipts of $1,000 from the sale of export property and gross, receipts of $1,100 from installation and maintenance services which are to be furnished by such DISC within 10 years after the sale and which are related to such sale. The $1,100 which the DISC receives for such services would not be qualified export receipts since the gross receipts from the services exceed 50 percent of the sum of the gross receipts from the sale and the gross receipts from the related services furnished by such DISC. The $1,000 which the DISC receives from the sale of export property would, however, be a qualified export receipt if the sale met the requirements of paragraph (b) of this section.

(e) *Gains from sales of certain qualified export assets.* Qualified export receipts of a DISC include gross receipts from the sale by such DISC of any assets (wherever located) which, as of the date of such sale, are qualified export assets as defined in §1.993–2 even though such assets are not export property (as defined in §1.993–3). Gross receipts are derived from the sale of such assets only where such sale results in recognized gain (see §1.993–6(a)). For purposes of this paragraph, losses from the sale of such qualified export assets shall not be taken into account for purposes of determining the DISC's qualified export receipts.

(f) *Dividends.* Qualified export receipts of a DISC for a taxable year include all dividends includible in the gross income of such DISC for such taxable year with respect to the stock of related foreign export corporations (as defined in §1.993–5) and all amounts includible in the gross income of such DISC with respect to such corporations pursuant to section 951 (relating to amounts included in the gross income of U.S. shareholders of controlled foreign corporations).

(g) *Interest on obligations which are qualified export assets.* Qualified export receipts of a DISC include interest on any obligation which is a qualified export asset of such DISC, including any amount includible in gross income as interest (such as, for example, an amount treated as original issue discount pursuant to section 1232) or as imputed interest under section 483. Gain from the sale of obligations described in this paragraph is treated (to the extent such gain is not treated as interest on such obligations) as qualified export receipts pursuant to paragraph (e) of this section.

(h) *Engineering and architectural services*—(1) *In general.* Qualified export receipts of a DISC include gross receipts from engineering services (as described in subparagraph (5) of this paragraph) or architectural services (as described in subparagraph (5) of this paragraph) or architectural services (as described in subparagraph (6) of this paragraph) furnished by such DISC (as described in subparagraph (7) of this paragraph) for a construction project (as defined in subparagraph (8) of this paragraph) located, or proposed for location, outside the United States. Such services may be performed within or without the United States.

(2) *Services included.* Engineering and architectural services include feasibility studies for a proposed construction project whether or not such project is ultimately initiated.

(3) *Excluded services.* Engineering and architectural services do not include—

(i) Services connected with the exploration for minerals or

(ii) Technical assistance or knowhow.

For purposes of this paragraph, the term ''technical assistance or know-how'' includes activities or programs designed to enable business, commerce, industrial establishments, and governmental organizations to acquire or use scientific, architectural, or engineering information.

(4) *Other services.* Receipts from the performance of construction activities other than engineering and architectural services constitute qualified export receipts to the extent that such activities are related and subsidiary services (within the meaning of paragraph (d) of this section) with respect to a sale or lease of export property.

(5) *Engineering services.* For purposes of this paragraph, engineering services in connection with any construction project (within the meaning of subparagraph (8) of this paragraph) include any professional services requiring engineering education, training, and experience and the application of special knowledge of the mathematical, physical, or engineering sciences to such professional services as consultation, investigation, evaluation, planning, design, or responsible supervision of construction for the purpose of assuring compliance with plans, specifications, and design.

(6) *Architectural services.* For purposes of this paragraph, architectural services include the offering or furnishing of any professional services such as consultation, planning, aesthetic, and structural design, drawings and specifications, or responsible supervision of construction (for the purpose of assuring compliance with plans, specifications, and design) or erection, in connection with any construction project (within the meaning of subparagraph (8) of this paragraph).

(7) *Definition of ''furnished by such DISC''.* For purposes of this paragraph, architectural and engineering services are considered furnished by a DISC if such services are provided—

(i) By the DISC,

(ii) By another person (whether or not a United States person) pursuant to a contract entered into by such person with the DISC at any time prior to the furnishing of such services, provided that the DISC acts as principal with respect to the furnishing of such services, or

(iii) By another person (whether or not a United States person) pursuant to a contract for the furnishing of such services entered into at any time prior to the furnishing of such services provided that the DISC acts as commission agent with respect to such services.

(8) *Definition of ''construction project''.* For purposes of this paragraph, the term ''construction project'' includes the erection, expansion, or repair (but not including minor remodeling or minor repairs) of new or existing buildings or other physical facilities including, for example, roads, dams, canals, bridges, tunnels, railroad, tracks, and pipelines. The term also includes site grading and improvement and installation of equipment necessary for the construction. Gross receipts from the sale or lease of construction equipment are not qualified export receipts unless such equipment is export property (as defined in §1.993–3).

(i) *Managerial services*—(1) *In general.* Qualified export receipts of a first DISC for its taxable year include gross receipts from the furnishing of managerial services provided for another DISC, which is not a related person, to aid such unrelated DISC in deriving qualified export receipts, provided that at least 50 percent of the gross receipts of the first DISC for such year consists of qualified export receipts derived from the sale or lease of export property and the furnishing of related and subsidiary services, as described in paragraph (b), (c), and (d) of this section, respectively.

For purposes of this paragraph, managerial services are considered furnished by a DISC if such services are provided—

(i) By the first DISC,

(ii) By another person (whether or not a United States person) pursuant to a contract entered into by such person with the first DISC at any time prior to the furnishing of such services, provided that the first DISC acts as principal with respect to the furnishing of such services, or

(iii) By another person (whether or not a United States person) pursuant to a contract for the furnishing of such

services entered into at any time prior to the furnishing of such services provided that the DISC acts as commission agent with respect to such services.

(2) *Definition of ''managerial services.''* The term ''managerial services'' as used in this paragraph means activities relating to the operation of another unrelated DISC which derives qualified export receipts from the sale or lease of export property and from the furnishing of services related and subsidiary to such sales or leases. Such term includes staffing and operational services necessary to operate such other DISC, but does not include legal, accounting, scientific, or technical services. Examples of managerial services are: (i) Export market studies, (ii) making shipping arrangements, and (iii) contracting potential foreign purchasers.

(3) *Status of recipient of managerial services*—(i) *In general.* Qualified export receipts of a first DISC include receipts from the furnishing of managerial services during any taxable year of a recipient if such recipient qualifies as a DISC (within the meaning of §1.992–1(a) for such taxable year.

(ii) *Recipient deemed to qualify as a DISC.* For purposes of subdivision (i) of this subparagraph, a recipient is deemed to qualify as a DISC for its taxable year if the first DISC obtains from such recipient a copy of such recipient's election to be treated as a DISC as described in §1.992–2(a) together with such recipient's sworn statement that such election has been filed with the Internal Revenue Service Center. The recipient may mark out the names of its shareholders on a copy of its election to be treated as a DISC before submitting it to the first DISC. The copy of the election and the sworn statement of such recipient must be received by the first DISC within 6 months after the beginning of the first taxable year of the recipient during which such first DISC furnishes managerial services for such recipient. The copy of the election and the sworn statement of the recipient need not be obtained by the first DISC for subsequent taxable years of the recipient.

(iii) *Recipient not treated as a DISC.* For purposes of subdivision (i) of this subparagraph, a recipient of managerial services is not treated as a DISC with respect to such services performed during a taxable year for which such recipient does not qualify as a DISC if the DISC performing such services does not believe or if a reasonable person would not believe (taking into account the furnishing DISC's managerial relationship with such recipient DISC) at the beginning of such taxable year that the recipient will qualify as a DISC for such taxable year.

(j) *Excluded receipts*—(1) *In general.* Notwithstanding the provisions of paragraphs (b) through (i) of this section, qualified export receipts of a DISC do not include any of the five amounts described in subparagraphs (2) through (6) of this paragraph.

(2) *Sales and leases of property for ultimate use in the United States.* Property which is sold or leased for ultimate use in the United States does not constitute export property. See §1.993–3(d)(4) (relating to determination of where the ultimate use of the property occurs). Thus, qualified export receipts of a DISC described in paragraph (b) or (c) of this section do not include gross receipts of the DISC from the sale or lease of such property.

(3) *Sales of export property accomplished by subsidy.* Qualified export receipts of a DISC do not include gross receipts described in paragraph (b) of this section if the sale of export property (whether or not such property consists of agricultural products) is pursuant to any of the following:

(i) The development loan program, or grants under the technical cooperation and development grants program of the Agency for International Development, or grants under the military assistance program administered by the Department of Defense, pursuant to the Foreign Assistance Act of 1961, as amended (22 U.S.C. 2151), unless the DISC shows to the satisfaction of the district director that, under the conditions existing at the time of the sale, the purchaser had a reasonable opportunity to purchase, on competitive terms and from a seller who was not a U.S. person, goods which were substantially identical to

such property and which were not manufactured, produced, grown, or extracted (as described in §1.993–3(c)) in the United States,

(ii) The Pub. L. 480 program authorized under title I of the Agricultural Trade Development and Assistance Act of 1954, as amended (7 U.S.C. 1691, 1701–1710),

(iii) For taxable years ending before January 1, 1974, the Barter program of the Commodity Credit Corporation authorized by section 4(h) of the Commodity Credit Corporation Charter Act, as amended (15 U.S.C. 714b(h)), and section 303 of the Agricultural Trade Development and Assistance Act of 1954, as amended (7 U.S.C. 1692) but only if the taxpayer treats such sales as sales giving rise to excluded receipts,

(iv) The Export Payment program of the Commodity Credit Corporation authorized by sections 5(d) and (f) of the Commodity Credit Corporation Charter Act, as amended (15 U.S.C. 714c (d) and (f)),

(v) The section 32 export payment programs authorized by section 32 of the Act of August 24, 1935, as amended (7 U.S.C. 612c), and

(vi) For taxable years beginning after November 3, 1972, the Export Sales program of the Commodity Credit Corporation authorized by sections 5 (d) and (f) of the Commodity Credit Corporation Charter Act, as amended (15 U.S.C. 714c (d) and (f)), other than the GSM–4 program provided under 7 CFR part 1488, and section 407 of the Agricultural Act of 1949, as amended (7 U.S.C. 1427), for the purpose of disposing of surplus agricultural commodities and exporting or causing to be exported agricultural commodities, except that for taxable years beginning on or before November 3, 1972, the taxpayer may treat such sales as sales giving rise to excluded receipts.

(4) *Sales or lease of export property and furnishing of engineering or architectural services for use by the United States*—(i) *In general.* Qualified export receipts of a DISC do not include gross receipts described in paragraph (b), (c), or (h) of this section if a sale or lease of export property, or the furnishing of engineering or architectural services, is for use by the United States or an instrumentality thereof in any case in which any law or regulation requires in any manner the purchase or lease of property manufactured, produced, grown, or extracted in the United States or requires the use of engineering or architectural services performed by a U.S. person. For example, a sale by a DISC of export property to the Department of Defense for use outside the United States would not produce qualified export receipts for such DISC if the Department of Defense purchased such property from appropriated funds subject to any provisions of the Armed Services Procurement Regulations (32 CFR subchapter A, part 6, subpart A) or any appropriations act for the Department of Defense for the applicable year which restricts the availability of such appropriated funds to the procurement of items which are grown, reprocessed, reused, or produced in the United States.

(ii) *Direct or indirect sales or leases.* Any sale or lease of export property is for use by the United States or an instrumentality thereof is such property is sold or leased by a DISC (or by a principal for whom such DISC acts as commission agent) to—

(*a*) A person who is a related person with respect to such DISC or such principal and who sells or leases such property for use by the United States or an instrumentality thereof or

(*b*) A person who is not a related person with respect to such DISC or such principal if, at the time of such sale or lease, there is an agreement or understanding that such property will be sold or leased for use by the United States or an instrumentality thereof (or if a reasonable person would have known at the time of such sale or lease that such property would be sold or leased for use by the United States or an instrumentality thereof) within 3 years after such sale or lease.

(iii) *Excluded programs.* The provisions of subdivisions (i) and (ii) of this subparagraph do not apply in the case of a purchase by the United States or an instrumentality thereof if such purchase is pursuant to—

(*a*) The Foreign Military Sales Act, as amended (22 U.S.C. 2751 *et seq.*), or a program under which the U.S. Government purchases property for resale, on

commercial terms, to a foreign government or agency or instrumentality thereof, or

(*b*) A program (whether bilateral or multilateral) under which sales to the U.S. Government are open to international competitive bidding.

(5) *Services.* Qualified export receipts of a DISC do not include gross receipts described in paragraph (d) of this section (concerning related and subsidiary services) if the services from which such gross receipts are derived are related and subsidiary to the sale or lease of property which results in excluded receipts pursuant to this paragraph.

(6) *Receipts within controlled group*—(i) *In general.* Gross receipts of a corporation do not constitute qualified export receipts for any taxable year of such corporation if—

(*a*) At the time of the sale, lease, or other transaction resulting in such gross receipts, such corporation and the person from whom such receipts are directly or indirectly derived (whether or not such corporation and such person are the same person) are members of the same controlled group (as defined in paragraph (k) of this section) and

(*b*) Such corporation and such person each qualifies (or is treated under section 992(a)(2)) as a DISC for its taxable year in which its receipts arise.

Thus, for example, assume that R, S, X, and Y are members of the same controlled group and that X and Y are DISC's. If R sells property to S and pays X a commission relating to that sale and if S sells the same property to an unrelated foreign party and pays Y a commission relating to that sale, the receipts received by X from the sale of such property by R to S will be considered to be derived from Y, a DISC which is a member of the same controlled group as X, and thus will not result in qualified export receipts to X. The receipts received by Y from the sale to an unrelated foreign party may, however, result in qualified export receipts to Y. For another example, if R and S both assign the commissions to X, receipts derived from the sale from R to S will be considered to be derived from X acting as commission agent for S and will not result in qualified export receipts to X. Receipts derived by X from the sale of property by S to an unrelated foreign party, may, however, constitute qualified export receipts.

(ii) *Leased property.* See §1.993–3(f)(2) regarding property not constituting export property in certain cases where such property is leased to any corporation which is a member of the same controlled group as the lessor.

(k) *Definition of ''controlled group''.* For purposes of sections 991 through 996 and the regulations thereunder, the term ''controlled group'' has the same meaning as is assigned to the term ''controlled group of corporations'' by section 1563(a), except that (1) the phrase ''more than 50 percent'' is substituted for the phrase ''at least 80 percent'' each place the latter phrase appears in section 1563(a), and (2) section 1563(b) shall not apply. Thus, for example, a foreign corporation subject to tax under section 881 may be a member of a controlled group. Furthermore, two or more corporations (including a foreign corporation) are members of a controlled group at any time such corporations meet the requirements of section 1563(a) (as modified by this paragraph).

(l) *DISC's entitlement to income*—(1) *Application of section 994.* A corporation which meets the requirements of §1.992–1(a) to be treated as a DISC for a taxable year is entitled to income, and the intercompany pricing rules of section 994(a)(1) or (2) apply, in the case of any transactions described in §1.994–1(b) between such DISC and its related supplier (as defined in §1.994–1(a)(3)). For purposes of this subparagraph, such DISC need not have employees or perform any specific function.

(2) *Other transactions.* In the case of a transaction to which the provisions of subparagraph (1) of this paragraph do not apply but from which a DISC derives gross receipts, the income to which the DISC is entitled as a result of the transaction is determined pursuant to the terms of the contract for such transaction and, if applicable, section 482 and the regulations thereunder.

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

Example 1. P Corporation forms S Corporation as a wholly-owned subsidiary. S qualifies as a DISC for its taxable year. S has no employees on its payroll. S is granted a franchise with respect to specified exports of P. P will sell such exports to S for resale by S. Such exports are of a type which produce qualified export receipts as defined in paragraph (b) of this section. P's sales force will solicit orders in the name of S using S's order forms. S places orders with P only when S itself has received orders. No inventory is maintained by S. P makes shipments directly to customers of S. Employees of P will act for S and billings and collections will be handled by P in the name of S. Under these facts, the income derived by S for such taxable year from the purchase and resale of the specified export is treated for Federal income tax purposes as the income of S, and the amount of income allocable to S will be determined under section 994 of the Code.

Example 2. P Corporation forms S Corporation as a wholly-owned subsidiary. S qualifies as a DISC for its taxable year. S has no employees on its payroll. S is granted a sales franchise with respect to specified exports of P and will receive commissions with respect to such exports. Such exports are of a type which will produce gross receipts for S which are qualified export receipts as defined in paragraph (b) of this section. P's sales force will solicit orders in the name of P. Billings and collections are handled directly by P. Under these facts, the commissions paid to S for such taxable year with respect to the specified exports shall be treated for Federal income tax purposes as the income of S, and the amount of income allocable to S is determined under section 994 of the Code.

[T.D. 7514, 42 FR 55454, Oct. 17, 1977; 42 FR 60910, Nov. 30, 1977, as amended by T.D. 7854, 47 FR 51739, Nov. 17, 1982]

§ 1.993–2 Definition of qualified export assets.

(a) *In general.* For a corporation to qualify as a DISC, at the close of its taxable year it must have qualified export assets with adjusted bases equal to at least 95 percent of the sum of the adjusted bases of all its assets. An asset which is a qualified export asset under more than one paragraph of this section shall be taken into account only once in determining the sum of the adjusted bases of all qualified export assets. Under section 993(b), the qualified export assets held by a corporation are—

(1) Export property as defined in §1.993–3 (see paragraph (b) of this section),

(2) Business assets described in paragraph (c) of this section,

(3) Trade receivables described in paragraph (d) of this section,

(4) Temporary investments to the extent described in paragraph (e) of this section,

(5) Producer's loans as defined in §1.993–4 (see paragraph (f) of this section),

(6) Stock or securities (described in paragraph (g) of this section) of related foreign export corporations as defined in §1.993–5,

(7) Export-Import Bank and other obligations described in paragraph (h) of this section,

(8) Financing obligations described in paragraph (i) of this section, and

(9) Funds awaiting investment described in paragraph (j) of this section.

(b) *Export property.* In general, export property is certain property held for sale or lease which meets the requirements of §1.993–3.

(c) *Business assets.* For purposes of this section, business assets are assets used by a DISC (other than as a lessor) primarily in connection with—

(1) The sale, lease, storage, handling, transportation, packaging, assembly, or servicing of export property, or

(2) The performance of engineering or architectural services (described in §1.993–1(h)) or managerial services (described in §1.993–1(i)) in furtherance of the production of qualified export receipts.

Assets used primarily in the manufacture, production, growth, or extraction (within the meaning of §1.993–3(c)) of property are not business assets.

(d) *Trade receivables*—(1) *In general.* For purposes of this section, trade receivables are accounts receivable and evidences of indebtedness which arise by reason of transactions of such corporation or of another corporation which is a DISC and which is a member of a controlled group which includes such corporation described in subparagraph (A), (B), (C), (D), (G), or (H), of section 993(a)(1) and which are due the DISC (or, if it acts as an agent, due its principal) and held by the DISC.

(2) *Trade receivables representing commissions.* If a DISC acts as commission agent for a principal in a transaction described in §1.993–1 (b), (c), (d), (e), (h),

or (i) which results in qualified export receipts for the DISC, and if an account receivable or evidence of indebtedness held by the DISC and representing the commission payable to the DISC as a result of the transaction arises (and, in the case of an evidence of indebtedness, designated on its face as representing such commission), such account receivable or evidence of indebtedness shall be treated as a trade receiveable. If, however, the principal is a related supplier (as defined in §1.994–1(a)(3)) with respect to the DISC, such account receivable or evidence of indebtedness will not be treated as a trade receivable unless it is payable and paid in a time and manner which satisfy the requirements of §1.994–1(e)(3) or (5) (relating to initial payment of transfer price or commission and procedure for adjustments to transfer price or commission, respectively), as the case may be. However, see subparagraph (3) of this paragraph for rules regarding certain accounts receivable representing commissions payable to a DISC by its related supplier.

(3) *Indebtedness arising under §1.994–1(e).* An indebtedness arising under §1.994–1(e)(3)(iii) (relating to initial payment of transfer price or commission) in favor of a DISC is not a qualified export asset. An indebtedness arising under §1.994–1(e)(5)(i) (relating to procedure for adjustments to transfer price or commission) in favor of a DISC is a trade receivable if it is paid in the time and manner described in §1.994–1(e)(5)(i) and (ii) and if it otherwise satisfies the requirements of subparagraph (2) of this paragraph. If such an indebtedness is not paid in the time and manner described in §1.994–1(e)(5)(i) and (ii), it is not a qualified export asset.

(e) *Temporary investments*—(1) *In general.* For purposes of this section, temporary investments are money, bank deposits (not including time deposits of more than 1 year), and other similar temporary investments to the extent maintained by a DISC as reasonably necessary to meet its requirements for working capital. For purposes of this paragraph, a temporary investment is an obligation, including an evidence of indebtedness as defined in paragraph (d)(1) of this section, which is a demand obligation or has a period remaining to maturity of not more than 1 year at the date it is acquired by the DISC. A temporary investment does not include trade receivables.

(2) *Determination of amount of working capital maintained.* For purposes of this paragraph—

(i) The working capital of a DISC is the excess of its current assets over current liabilities.

(ii) Current assets are cash and other assets (other than trade receivables) which may reasonably be expected to be converted into cash or sold or consumed during the current normal operating cycle of the DISC's trade or business.

(iii) Current liabilities are obligations (or portions of obligations) due within the current normal operating cycle of the trade or business of the DISC whose satisfaction when due is reasonably expected to require the use of current assets.

(iv) Generally accepted financial accounting treatments will be accepted, and

(v) Current assets (other than temporary investments) are taken into account before temporary investments, and trade receivables are never taken into account, in determining whether such temporary investments are maintained by the DISC as reasonably necessary to meet his current liabilities and its requirements for working capital.

(3) *Determination of amount of working capital reasonably required.* For purposes of this paragraph, a determination of the amount of money, bank deposits, and other similar temporary investments reasonably necessary to meet the requirements of the DISC for working capital will depend upon the nature and volume of the activities of the DISC existing at the end of the DISC's taxable year for which such determination is made, such as, for example—

(i) In the case of a DISC which purchases and sells inventory, the amount of working capital reasonably required is limited to an amount reasonably necessary to meet the ordinary operating expenses during the current normal operating cycle of the trade or business of the DISC, an amount reasonably needed to meet specific and definite plans for expansion and any

amounts necessary for reasonably anticipated extraordinary business expenses.

(ii) In the case of a DISC which actively conducts a trade or business (including the employment of a sales force) and receives commissions in respect of goods to which such DISC does not have title, the amount of working capital required will depend upon the nature and volume of the activities of the DISC which produce such income as they exist on the applicable determination date. In determining the amount of working capital which is reasonably required for the production of such income, the anticipated future needs of the business will be taken into account to the extent that such needs relate to the year of the DISC following the applicable determination date. Anticipated future needs relating to a later period will not be taken into account unless it is clearly established that such needs are reasonably related to the production of such income as of the applicable determination date.

(iii) In the case of a DISC which does not actively conduct a trade or business, and which receives commissions solely by reason of section 994(a)(1), (a)(2), or (b) with respect to goods to which such DISC does not have title, no working capital would be required beyond a de minimis amount unless it appears from the facts and circumstances that additional working capital will be required.

(iv) In the case of a DISC deriving income from the leasing of property, the amount of working capital required will be determined on the basis of the facts and circumstances in such case.

(4) *Relationship of working capital to other qualified export assets.* If a temporary investment is a qualified export asset under any provision of this section (other than this paragraph), this paragraph shall not affect its status as a qualified export asset. However, any such temporary investment is taken into account before other temporary investments in determining whether such other temporary investments are maintained by a DISC as reasonably necessary to meet its requirements for working capital. Current assets (other than temporary investments) are taken into account before temporary investments, and trade receivables are never taken into account, in determining whether such temporary investments are maintained by the DISC as reasonably necessary requirements for working capital. An obligation issued or incurred by a member of a controlled group (as defined in §1.993–1(k)) of which the DISC is a member is not a qualified export asset under this paragraph. For rules regarding working capital as of the end of each month of a taxable year for purposes of the 70-percent reasonableness standard with respect to certain deficiency distributions, see paragraph (j)(3) of this section.

(f) *Producer's loans.* For purposes of this section, a producer's loan is an evidence of indebtedness arising in connection with producer's loans which are made by a DISC and which meet the requirements of §1.993–4. If a producer's loan is a qualified export asset, interest accrued with respect to the producer's loan will also be treated as a qualified export asset provided that payment is made in the form of money, property (valued at its fair market value on its date of transfer and including accounts receivable for sales by or through a DISC), a written obligation which qualifies as a debt under the safe harbor rule of §1.992–1(d)(2)(ii), or an accounting entry offsetting the account receivable against an existing debt owed by the person in whose favor the account receivable was established to the person with whom it engaged in the transaction and that payment is made no later than 60 days following the close of the taxable year of accrual of the interest. This paragraph (f) is effective for taxable years beginning after January 10, 1985 except that the taxpayer may at its option apply the provisions of this paragraph to taxable years ending after December 31, 1971.

(g) *Stock or securities of related foreign corporations.* For purposes of this section, the term ''stock or securities'', with respect to a related foreign export corporation (as defined in §1.993–5), has the same meaning as such term has as used in section 351 (relating to transfers to controlled corporations), except that the term ''securities'' does not include obligations which are repaid, in whole or in part, at any time during

the taxable year of the DISC following the taxable year of the DISC during which such obligations were acquired by the DISC or were issued, unless the DISC demonstrates to the satisfaction of the district director that the repayment was for bona fide business purposes and not for the purpose of avoidance of Federal income taxes.

(h) *Export-Import Bank obligations.* For purposes of this section, the term ''Export-Import Bank obligations'' means obligations issued, guaranteed, insured, or reinsured (in whole or in part) by the Export-Import Bank of the United States or by the Foreign Credit Insurance Association, but only if such obligations are acquired by the DISC—

(1) From the Export-Import Bank of the United States,

(2) From the Foreign Credit Insurance Association, or

(3) From the person selling or purchasing the goods or services by reason of which such obligations arose, or from any corporation which is a member of the same controlled group (as defined in §1.993–1(k)) as such person.

For purposes of this paragraph, obligations issued by a person described in subparagraphs (1), (2), and (3) of this paragraph are treated as acquired from such person by the DISC if acquired from any person not more than 90 days after the date of original issue (as defined in §1.1232–3(b)(3)). Examples of specific types of Export-Import Bank obligations include debentures issued by such bank and certificates of loan participation.

(i) *Financing obligations.* For purposes of this section, financing obligations are obligations (held by a DISC) of a domestic corporation organized solely for the purpose of financing sales of export property pursuant to an agreement with the Export-Import Bank of the United States under which such corporation makes export loans guaranteed by such Bank.

(j) *Funds awaiting investment*—(1) *In general.* For purposes of this section, subject to the limitation descibed in subparagraph (2) of this paragraph, if, at the close of a DISC's taxable year, the sum of the DISC's money, bank deposits, and other similar temporary investments is determined under paragraph (e) of this section to exceed an amount reasonably necessary to meet the DISC's requirements for working capital, the amount of the DISC's bank deposits in the United States to the extent of the amount of this excess are funds awaiting investment at the close of such taxable year.

(2) *Limitation.* Bank deposits described in subparagraph (1) of this paragraph are funds awaiting investment only if, by the last day of each of the sixth, seventh, and eighth months after the close of such taxable year, the sum of the adjusted bases of the qualified export assets of the DISC (other than such bank deposits) equals or exceeds 95 percent of the sum of the adjusted bases of all assets of the DISC (including such bank deposits) it held on the last day of such taxable year. For purposes of this subparagraph, the adjusted bases of assets of a DISC are determined as of the end of each of the months referred to in this subparagraph. Funds awaiting investment as described in this paragraph need not be traceable to any of the qualified export assets held by the DISC at the end of any of the months referred to in this subparagraph.

(3) *Coordination with certain deficiency distribution provisions.* Under section 992(c)(3) and §1.992–3(d) a deficiency distribution made on or before the 15th day of the ninth month after the end of a corporation's taxable year is deemed to be for reasonable cause if certain requirements are met, including the requirement (described in section 992(c)(3)(B) and §1.992–3(d)(2)) that the sum of the adjusted bases of the qualified export assets held by the corporation on the last day of each month of such year equals or exceeds 70 percent of the sum of the adjusted bases of all assets held by the corporation on each such last day. If, on any such last day, the sum or a DISC's money, bank deposits, and other similar temporary investments is determined under paragraph (e) of this section to exceed an amount reasonably necessary to meet the DISC's requirements for working capital, the amount of the DISC's bank deposits to the extent of the amount of this excess are funds awaiting investment on such last day, if either—

(i) The requirements of subparagraph (2) of this paragraph are satisfied with

respect to the taxable year of the DISC which includes such month or

(ii) At the close of such taxable year the sum of the DISC's money, bank deposits, and other similar temporary investments is determined under paragraph (e) of this section not to exceed an amount reasonably necessary to meet the DISC's requirements for working capital.

(Secs. 995(e)(7), (8) and (10), 995(g) and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1655, 26 U.S.C. 995 (e)(7), (8) and (10); 90 Stat. 1659, 26 U.S.C. 995(g); and 68A Stat 917, 26 U.S.C. 7805))

[T.D. 7514, 42 FR 55459, Oct. 17, 1977; 42 FR 60910, Nov. 30, 1977, as amended by T.D. 7854, 47 FR 51740, Nov. 17, 1982; T.D. 7984, 49 FR 40018, Oct. 12, 1984]

§ 1.993–3 Definition of export property.

(a) *General rule.* Under section 993(c), except as otherwise provided with respect to excluded property in paragraph (f) of this section and with respect to certain short supply property in paragraph (i) of this section, export property is property in the hands of any person (whether or not a DISC)—

(1) Manufactured, produced, grown, or extracted in the United States by any person or persons other than a DISC (see paragraph (c) of this section),

(2) Held primarily for sale or lease in the ordinary course of a trade or business to any person for direct use, consumption, or disposition outside the United States (see paragraph (d) of this section),

(3) Not more than 50 percent of the fair market value of which is attributable to articles imported into the United States (see paragraph (e) of this section), and

(4) Which is not sold or leased by a DISC, or with a DISC as commission agent, to another DISC which is a member of the same controlled group (as defined in §1.993–1(k)) as the DISC.

(b) *Services.* For purposes of this section, services (including the written communication of services in any form) are not export property. Whether an item is property or services shall be determined on the basis of the facts and circumstances attending the development and disposition of the item. Thus, for example, the preparation of a map of a particular construction site would constitute services and not export property, but standard maps prepared for sale to customers generally would not constitute services and would be export property if the requirements of this section were otherwise met.

(c) *Manufacture, production, growth, or extraction of property*—(1) *By a person other than a DISC.* Export property may be manufactured, produced, grown, or extracted in the United States by any person, provided that such person does not qualify (and is not treated) as a DISC. Property held by a DISC which was manufactured, produced, grown, or extracted by it at a time when it did not qualify (and was not treated) as a DISC is not export property of the DISC. Property which sustains further manufacture or production outside the United States prior to sale or lease by a person but after manufacture or production in the United States will not be considered as manufactured, produced, grown, or extracted in the United States by such person.

(2) *Manufactured or produced*—(i) *In general.* For purposes of this section, property which is sold or leased by a person is considered to be manufactured or produced by such person if such property is manufactured or produced (within the meaning of either subdivision (ii), (iii), or (iv) of this subparagraph) by such person or by another person pursuant to a contract with such person. Except as provided in subdivision (iv) of this subparagraph, manufacture or production of property does not include assembly or packaging operations with respect to property.

(ii) *Substantial transformation.* Property is manufactured or produced by a person if such property is substantially transformed by such person. Examples of substantial transformation of property would include the conversion of woodpulp to paper, steel rods to screws and bolts, and the canning of fish.

(iii) *Operations generally considered to constitute manufacturing.* Property is manufactured or produced by a person if the operations performed by such person in connection with such property are substantial in nature and are generally considered to constitute the manufacture or production of property.

(iv) *Value added to property.* Property is manufactured or produced by a person if with respect to such property conversion costs (direct labor and factory burden including packaging or assembly) of such person account for 20 percent of more of—

(*a*) The cost of goods sold or inventory amount of such person for such property is such property is sold or held for sale, or

(*b*) The adjusted basis of such person for such property, as determined in accordance with the provisions of section 1011, if such property is held for lease or leased.

The value of parts provided pursuant to a services contract, as described in §1.993–1 (d)(4)(v), is not taken into account in applying this subdivision.

(d) *Primary purpose of which property is held*—(1) *In general*—(i) *General rule.* Under paragraph (a)(2) of this section, export property (*a*) must be held primarily for the purpose of sale or lease in the ordinary course of trade or business to a DISC, or to any other person, and (*b*) such sale or lease must be for direct use, consumption, or disposition outside the United States. Thus, property cannot qualify as export property unless it is sold or leased for direct use, consumption or disposition outside the United States. Property is sold or leased for direct use, consumption, or disposition outside the United States if such sale or lease satisfies the destination test described in subparagraph (2) of this paragraph, the proof of compliance requirements described in subparagraph (3) of this paragraph, and the use outside the United States test described in subparagraph (4) of this paragraph.

(ii) *Factors not taken into account.* In determining whether property which is sold or leased to a DISC is sold or leased for direct use consumption, or disposition outside the United States, the fact that the acquiring DISC holds the property in inventory or for lease prior to the time it sells or leases it for direct use, consumption, or disposition outside the United States will not affect the characterization of the property as export property. Export property need not be physically segregated from other property.

(2) *Destination test.* (i) For purposes of subparagraph (1) of this paragraph the destination test in this subparagraph is satisfied with respect to property sold or leased by a seller or lessor only if it is delivered by such seller or lessor (or an agent of such seller or lessor) regardless of the F.O.B. point or the place at which title passes or risk of loss shifts from the seller or lessor—

(*a*) Within the United States to a carrier or freight forwarder for ultimate delivery outside the United States to a purchaser or lessee (or to a subsequent purchaser or sublessee),

(*b*) Within the United States to a purchaser or lessee, if such property is ultimately delivered, directly used, or directly consumed outside the United States (including delivery to a carrier or freight forwarder for delivery outside the United States) by the purchaser or lessee (or a subsequent purchaser or sublessee) within 1 year after such sale or lease,

(*c*) Within or outside the United States to a purchaser or lessee which, at the time of the sale or lease, is a DISC and is not a member of the same controlled group (as defined in §1.993–1(k)) as the seller or lessor,

(*d*) From the United States to the purchaser or lessee (or a subsequent purchaser or sublessee) at a point outside the United States by means of a ship, aircraft, or other delivery vehicle, owned, leased, or chartered by the seller or lessor,

(*e*) Outside the United States to a purchaser or lessee from a warehouse, a storage facility, or assembly site located outside the United States, if such property was previously shipped by such seller or lessor from the United States, or

(*f*) Outside the United States to a purchaser or lessee if such property was previously shipped by such seller or lessor from the United States and if such property is located outside the United States pursuant to a prior lease by the seller or lessor, and either (*1*) such prior lease terminated at the expiration of its term (or by the action of the prior lessee acting alone), (*2*) the sale occurred or the term of the subsequent lease began after the time at which the term of the prior lease would have expired, or (*3*) the lessee under the

subsequent lease is not a related person (as defined in §1.993–1(a)(6)) with respect to the lessor and the prior lease was terminated by the action of the lessor (acting alone or together with the lessee).

(ii) For purposes of this subparagraph (other than (*c*) and (*f*)(*3*) of subdivision (i) thereof), any relationship between the seller or lessor and any purchaser, subsequent purchaser, lessee, or sublessee is immaterial.

(iii) In no event is the destination test of this subparagraph satisfied with respect to property which is subject to any use (other than a resale or sublease), manufacture, assembly, or other processing (other than packaging) by any person between the time of the sale or lease by such seller or lessor and the delivery or ultimate delivery outside the United States described in this subparagraph.

(iv) If property is located outside the United States at the time it is purchased by a person or leased by a person as lessee, such property may be export property in the hands of such purchaser or lessee only if it is imported into the United States prior to its further sale or lease (including a sublease) outside the United States. Paragraphs (a)(3) and (e) of this section (relating to 50 percent foreign content test) are applicable in determining whether such property is export property. Thus, for example, if such property is not subjected to manufacturing or production (as defined in paragraph (c) of this section) within the United States after such importation, it does not qualify as export property.

(3) *Proof of compliance with destination test*—(i) *Delivery outside the United States.* For purposes of subparagraph (2) of this paragraph (other than subdivision (i)(*c*) thereof), a seller or lessor shall establish ultimate delivery, use, or consumption of property outside the United States by providing—

(*a*) A facsimile or carbon copy of the export bill of lading issued by the carrier who delivers the property,

(*b*) A certificate of an agent or representative of the carrier disclosing delivery of the property outside the United States,

(*c*) A facsimile or carbon copy of the certificate of lading for the property executed by a customs officer of the country to which the property is delivered,

(*d*) If such country has no customs administration, a written statement by the person to whom delivery outside the United States was made,

(*e*) A facsimile or carbon copy of the shipper's export declaration, a monthly shipper's summary declaration filed with the Bureau of Customs, or a magnetic tape filed in lieu of the Shipper's Export Declaration, covering the property,

(*f*) Any other proof (including evidence as to the nature of the property or the nature of the transaction) which establishes to the satisfaction of the Commissioner that the property was ultimately delivered, or directly sold, or directly consumed outside the United States within 1 year after the sale or lease.

(ii) The requirements of subdivision (i) (*a*), (*b*), (*c*), or (*e*) of this subparagraph will be considered satisfied even though the name of the ultimate consignee and the price paid for the goods is marked out provided that, in the case of a Shipper's Export Declaration or other document listed in such subdivision (*e*) or a document such as an export bill of lading such document still indicates the country in which delivery to the ultimate consignee is to be made and, in the case of a certificate of an agent or representative of the carrier, that such document indicates that the property was delivered outside the United States.

(iii) A seller or lessor shall also establish the meeting of the requirement of subparagraph (2)(i) of this paragraph (other than subdivision (*c*) thereof), that the property was delivered outside the United States without further use, manufacture, assembly, or other processing within the United States.

(iv) *Sale or lease to an unrelated DISC.* For purposes of subparagraph (2)(i)(*c*) of this paragraph, a purchaser or lessee of property is deemed to qualify as a DISC for its taxable year if the seller or lessor obtains from such purchaser or lessee a copy of such purchaser's or lessee's election to be treated as a DISC as described in §1.992–2(a) together with such purchaser's or lessee's sworn statement that such election has

been filed with the Internal Revenue Service Center. The copy of the election and the sworn statement of such purchaser or lessee must be received by the seller or lessor within 6 months after the sale or lease. A purchaser or lessee is not treated as a DISC with respect to a sale or lease during a taxable year for which such purchaser or lessee does not qualify as a DISC if the seller or lessor does not believe or if a reasonable person would not believe at the time such sale or lease is made that the purchaser or lessee will qualify as a DISC for such taxable year.

(v) *Failure of proof.* If a seller or lessor fails to provide proof of compliance with the destination test as required by this subparagraph, the property sold or leased is not export property.

(4) *Sales and leases of property for ultimate use in the United States*—(i) *In general.* For purposes of subparagraph (1) of this paragraph, the use test in this subparagraph is satisfied with respect to property which—

(*a*) Under subdivisions (ii) through (iv) of this subparagraph is not sold for ultimate use in the United States or

(*b*) Under subdivision (v) of this subparagraph is leased for ultimate use outside the United States.

(ii) *Sales of property for ultimate use in the United States.* For purposes of subdivision (i) of this subparagraph, a purchaser of property (including components, as defined in subdivision (vii) of this subparagraph) is deemed to use such property ultimately in the United States if any of the following conditions exists:

(*a*) Such purchaser is a related person (as defined in §1.993–1(a)(6)) with respect to the seller and such purchaser ultimately uses such property, or a second product into which such property is incorporated as a component, in the United States.

(*b*) At the time of the sale, there is an agreement or understanding that such property, or a second product into which such property is incorporated as a component, will be ultimately used by the purchaser in the United States.

(*c*) At the time of the sale, a reasonable person would have believed that such property or such second product would be ultimately used by such purchaser in the United States unless, in the case of a sale of components, the fair market value of such components at the time of delivery to the purchaser constitutes less than 20 percent of the fair market value of the second product into which such components are incorporated (determined at the time of completion of the production, manufacture or assembly of such second product).

For purposes of (b) of this subdivision, there is an agreement or understanding that property will ultimately be used in the United States if, for example, a component is sold abroad under an express agreement with the foreign purchaser that the component is to be incorporated into a product to be sold back to the United States. As a further example there would also be such an agreement or understanding if the foreign purchaser indicated at the time of the sale or previously that the component is to be incorporated into a product which is designed principally for the United States market. However, such an agreement or understanding does not result from the mere fact that a second product, into which components exported from the United States have been incorporated and which is sold on the world market, is sold in substantial quantities in the United States.

(iii) *Use in the United States.* For purposes of subdivision (ii) of this subparagraph, property (including components incorporated into a second product) is or would be ultimately used in the United States by such purchaser if, at any time within 3 years after the purchase of such property or components, either such property or components (or the second product into which such components are incorporated) is resold by such purchaser for use by a subsequent purchaser within the United States or such purchaser or subsequent purchaser fails, for any period of 365 consecutive days, to use such property or second product predominantly outside the United States as defined in subdivision (vi) of this subparagraph).

(iv) *Sales to retailers.* For purposes of subdivision (ii)(*c*) of this subparagraph, property sold to any person whose principal business consists of selling from inventory to retail customers at retail outlets ouside the United States will be

considered as property for ultimate use outside the United States.

(v) *Leases of property for ultimate use outside the United States.* For purposes of subdivision (i) of this subparagraph a lessee of property is deemed to use such property ultimately outside the United States during a taxable year of the lessor if such property is used predominantly outside the United States (as defined in subdivision (vi) of this subparagraph) by the lessee during the portion of the lessor's taxable year which is included within the term of the lease. A determination as to whether the ultimate use of leased property satisfies the requirements of this subdivision is made for each taxable year of the lessor. Thus, leased property may be used predominantly outside the United States for a taxable year of the lessor (and thus, constitute export property if the remaining requirements of this section are met) even if the property is not used predominantly outside the United States in earlier taxable years or later taxable years of the lessor.

(vi) *Predominant use outside the United States.* For purposes of this subparagraph, property is used predominantly outside the United States for any period if, during such period, such property is located outside the United States more than 50 percent of the time. An aircraft, railroad rolling stock, vessel, motor vehicle, container, or other property used for transportation purposes in deemed to be used predominantly outside the United States for any period if, during such period, either such property is located outside the United States more than 50 percent of the time or more than 50 percent of the miles traversed in the use of such property are traversed in outside the United States. However, any such property is deemed to be within the United States at all times during which it is engaged in transport between any two points within the United States, except where such transport constitutes uninterrupted international air transportation within the meaning of section 4262(c)(3) and the regulations thereunder (relating to tax on air transportation of persons). For purposes of applying section 4262(c)(3) to this subdivision, the term ''United States'' has the same meaning as in §1.993–7.

(vii) *Component.* For purposes of this subparagraph, a component is property which is (or is reasonably expected to be) incorporated into a second product by the purchaser of such component by means of production, manufacture, or assembly.

(e) *Foreign content of property*—(1) *The 50 percent test.* Under paragraph (a)(3) of this section, no more than 50 percent of the fair market value of export property may be attributable to the fair market value of articles which were imported into the United States. For purposes of this paragraph, articles imported into the United States are referred to as ''foreign content''. The fair market value of the foreign content of export property is computed in accordance with subparagraph (4) of this paragraph. The fair market value of export property which is sold to a person who is not a related person with respect to the seller is the sale price for such property (not including interest finance or carrying charges, or similar charges)

(2) *Application of 50 percent test.* The 50 percent test described in subparagraph (1) of this paragraph is applied on an item-by-item basis If, however, a person sells or leases a substantial volume of substantially identical export property in a taxable year and if all of such property contains substantially identical foreign content is substantially the same proportion, such person may determine the portion of foreign content contained in such property on an aggregate basis.

(3) *Parts and services.* If, at the time property is sold or leased the seller or lessor agrees to furnish parts pursuant to a services contract (as provided in §1.993–1(d)(4)(v)) and the price for the parts is not separately stated, the 50 percent test described in subparagraph (1) of this paragraph is applied on an aggregate basis to the property and parts. If the price for the parts is described in subparagraph (1) of this paragraph is applied separately to the property and to the parts.

(4) *Computation of foreign content*—(i) *Valuation.* For purposes of applying the

50 percent test described in subparagraph (1) of this paragraph, it is necessary to determine the fair market value of all articles which constitute foreign content of the property being tested to determine if it is export property. The fair market value of such imported articles is determined as of the time such articles are imported into the United States. With respect to articles imported into the United States before July 1, 1980, the fair market value of such articles is their appraised value as determined under section 402 or 402a of the Tariff Act of 1930 (19 U.S.C. 1401a or 1402) in connection with their importation. With respect to articles imported into the United States on or after July 1, 1980, the fair market value of such articles is their appraised value as determined under section 402 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with their importation. The appraised value of such articles is the full dutiable value of such articles, determined, however, without regard to any special provision in the United States tariff laws which would result in a lower dutiable value. Thus, an article which is imported into the United States is treated as entirely imported even if all or a portion of such article was originally manufactured, produced, grown, or extracted in the United States.

(ii) *Evidence of fair market value.* For purposes of subdivision (i) of this subparagraph, the fair market value of imported articles constituting foreign content may be evidenced by the customs invoice issued on the importation of such articles into the United States. If the holder of such articles is not the importer (or a related person with respect to the importer), the fair market value of such articles may be evidenced by a certificate based upon information contained in the customs invoice and furnished to the holder by the person from whom such articles (or property incorporating such articles) were purchased. If a customs invoice or certificate described in the preceding sentence is not available to a person purchasing property, such person shall establish that no more than 50 percent of the fair market value of such property is attributable to the fair market value of articles which were imported into the United States.

(iii) *Interchangeable component articles*—(*a*) Where identical or similar component articles can be incorporated interchangeably into property and a person acquires some such component articles that are imported into the United States and other such component articles that are not imported into the United States, the determination whether imported component articles were incorporated in such property as is exported from the United States shall be made on a substitution basis as in the case of the rules relating to drawback accounts under the customs laws. See section 313(b) of the Tariff Act of 1930, as amended (19 U.S.C. 1313(b)).

(*b*) The provisions of (*a*) of this subdivision may be illustrated by the following example:

Example. Assume that a manufacturer produces a total of 20,000 electronic devices. The manufacturer exports 5,000 of the devices and subsequently sells 11,000 of the devices to a DISC which exports the 11,000 devices. The major single component article in each device is a tube which represents 60 percent of the fair market value of the device at the time the device is sold by the manufacturer. The manufacturer imports 8,000 of the tubes and produces the remaining 12,000 tubes. For purposes of this subdivision, in accordance with the substitution principle used in the customs drawback laws, the 5,000 devices exported by the manufacturer are each treated as containing an imported tube because the devices were exported prior to the sale to the DISC. The remaining 3,000 imported tubes are treated as being contained in the first 3,000 devices purchased and exported by the DISC. Thus, since the 50 percent test is not met with respect to the first 3,000 devices purchased and exported by the DISC, those devices are not export property. The remaining 8,000 devices purchased and exported by the DISC are treated as containing tubes produced in United States, and those devices are export property (if they otherwise meet the requirements of this section).

(f) *Excluded property*—(1) *In general.* Notwithstanding any other provision of this section, the following property is not export property—

(i) Property described in subparagraph (2) of this paragraph (relating to property leased to a member of a controlled group),

(ii) Property described in subparagraph (3) of this paragraph (relating to certain types of intangible property),

(iii) Products described in paragraph (g) of this section (relating to depletable products), and

(iv) Products described in paragraph (h) of this section (relating to certain export controlled products).

(2) *Property leased to member of controlled group*—(i) *In general.* Property leased to a person (whether or not a DISC) which is a member of the same controlled group (as defined in §1.993–1(k)) as the lessor constitutes export property for any period of time only if during the period—

(*a*) Such property is held for sublease, or is subleased, by such person to a third person for the ultimate use of such third person;

(*b*) Such third person is not a member of the same controlled group; and

(*c*) Such property is used predominantly outside the United States by such third person.

(ii) *Predominant use.* The provisions of paragraph (d)(4)(vi) of this section apply in determining under subdivision (i)(*c*) of this subparagraph whether such property is used predominently outside the United States by such third person.

(iii) *Leasing rule.* For purposes of this subparagraph, leased property is deemed to be ultimately used by a member of the same controlled group as the lessor if such property is leased to a person which is not a member of such controlled group but which subleases such property to a person which is a member of such controlled group. Thus, for example, if X, a DISC for the taxable year, leases a movie film to Y, a foreign corporation which is not a member of the same controlled group as X, and Y then subleases the film to persons which are members of such group for showing to the general public, the film is not export property. On the other hand, if X, a DISC for the taxable year, leases a movie film to Z, a foreign corporation which is a member of the same controlled group as X, and Z then subleases the film to Y, another foreign corporation, which is not a member of the same controlled group for showing to the general public, the film is not disqualified under this subparagraph from being export property.

(iv) *Certain copyrights.* With respect to a copyright which is not excluded by subparagraph (3) of this paragraph from being export property, the ultimate use of such property is the sale or exhibition of such property to the general public. Thus, if A, a DISC for the taxable year, leases recording tapes to B, a foreign corporation which is a member of the same controlled group as A, and if B makes records from the recording tape and sells the records to C, another foreign corporation, which is not a member of the same controlled group, for sale by C to the general public, the recording tape is not disqualified under this subparagraph from being export property, notwithstanding the leasing of the recording tape by A to a member of the same controlled group, since the ultimate use of the tape is the sale of the records (*i.e.*, property produced from the recording tape).

(3) *Intangible property.* Export property does not include any patent, invention, model, design, formula, or process, whether or not patented, or any copyright (other than films, tapes, records, or similar reproductions, for commercial or home use), goodwill, trademark, tradebrand, franchise, or other like property. Although a copyright such as a copyright on a book does not constitute export property, a copyrighted article (such as a book) if not accompanied by a right to reproduce it is export property if the requirements of this section are otherwise satisfied. However, a license of a master recording tape for reproduction outside the United States is not disqualified under this subparagraph from being export property.

(g) *Depletable products*—(1) *In general.* Under section 993(c)(2)(C), a product or commodity which is a depletable product (as defined in subparagraph (2) of this paragraph) or contains a depletable product is not export property if—

(i) It is a primary product from oil, gas, coal, or uranium (as described in subparagraph (3) of this paragraph), or

(ii) It does not qualify as a 50-percent manufactured or processed product (as described in subparagraph (4) of this paragraph).

(2) *Definition of ''depletable product''.* For purposes of this paragraph, the term ''depletable product'' means any product or commodity of a character with respect to which a deduction for depletion is allowable under section 613 or 613A. Thus, the term depletable product includes any mineral extracted from a mine, an oil or gas well, or any other natural deposit, whether or not the DISC or related supplier is allowed a deduction, or is eligible to take a deduction, for depletion with respect to the mineral in computing its taxable income. Thus, for example, iron ore purchased by a DISC from a broker is a depletable product in the hands of the DISC for purposes of this paragraph even though the DISC is not eligible to take a deduction for depletion under section 613 or 613A.

(3) *Primary product from oil, gas, coal, or uranium.* A primary product from oil, gas, coal, or uranium is not export property. For purposes of this paragraph—

(i) *Primary product from oil.* The term ''primary product from oil'' means crude oil and all products derived from the destructive distillation of crude oil, including—

(*a*) Volatile products,

(*b*) Light oils such as motor fuel and kerosene,

(*c*) Distillates such as naphtha,

(*d*) Lubricating oils,

(*e*) Greases and waxes, and

(*f*) Residues such as fuel oil.

For purposes of this paragraph, a product or commodity derived from shale oil which would be a primary product from oil if derived from crude oil is considered a primary product from oil.

(ii) *Primary product from gas.* The term ''primary product from gas'' means all gas and associated hydrocarbon components from gas wells or oil wells, whether recovered at the lease or upon further processing, including—

(*a*) Natural gas,

(*b*) Condensates,

(*c*) Liquefied petroleum gases such as ethane, propane, and butane, and

(*d*) Liquid products such as natural gasoline.

(iii) *Primary product from coal.* The term ''primary product from coal'' means coal and all products recovered from the carbonization of coal including—

(*a*) Coke,

(*b*) Coke-oven gas,

(*c*) Gas liquor,

(*d*) Crude light oil, and

(*e*) Coal tar.

(iv) *Primary product from uranium.* The term ''primary product from uranium'' means uranium ore and uranium concentrates (known in the industry as ''yellow cake''), and nuclear fuel materials derived from the refining of uranium ore and uranium concentrates, or produced in a nuclear reaction, including—

(*a*) Uranium hexafluoride,

(*b*) Enriched uranium hexafluoride,

(*c*) Uranium metal,

(*d*) Uranium compounds, such as uranium carbide,

(*e*) Uranium dioxide, and

(*f*) Plutonium fuels.

(v) *Primary products and changing technology.* The primary products from oil, gas, coal, or uranium described in subdivisions (i) through (iv) of this subparagraph and the processes described in those subdivisions are not intended to represent either the only primary products from oil, gas, coal, or uranium, or the only processes from which primary products may be derived under existing and future technologies, such as the gasification and liquefaction of coal.

(vi) *Petrochemicals.* For purposes of this paragraph, petrochemicals are not considered primary products from oil, gas, or coal.

(4) *50-percent manufactured or processed product*—(i) *In general.* A product or commodity (other than a primary product from oil, gas, coal, or uranium) which is or contains a depletable product is not excluded from the term ''export property'' by reason of section 993(c)(2)(C) if it is a 50-percent manufactured or processed product. Such a product or commodity is a ''50-percent manufactured or processed product'' if, after the cutoff point of the depletable product, it is manufactured or processed (as defined in subdivision (ii) of this subparagraph) and either the cost test described in subdivision (iv) of this subparagraph or the fair market value test described in subdivision (v) of this subparagraph is satisfied. To determine

cutoff point, see subdivisions (vi) and (vii) of this subparagraph.

(ii) *Manufactured or processed.* A product is manufactured or processed if it is manufactured or produced within the meaning of paragraph (c)(2) of this section, except that for purposes of this subdivision the term manufacturing or processing does not include any excluded process (as defined in subdivision (iii) of this subparagraph) and the term conversion costs (as used in subdivision (iv) of such paragraph (c)(2)) does not include any costs attributable to any excluded process.

(iii) *Excluded processes.* For purposes of this paragraph, excluded processes are extracting (*i.e.,* all processes which are applied before the cutoff point of the mineral to which such processes are applied), and handling, packing, packaging, grading, storing, and transporting.

(iv) *Cost test.* A product or commodity will qualify as a 50-percent manufactured or processed product if—

(*a*) Its manufacturing and processing costs (that is, the portion of the cost of goods sold or inventory amount of the product or commodity attributable to the aggregate cost of manufacturing or processing each mineral contained therein) equal or exceed—

(*b*) An amount equal to either of the following:

(*1*) 50 percent of its cost of goods sold or inventory amount (decreased, at the DISC's option, by the portion of such cost or amount the DISC establishes is allocable to the difference between each prior owner's selling price for each depletable product contained in such product or commodity and such prior owner's cost of goods sold with respect thereto).

(*2*) The aggregate of the cost at the cutoff point (see subdivisions (vi) and (vii) of this subparagraph) properly attributable to each mineral contained in such product or commodity. However, if this subdivision (*2*) is applied, then the amount in (*a*) of this subparagraph (iv) shall be decreased and the amount in this subdivision (*2*) shall be increased, by so much of the cost of goods sold or inventory amount of the product or commodity as is properly allocable to any process other than transportation applied after the cutoff point of such mineral which would be a mining process (within the meaning of §1.613–4) were it applied before such point.

(v) *Fair market value test.* A product or commodity will qualify as a 50-percent manufactured or processed product if—

(*a*) The excess of its fair market value on the date it is sold, exchanged, or otherwise disposed of (or, if not sold, exchanged, or otherwise disposed of, the last day of the DISC's taxable year) over the portion thereof properly allocable to excluded processes other than extracting is equal to or greater than

(*b*) Twice the aggregate of the fair market value at the cutoff point for each mineral contained in such product or commodity.

For purposes of this subdivision (v), the fair market value of a product or commodity on the date it is sold, exchanged, or otherwise disposed of is the price at which it is disposed of, subject to any adjustment that may be required under the arm's length standard of section 482 and the regulations thereunder. If such product or commodity is not sold, exchanged, or otherwise disposed of, then, for purposes of section 992(a)(1)(B) (relating to the 95-percent test with respect to qualified export assets), the fair market value of a product or commodity on the last day of the DISC's taxable year is the arm's length price at which such product or commodity would have been sold on such date, determined by applying the principles of section 482 and the regulations thereunder.

(vi) *Cutoff point of a mineral.* For purposes of this subparagraph:

(*a*) The cutoff point is the point at which gross income from the property (within the meaning of section 613(a)) was in fact determined.

(*b*) The cost at the cutoff point is deemed to be the amount of the gross income from the property of the taxpayer eligible for a depletion deduction with respect to the mineral.

(*c*) The fair market value at the cutoff point is deemed to be the amount of the gross income from the property of the taxpayer eligible for a depletion deduction with respect to the mineral, except that, if (*1*) the fair market value of a product or commodity on the date

specified in subdivision (v)(*a*) of this subparagraph exceeds the aggregate of the fair market value at the cutoff point for each mineral contained therein and (*2*) 10 percent or more of such excess is attributable to a net increase in the fair market values of such minerals by reason of factors other than manufacturing or processing or the application of excluded processes (such as, for example, increases in the fair market values of some minerals by reason of inflation or speculation exceed decreases in such values of other minerals by reason of deflation or speculation), then the aggregate of the fair market value at the cutoff point for each such mineral shall be increased to reflect the net excess so attributable.

(*d*) The provisions of this subdivision (vi) are illustrated by the following example.

Example. An integrated manufacturer, X, on February 1, 1976, had gross income from the property (within the meaning of section 613(a)) of $50 with respect to a specified volume of a mineral. Thus, the cost at the cutoff point of the mineral was $50. X converted the mineral into a product which it sold on July 15, 1976, for $75. Of the $25 excess of the selling price over the gross income from the property, $23 was attributable to manufacturing, processing, and the application or excluded processes, and $2 was attributable to an increase in the fair market value of the mineral due to inflation between February 1 and July 15, 1976. Since only 8 percent of such excess ($2/$25) was attributable to factors other than manufacturing, processing, and the application of excluded processes, the fair market value at the cutoff point of the mineral is $50. However, had $3 of the $25 excess, or 12 percent, been attributable to an increase in the fair market value of the mineral due to inflation, then the fair market value at the cutoff point of the mineral would be $53.

(vii) [Reserved]

(viii) *Special rule for certain used products and scrap products.* If a product or commodity is a used 50-percent manufactured or processed product, or is recovered as scrap from a 50-percent manufactured or processed product, such product or commodity will be treated as a 50-percent manufactured or processed product.

(ix) *Special rule for byproducts and waste products.* For purposes of applying the cost test or fair market value test of subdivision (iv) or (v) of this subparagraph if a depletable product is recovered from a manufacturing process as a byproduct or waste product, then the cost and fair market value at the cutoff point are each deemed to be the lesser of—

(*a*) The fair market value of the waste product or byproduct containing the depletable product, determined as of the date the byproduct or waste product is recovered, or

(*b*) The amount the cost at the cutoff point would be for a depletable product of like kind and grade which is extracted, determined as of the date the byproduct or waste product is recovered.

For purposes of (*b*) of this subdivision the cutoff point for the depletable product of like kind and grade is deemed to be the point at which gross income from the property would be determined if such depletable product were sold by the taxpayer eligible to take a deduction for depletion after the completion of all mining processes applied to the depletable product and before the application of any nonmining process.

(x) *Proof of satisfaction of 50-percent manufactured or processed test.* (*a*) No substantiation is required to establish that either the cost test or the fair market value test of subdivisions (iv) or (v) of this subparagraph is satisfied or that a product or commodity qualifies under (viii) of this subdivision as either a used 50-percent manufactured or processed product or as scrap from a 50-percent manufactured or processed product as long as it is reasonably obvious, on the basis of all relevant facts and circumstances, that either the cost test or fair market value test is satisfied, or that the product or commodity qualifies as either as used 50-percent manufactured or processed product or as scrap from a 50-percent manufactured or processed product. Thus, for example, in the case of a DISC exporting a high precision lens at least 50 percent of the fair market value of which is obviously attributable to grinding, no substantiation of gross income from the property properly allocable to the depletable products contained in the lens, cost, or fair market values will be required.

(*b*) In cases in which satisfaction of either the cost test or the fair market value test is not reasonably obvious, a DISC will be required to substantiate the gross income from the property properly allocable to each depletable product in a product or commodity and either all costs or fair market values relied upon the DISC.

(*c*) For purposes of substantiating (*1*) gross income from the property properly allocable to a depletable product, (*2*) costs, and (*3*) fair market values, the DISC and related supplier shall each identify items in (or that were in) inventory in the same manner each used to identify items in inventory for purposes of computing Federal income tax.

(xi) *Application of 50-percent test.* The 50-percent test described in this subparagraph is applied on an item-by-item basis. If, however, a DISC sells a substantial volume of substantially identical products or commodities and if all or a group of such products or commodities contain substantially identical depletable products in substantially the same proportions and have cost or fair market value relationships (as the case may be) that are in substantially the same proportions, such DISC may apply the 50-percent test on an aggregate basis with respect to all such products or commodities, or group, as the case may be.

(5) *Effective dates.* Except as provided in subparagraph (6) of this paragraph, section 993(c)(2)(C) applies—

(i) With respect to any product or commodity not owned by a DISC, to sales, exchanges, or other dispositions made after March 18, 1975, with respect to which the DISC derives gross receipts.

(ii) With respect to any product or commodity acquired by a DISC after March 18, 1975.

(iii) With respect to any product or commodity owned by a DISC on March 18, 1975, to sales, exchanges, or other dispositions made after March 18, 1976, and to owning such product or commodity after such date.

For purposes of this paragraph and subparagraph (6) of this paragraph, the date of a sale, exchange, or other disposition of a product or commodity is the date as of which title to such product or commodity passes. The accounting method of a person is not determinative of the date of a sale, exchange, or other disposition.

(6) *Fixed contracts.* Section 1101(f) of the Tax Reform Act of 1976 provides an exception to the effective date rules in this paragraph and in paragraph (h) of this section. Section 1101(f)(2) of the Act provides that section 993(c)(2)(C) and (D) shall not apply to sales, exchanges, and other dispositions made after March 18, 1975, but before March 19, 1980, if they are made pursuant to a fixed contract. Section 1101(f)(2) also defines fixed contract. Under that definition, if the seller can vary the price of the product for unspecified cost increases (which could include tax cost increases), or if the quantity of products or commodities to be sold can be increased or decreased under the contract by the seller without penalty, the contract is not to be considered a fixed contract with respect to the amount over which the seller has discretion. For example, if a contract calls for a minimum delivery of x amount of a product but allows the seller to refuse to deliver goods beyond that minimum amount (or allows a renegotiation of the sales price of goods beyond that amount), then with respect to the amount above the minimum the contract is not a fixed quantity contract.

(h) *Export controlled products*—(1) *In general.* An export controlled product is not export property. A product or commodity may be an export controlled product at one time but not an export controlled product at another time. For purposes of this paragraph, a product or commodity is an ''export controlled product'' at a particular time if at that time the export of such product or commodity is prohibited or curtailed under section 4(b) of the Export Administration Act of 1969 or section 7(a) of the Export Administration Act of 1979, to effectuate the policy relating to the protection of the domestic economy set forth in such Acts (paragraph (2)(A) of section 3 of the Export Administration Act of 1969 and paragraph (2)(C) of section 3 of the Export Administration Act of 1979). Such policy is to use export controls to the extent necessary ''to protect the domestic economy from the excessive drain of scarce

materials and to reduce the serious inflationary impact of foreign demand.''

(2) *Products considered export controlled products*—(i) *In general.* For purposes of this paragraph, an export controlled product is a product or commodity which is subject to short supply export controls under 15 CFR part 377. A product or commodity is considered an export controlled product for the duration of each control period which applies to such product or commodity. A control period of a product or commodity begins on and includes the initial control date (as defined in subdivision (ii) of this subparagraph) and ends on and includes the final control date (as defined in subdivision (iii) of this subparagraph).

(ii) *Initial control date.* The initial control date of a product or commodity which was subject to short supply export controls on March 19, 1975, is March 19, 1975. The initial control date of a product or commodity which is subject to short supply export controls after March 19, 1975, is the effective date stated in the regulations to 15 CFR part 377 which subjects such product or commodity to short supply export controls. If there is no effective date stated in such regulations, the initial control date of such product or commodity is the date on which such regulations are filed for publications in the FEDERAL REGISTER.

(iii) *Final control date.* The final control date of a product or commodity is the effective date stated in the regulations to 15 CFR part 377 which removes such product or commodity from short supply export controls. If there is no effective date stated in such regulations, the final control date of such product or commodity is the date on which such regulations are filed for publication in the FEDERAL REGISTER.

(iv) *Expiration of Export Administration Act.* An initial control date and a final control date cannot occur after the expiration date of the Export Administration Act under the authority of which the short supply export controls were issued.

(3) *Effective dates*—(i) *Products controlled on March 19, 1975.* Except as provided in paragraph (g)(6) of this section, if a product or commodity was subject to short supply export controls on March 19, 1975, this paragraph applies—

(*a*) With respect to any such product or commodity not owned by a DISC, to sales, exchanges, other dispositions, or leases made after March 18, 1975, with respect to which the DISC derives gross receipts.

(*b*) With respect to any such product or commodity acquired by a DISC after March 18, 1975, and

(*c*) With respect to any such product or commodity owned by a DISC on March 18, 1975, to sales, exchanges, other dispositions, and leases made after March 18, 1976, and to owning such product or commodity after such date.

(ii) *Products first controlled after March 19, 1975.* If a product or commodity becomes subject to short supply export controls after March 19, 1975, this paragraph applies to sales, exchanges, other dispositions, or leases of such product or commodity made on or after the initial control date of such product or commodity, and to owning such product or commodity on or after such date.

(iii) *Date of sale, exchange, lease, or other disposition.* For purposes of this subparagraph, the date of sale, exchange, or other disposition of a product or commodity is the date as of which title to such product or commodity passes. The date of a lease is the date as of which the lessee takes possession of a product or commodity. The accounting method of a person is not determinative of the date of sale, exchange, other disposition, or lease.

(iv) *Property in short supply.* If the President determines that the supply of any property which is otherwise export property as defined in this section is insufficient to meet the requirements of the domestic economy, he may by Executive order designate such property as in short supply. Any property so designated will be treated as property which is not export property during the period beginning with the date specified in such Executive order and ending with the date specified in an Executive order setting forth the

President's determination that such property is no longer in short supply.

[T.D. 7514, 42 FR 55461, Oct. 17, 1977, as amended by T.D. 7513, 42 FR 57309, Nov. 2, 1977; T.D. 7854, 47 FR 51740, Nov. 17, 1982]

§ 1.993–4 Definition of producer's loans.

(a) *General rule*—(1) *Definition.* Under section 993(d), a loan made by a DISC to a person, referred to in this section as the ''borrower,'' is a producer's loan if—

(i) The loan is made out of accumulated DISC income within the meaning of subparagraph (3) of this paragraph.

(ii) The loan is evidenced by an obligation described in subparagraph (4) of this paragraph.

(iii) The requirement as to the trade or business of the borrower described in subparagraph (5) of this paragraph is satisfied.

(iv) At the time the loan is made, the obligation referred to in subdivision (ii) of this subparagraph bears a legend stating ''This Obligation Is Designated A Producer's Loan Within The Meaning of section 993(d) of the Internal Revenue Code'' or words of substantially the same meaning.

(v) The limitation as to the export-related assets of the borrower described in paragraph (b) of this section is satisfied.

(vi) The requirement as to the increased investment of the borrower in export-related assets described in paragraph (c) of this section is satisfied, and

(vii) The requirement of paragraph (d) of this section as to proof of compliance with paragraphs (b) and (c) of this section is satisfied.

(2) *Application of this section*—(i) *In general.* A loan which is a producer's loan is a qualified export asset of the DISC (see §1.993–2(a)(5) and (F)). The interest on a producer's loan is a qualified export receipt of the DISC (see §1.993–1(g)). A producer's loan is not a dividend to a borrower which is also a shareholder of the DISC making the loan. For rules with respect to deemed distributions by reason of the amount of foreign investment attributable to producer's loans, see section 995(b)(1)(G) and (d) and the regulations thereunder.

(ii) *No tracing of loan proceeds.* For purposes of applying this section, in order to qualify as a producer's loan, the proceeds of the loan need not be traced to an investment in any specific asset.

(iii) *Unrelated borrower.* For purposes of applying this section, it is not necessary for a borrower to be a related person with respect to the DISC from which it receives a producer's loan, or a member of the same controlled group as the DISC.

(iv) *Unpaid balance of producer's loans.* For purposes of applying this section, the unpaid balance of producer's loans does not include the unpaid balance of any producer's loan to the extent the loan has been deducted or charged off by the DISC as totally or partially worthless under section 165 or 166.

(v) *Refinancing, renewal, and extension.* For purposes of applying this section, the refinancing, renewal, or extension of a producer's loan shall be treated as the making of a new loan which may qualify as a producer's loan only if the requirements of subparagraph (1) of this paragraph are met.

(vi) *Events subsequent to time loan is made.* The determination as to whether a loan qualifies as a producer's loan is made on the basis of the relevant facts taken into account for purposes of determining whether the loan was a producer's loan when made. Thus, for example, if the accumulated DISC income of the lender is later reduced below the unpaid balance of all producer's loans previously made by the DISC, such subsequent decrease in the amount of accumulated DISC income will not result in later disqualification of such loan (or part thereof) as a producer's loan. Similarly, if a loan (or part of a loan) does not qualify as a producer's loan because of an insufficient amount of accumulated DISC income at the time the loan is made, a subsequent increase in the amount of accumulated DISC income will not result in later qualification of such loan (or part thereof) as a producer's loan. As a further example, for purposes of applying the borrower's export related assets limitation described in paragraph (b) of this section, a loan which qualifies as a producer's loan when made will not later be disqualified if

property, the gross receipts from the sale or lease of which were includible in the numerator of the fraction described in paragraph (b)(3)(i) of this section at the time of sale or lease by the borrower, is later characterized as excluded property (as defined in §1.993–3(f)).

(vii) *Application of tests under paragraphs (b) and (c) on controlled group bases.* If the borrower is a member of a controlled group (as defined in §1.993–1(k)) at the time a loan is made, all amounts that must be determined for purposes of applying the limitation and increased investment requirement with respect to the export-related assets of the borrower (described in paragraphs (b) and (c), respectively, of this section) may be determined at the election of the borrower by aggregating such amounts for all members of the controlled group, determined for the taxable year of each member of the controlled group during which the loan is made, excluding only such members of the group as are DISC's or foreign corporations for such year. However, such amounts may be included only to the extent that such amounts have not already been taken into account in applying the limitation and increased investment requirement with respect to any other borrower. Amounts to be aggregated for all such members if such election is made include, for example, gross receipts (described in paragraphs (b)(3)(i) and (ii) of this section) and export-related assets (described in paragraph (b)(2) of this section). The borrower may make such election by causing its written statement of election to be attached to the lending DISC's return under section 6011(e)(2) for the first taxable year of the lending DISC within which or with which the borrower's taxable year for which the election is to apply ends. An election once made is binding on all members of the controlled group which includes the borrower with respect to all taxable years of the borrower beginning with its first taxable year for which the election is made. A borrower who makes such election may revoke it only if it secures the consent of the Commissioner to such revocation upon application made through the lending DISC.

(3) *Loan out of accumulated DISC income*—(i) *In general.* A loan is a producer's loan only to the extent that it is made out of accumulated DISC income. A loan is made out of accumulated DISC income only if the amount of the loan, when added to the unpaid balance at the time such loan is made of all other producer's loans made by a DISC, does not exceed the amount of accumulated DISC income of the DISC at the beginning of the month in which the loan is made. The amount of accumulated DISC income at the beginning of any month is determined as if the DISC's taxable year closed at the end of the immediately preceding month.

(ii) *Presumption.* A loan made during a taxable year shall be deemed under subdivision (i) of this subparagraph to have been made out of accumulated DISC income if the balance of producer's loans at the beginning of the year and those made during the year do not exceed accumulated DISC income at the end of the year.

(iii) *Deemed distributions.* For purposes of this subparagraph, accumulated DISC income as of the end of any taxable year (or month) shall be determined without regard to deemed distributions under section 995(b)(1)(G) for the amount of foreign investment attributable to producer's loans for such year (or for the taxable year for which such month is a part) but actual distributions shall be taken into account.

(4) *Evidence and terms of obligation.* A loan is a producer's loan only if the loan is evidenced by a note or other evidence of indebtedness which is made by the borrower and which has a stated maturity date not more than 5 years from the date the loan is made. Accordingly, a loan which does not have a stated maturity date or which has a stated maturity date more than 5 years from the date such loan is made can never meet the 5-year requirement of this subparagraph. Thus, for example, even if there is a period of less than 5 years remaining to the stated maturity date of a loan, the loan can never be a producer's loan if it had a stated maturity date more than 5 years from the date it was made. For a further example, if a loan having a period remaining to maturity of 2 years is extended for a further period of 3 years (making a

total of 5 years to maturity from the date of the extension), the extension of the loan would under subparagraph (2)(v) of this paragraph constitute the making of a new producer's loan and the original producer's loan would terminate. If, however, a loan having a period remaining to maturity of 2 years is extended for a further period of 4 years (making a total of 6 years to maturity from the date of the extension), the original producer's loan will terminate and the new loan will not be a producer's loan. If a producer's loan is not paid in full at its maturity date and is not formally refinanced, renewed, or extended, such loan shall be deemed to be a new loan which does not have a stated maturity date and, thus, will not be a producer's loan. For purposes of this subparagraph, an evidence of indebtedness is a written instrument of indebtedness. Section 482 and the regulations thereunder are applicable to determine, in the case of a loan by the DISC to a borrower which is owned or controlled directly or indirectly by the same interests as the DISC within the meaning of section 482, whether the interest charged on such loan is at an arm's length rate.

(5) *Borrower's trade or business.* A loan is a producer's loan only if the loan is made to a person engaged in the United States in the manufacture, production, growth, or extraction (within the meaning of §1.993–3(c)) of export property determined without regard to §1.993–3(f)(1)(iii) and (iv). The borrower may also be engaged in other trades or businesses and the loan need not be traceable to specific investments in export property.

(b) *Borrower's export related assets limitation*—(1) *General rule.* A loan to a borrower is a producer's loan only to the extent that the amount of the loan, when added to the unpaid balance of all other producer's loans made by all DISC's to the borrower which are outstanding at the time the loan is made, does not exceed an amount equal to the amount of the borrower's export-related assets (determined under subparagraph (2) of this paragraph) multiplied by the fraction set forth in subparagraph (3) of this paragraph.

(2) *Amount of export-related assets*—(i) *In general.* For purposes of subparagraph (1) of this paragraph, the amount of the borrower's export-related assets is the sum of the amounts described in subdivisions (ii), (iii), and (iv) of this subparagraph.

(ii) *Borrower's plant and equipment.* The amount described in this subdivision is the sum of the borrower's adjusted bases (determined as of the beginning of the borrower's taxable year in which a loan is made to it) for plant, machinery, equipment, and supporting production facilities, which are located in the United States. Supporting production facilities are all property used primarily in connection with the manufacture, production, growth, or extraction (within the meaning of §1.993–3(c)) or storage, handling, transportation, or assembly of property by the borrower.

(iii) *Borrower's property held primarily for sale or lease.* The amount described in this subdivision is the amount of the borrower's property (at the beginning of the taxable year of the borrower in which a loan is made to it) held primarily for sale or lease to customers in the ordinary course of its trade or business. The amount of such property held for sale is determined under the methods of identifying and valuing inventory normally used by the borrower. The amount of such property held for lease or leased is the borrower's adjusted bases, determined under section 1011, for such property.

(iv) *Borrower's research and experimental expenditures.* The amount described in this subdivision is the aggregate amount, whether or not charged to capital account, of research and experimental expenditures (within the meaning of section 174) incurred in the United States by the borrower during each of its taxable years which begin after December 31, 1971, and precede the taxable year in which the loan is made to the borrower. Such research and experimental expenditures need bear no relationship to export property (as defined in §1.993–3) of the borrower. The aggregate amount of all such expenditures for each of such preceding taxable years is taken into account for purposes of this subparagraph, regardless of whether all or any portion of the aggregate amount has been taken into account with respect to producer's

loans made to the borrower by any DISC in preceding taxable years. The aggregate amount of all such expenditures shall include such expenditures of a corporation, the assets of which were acquired by the borrower in a distribution or a transfer described in section 381(a)(1) or (2) (relating to carryovers in certain corporate acquisitions).

(3) *Fraction referred to in subparagraph (1) of this paragraph*—(i) *Numerator of fraction.* The numerator of the fraction set forth in this subparagraph is the sum of the borrower's gross receipts for each of its 3 taxable years immediately preceding the taxable year in which the loan is made (but not including any taxable year beginning before January 1, 1972) from the sale or lease of export property (determined without regard to §1.993–3(f)(1)(iii) and (iv)) which is manufactured, produced, grown, or extracted (within the meaning of §1.993–3(c)) by the borrower whether or not sold or leased directly or through a related domestic person (notwithstanding §1.993–3(a)(4) and (f)(2)). For purposes of the preceding sentence, with respect to a sale or lease to a related DISC in which the transfer price is determined under section 994(a)(1) or (2), the rules under §1.994–1(c)(5) (relating to incomplete transactions) shall be applied, and with respect to all other sales and leases the rules under §1.994–1(c)(5) other than subdivision (i)(*d*) thereof shall be applied.

(ii) *Denominator of fraction.* The denominator of the fraction set forth in this subparagraph is the sum of the amount included in the numerator and all other gross receipts of the borrower, for each of its taxable years for which gross receipts are included in the numerator of the fraction, from all sales or leases of all property held by the borrower primarily for sale or lease to customers in the ordinary course of its trade or business. For purposes of subdivision (i) of this subparagraph and this subdivision, if such property is sold or leased to a domestic related person which resells or subleases such property, the borrower's gross receipts shall be the gross receipts derived by the domestic related person from the resale or sublease of the export property.

(iii) *Taxable years.* If the borrower has not engaged in the sale or lease of property (as described in this subparagraph) for the 3 immediately preceding taxable years, or if 3 taxable years beginning after December 31, 1971, have not elapsed, the fraction will be computed on the basis of such gross receipts for its taxable years immediately preceding the loan and beginning after December 31, 1971, during which the borrower has so engaged. No producer's loans can be made to a borrower until after the end of the first taxable year of the borrower beginning after December 31, 1971.

(c) *Requirement for increased investment in export-related assets*—(1) *In general.* A loan to a borrower is a producer's loan only to the extent that the amount of the loan, when added to the unpaid balance of all other producer's loans made by all DISC's to the borrower during the borrower's taxable year during which such loan is made, does not exceed the amount of the borrower's increase for the year in investment in export-related assets. Such increase for any taxable year is the sum of—

(i) The increase (if any) in the borrowers adjusted basis of certain types of assets as determined under subparagraph (2) of this paragraph and

(ii) The amount (if any) during the year of its research and experimental expenditures as determined under paragraph (b)(2)(iv) of this section.

(2) *Increase in adjusted basis.* The amount under this subparagraph is the amount (not less than zero) by which—

(i) The borrower's adjusted basis (determined as of the end of its taxable year in which the producer's loan is made) in all of its property which is described in paragraph (b)(2)(ii) (plant and equipment), and (iii) (property held primarily for sale or lease) of this section, including any such property acquired by it during such taxable year, exceeds

(ii) Its adjusted bases in all such property (determined as of the beginning of such year).

(3) *Ordering rule.* If during the borrower's taxable year the amount of increase in investment in export-related assets determined under this subparagraph is exceeded by amounts loaned to

the borrower during such year that would otherwise qualify as producer's loans, such loans shall be applied in the order made against the amount of such increase in order to determine which loans qualify as producer's loans.

(d) *Proof of borrower's compliance with paragraphs (b) and (c) of this section.* For purposes of paragraphs (b) and (c) of this section, a DISC shall be prepared to establish initially the compliance of the borrower with the requirements of such paragraphs by providing the written statement of the borrower, certified by a certified public accountant, stating that the borrower has complied with the limitation and increased investment requirement in section 993(d)(2) and (3) of the Internal Revenue Code of 1954. In lieu of certification by a certified public accountant, the DISC may attach to its return a statement signed by the borrower under penalties of perjury on a form provided by the Internal Revenue Service certifying that the borrower has complied with the limitation and increased investment requirement in section 993(d)(2) and (3) of the Internal Revenue Code of 1954. For taxable years ending after October 17, 1977, the DISC must attach either the certification by the certified public accountant or the certification by the borrower to its return. Additional full substantiation of the borrower's compliance with the requirements of such paragraphs may be required by the district director. If full substantiation of such compliance is not provided by the DISC (or the borrower) when required, the loan shall be deemed not to be a producer's loan.

(e) *Special limitation in the case of domestic film maker*—(1) *General rule.* The limitation of paragraph (b) of this section as to the export-related assets of the borrower will be considered satisfied if the DISC—

(i) Is engaged in the trade or business of selling or leasing films which are export property, or is acting as a commission agent for a person who is so engaged,

(ii) Makes a loan to a borrower which is a domestic film maker (as defined in subparagraph (5) of this paragraph) for the purpose of making a film, and

(iii) The amount of such loan, when added to the unpaid balance of all other producer's loans made by all DISC's to the borrower which are outstanding at the time the loan is made, does not exceed an amount determined by multiplying—

(*a*) The sum of (*1*) the amount of the export-related assets of the borrower (determined under paragraph (b)(2)(i) of this section as of the beginning of the borrower's taxable year in which the loan is made), plus (*2*) the amount of a reasonable estimate of the amount of such export related assets obtained or to be obtained by the borrower during such year and subsequent years with respect to films as to which filming begins within such year by

(*b*) The percentage which, based on the experience of other film makers of similar films for the 5 calendar years preceding the calendar year in which the loan is made, the annual gross receipts (as described in §1.993–6(a)(1), whether or not such films constitute property described therein) of such other film makers from the sale or lease of such films outside the United States is of the annual gross receipts of such other film makers from all sales or leases of such films.

(2) *Purpose of loan.* A loan by a DISC will be deemed to be for the making of a film if there exists a written agreement between the DISC and the borrower, executed at or before the time the loan is made, stating that the loan is made or to be made to enable the borrower to make such film.

(3) *Reasonable estimate of amounts.* For purposes of subparagraph (1)(iii)(*a*)(*2*) of this paragraph, a reasonable estimate shall be based on the conditions known by the DISC and borrower to exist at the time a loan is made (or which the DISC and borrower have reason to know to exist at such time).

(4) *Experience of film makers.* For purposes of subparagraph (1)(iii)(*b*) of this paragraph, the experience of other film makers of similar films for the 5 calendar years preceding the calendar year in which the loan is made shall be derived from such records and statistics as are acknowledged in the trade as reasonably reliable.

(5) *Domestic film maker.* For purposes of this section, a borrower is a domestic film maker with respect to a film if—

(i) The borrower is a U.S. person within the meaning of section 7701(a)(30), except that (*a*) with respect to a partnership all of the partners must be U.S. persons and (*b*) with respect to a corporation all of its officers and at least a majority of its directors must be U.S. persons,

(ii) The borrower is engaged in the trade or business of making the film with respect to which the loan is made,

(iii) Each studio, if any, used or to be used for filming or for recording sound incorporated into such film is located in the United States (as defined in section 7701(a)(9)),

(iv) At least 80 percent of the aggregate playing time of the film is or will be photographed within the United States (as defined in section 7701(a)(9)), and

(v) At least 80 percent of the total amount (not including any amount which is contingent upon receipts or profits of such film and which is fully taxable by the United States) paid or to be paid for services performed in the making of the film is either paid or to be paid to persons who are U.S. persons at the time such services are performed or consists of amounts which are fully taxable by the United States.

(6) *Amounts as fully taxable.* For purposes of subparagraph (5)(v) of this paragraph, an amount is considered fully taxable by the United States if the entire amount is included in gross income under section 61 or is subject to withholding under any provision of U.S. law or treaty to which the U.S. is a party and is not exempt from taxation under any provision of such law or treaty. Where a nonresident alien individual is engaged for the making of a film or where a foreign corporation is engaged to furnish the services of one of its officers or employees for the making of a film, the amount paid such individual or corporation will be considered as fully taxable by the United States only if it meets the test of this subparagraph.

[T.D. 7514, 42 FR 55464, Oct. 17, 1977, as amended by T.D. 7513, 42 FR 57311, Nov. 2, 1977; T.D. 7514, 42 FR 60910, Nov. 30, 1977; T.D. 7854, 47 FR 51741, Nov. 17, 1982]

§ 1.993–5 Definition of related foreign export corporation.

(a) *General rule*—(1) *Definition.* Under section 993(e), a foreign corporation is a related foreign export corporation with respect to a DISC if—

(i) It is a foreign international sales corporation described in paragraph (b) of this section,

(ii) It is a real property holding company described in paragraph (c) of this section, or

(iii) It is an associated foreign corporation described in paragraph (d) of this section.

(2) *Application of this section.* It is necessary to determine whether a foreign corporation is a related foreign export corporation with respect to a DISC for the following two purposes:

(i) *Qualified export assets.* Under §1.993–2(g), the stock or securities of a related foreign export corporation held by the DISC are qualified export assets.

(ii) *Qualified export receipts.* Under §1.993–1 (e), (f), and (g), certain receipts of the DISC with respect to stock or securities of a related foreign export corporation held by the DISC are qualified export receipts.

(b) *Foreign international sales corporation*—(1) *In general.* A foreign corporation is a foreign international sales corporation with respect to a taxable year of a DISC if—

(i) On each day during such taxable year of the DISC on which the foreign corporation has stock issued and outstanding, the DISC owns directly stock of the foreign corporation possessing more than 50 percent of the total combined voting power of all classes of stock of the foreign corporation entitled to vote as determined under the principles of §1.957–1(b) (relating to definition of controlled foreign corporation),

(ii) 95 percent or more of such foreign corporation's gross receipts (as defined in §1.993–6) for its taxable year ending with or within such taxable year of the DISC consists of qualified export receipts described in §1.993–1 (b) through (e) or interest described in §1.993–1(g) derived from any obligations described in §1.993–2 (d) or (e), and

(iii) The sum of the adjusted bases of the assets of the foreign corporation

which are qualified export assets described in §1.993–2 (b) through (e) and which are held by the foreign corporation at the close of its taxable year which ends with or within such taxable year of the DISC equals or exceeds 95 percent of the sum of the adjusted bases of all assets held by the foreign corporation at the close of such taxable year.

(2) *Certain determinations.* The determinations as to whether gross receipts are qualified export receipts described in subparagraph (1)(ii) of this paragraph and as to whether assets are qualified export assets described in subparagraph (1)(iii) of this paragraph are made by applying the requirements of §§1.993–1 and 1.993–2 to the foreign corporation as if it were a domestic corporation being tested to determine whether it is a DISC. For purposes of making either of such determinations, the principles of accounting applicable for purposes of computing earnings and profits under §1.964–1 (relating to a controlled foreign corporation's earnings and profits) shall apply.

(c) *Real property holding company*—(1) *In general.* A foreign corporation is a real property holding company with respect to a taxable year of a DISC if—

(i) On each day during such taxable year of the DISC on which the foreign corporation has stock issued and outstanding, the DISC owns directly stock of the foreign corporation possessing more than 50 percent of the total combined voting power of all classes of stock of the foreign corporation entitled to vote as determined under the principles of §1.957–1(b) and

(ii) The sole function of the foreign corporation is to hold title to real property situated outside the United States for the exclusive use of the DISC, title to which may not be held by the DISC (and, if the DISC subleases such property to a related supplier, as described in subparagraph (3) of this paragraph, by such related supplier) under the law of the country in which such property is situated.

(2) *Activities of the foreign corporation.* For purposes of subparagraph (1)(ii) of this paragraph, a foreign corporation which holds title to real property situated outside the United States may also perform activities with respect to such property (such as management, maintenance, and payment of taxes) which are ancillary to its function of holding title to such property.

(3) *Exclusive use by the DISC.* Real property held by the foreign corporation must be used exclusively by the DISC whether under a lease or any other arrangement. Real property is not so used by the DISC if the DISC subleases such property to any other person. If, however, during a taxable year of the DISC—

(i) 90 percent or more of the qualified export receipts of the DISC for such year are derived from transactions with respect to which it is a commission agent for a related supplier (as defined in §1.994–1(a)(3)(ii)), and

(ii) The DISC subleases such property to such related supplier

then such property will be considered as used exclusively by the DISC during such year if such related supplier does not sublease such property.

(d) *Associated foreign corporation*—(1) *In general.* A foreign corporation is an associated foreign corporation with respect to a taxable year of the DISC if—

(i) On each day during such taxable year of the DISC on which the foreign corporation has stock issued and outstanding, the DISC, or one or more members of the same controlled group of corporations (as defined in subparagraph (2) of this paragraph) as the DISC, owns (within the meaning of section 1563 (d) and (e)) stock of the foreign corporation possessing less than 10 percent of the total combined voting power of all classes of stock of the foreign corporation entitled to vote, as determined under the principles of §1.957–1(b), or owns no stock of such corporation, and

(ii) The ownership of stock, or of securities (as defined in §1.993–2(g)), of the foreign corporation by the DISC or by one or more members of such controlled group of corporations reasonably furthers a transaction or transactions giving rise to qualified export receipts for the DISC.

(2) *Controlled group of corporations.* For purposes of this paragraph, the term ''controlled group of corporations'' has the same meaning assigned to the term in section 1563(a) and not section 993(a)(3) and §1.993–1(k). Thus,

for purposes of this paragraph, the test of control is 80 percent control and, since the rules of section 1563(b) apply, only domestic members are considered to be members of the controlled group.

(3) *Furtherance of qualified export receipts.* Ownership of stock or securities of a foreign corporation will be considered as reasonably furthering a transaction or transactions giving rise to qualified export receipts for a DISC if—

(i) The ownership is necessary to obtain or maintain the foreign corporation as a customer of the DISC or of a related supplier, as defined in §1.994–1(a)(3)(ii) of the DISC or to aid the sales distribution system of the DISC or of such related supplier, and

(ii) The amount of the investment in the foreign corporation bears a reasonable relationship to the amount of the DISC's annual net profit from transactions in its trade or business which it may reasonably expect to derive on account of such ownership.

In determining whether the amount of the investment is reasonable, there shall be taken into account any stock or securities of the foreign corporation owned by any other foreign corporation which, if it were a domestic corporation, would be a member of the same controlled group of corporations as the DISC.

[T.D. 7514, 42 FR 55467, Oct. 17, 1977; 42 FR 60910, Nov. 30, 1977]

§ 1.993–6 Definition of gross receipts.

(a) *General rule.* Under section 993(f), for purposes of sections 991 through 996, the gross receipts of a person for a taxable year are—

(1) The total amounts received or accrued by the person from the sale or lease of property held primarily for sale or lease in the ordinary course of a trade or business, and

(2) Gross income recognized from all other sources, such as, for example, from—

(i) The furnishing of services (whether or not related to the sale or lease of property described in subparagraph (1) of this paragraph),

(ii) Dividends and interest,

(iii) The sale at a gain of any property not described in subparagraph (1) of this paragraph, and

(iv) Commission transactions as and to the extent described in paragraph (e) of this section.

(b) *Nongross receipts items.* For purposes of paragraph (a) of this section, gross receipts do not include amounts received or accrued by a person from—

(1) The proceeds of a loan or of the repayment of a loan, or

(2) A receipt of property in a transaction to which section 118 (relating to contribution to capital) or 1032 (relating to exchange of stock for property) applies.

(c) *Nonreduction of total amounts.* For purposes of paragraph (a) of this section, the total amounts received or accrued by a person are not reduced by returns and allowances, costs of goods sold, expenses, losses, a deduction for dividends received under section 243, or any other deductible amounts.

(d) *Method of accounting.* For purposes of paragraph (a) of this section, the total amounts received or accrued by a person shall be determined under the method of accounting used in computing its taxable income. If, for example, a DISC receives advance or installment payments for the sale or lease of property described in paragraph (a)(1) of this section, for the furnishing of services, or which represent recognized gain from the sale of property not described in paragraph (a)(1) of this section, any amount of such advance payments is considered to be gross receipts of the DISC for the taxable year for which such amount is included in the gross income of the DISC.

(e) *Commission transactions.* (1) In the case of transactions which give rise to a commission on the sale or lease of property or the furnishing of services by a principal, the amount recognized by the commission agent as gross income from all such transactions shall be the gross receipts derived by the principal from the sale or lease of the property, or the gross income derived by the principal from the furnishing of services, with respect to which the commissions are derived. In the case of a commission agent for a related supplier (as defined in §1.994–1(a)(3)(ii)), the gross receipts or gross income of such agent shall be determined as if it used the same method of accounting as its related supplier. In the case of a

commission agent for a principal other than a related supplier, the gross receipts or gross income of such principal shall be determined as if such principal used the same method of accounting as its agent.

(2) If the commission arrangement provides that the commission agent will receive a commission only with respect to sales or leases of export property, or the furnishing of services, which result in qualified export receipts, the commission agent will not take into account the gross receipts or gross income, as the case may be, derived by the principal from any transaction for which the commission agent would not be entitled to a commission under the commission arrangement.

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

Example. During 1973, M, a related supplier (as defined in §1.994–1(a)(3)(ii)) of N, is engaged in the manufacture of machines in the United States. N, a calendar year taxpayer, is engaged in the sale and lease of such machines in foreign countries. N furnishes services which are related and subsidiary to its sale and lease of such machines. N also acts as a commission agent in foreign countries for Z, an unrelated supplier, with respect to Z's sale of products. N receives dividends on stock owned by it in a related foreign export corporation (as defined in §1.993–5), interest on producer's loans made to M, and proceeds from sales of business assets located outside the United States resulting in a recognized gains and losses. N's gross receipts for 1973 are $3,550, computed on the basis of the additional facts assumed in the table below:

(1) N's sales receipts for machines manufactured by M (without reduction for cost of goods sold and selling expenses)	$1,500
(2) N's lease receipts for machines manufactured by M (without reduction for depreciation and leasing expenses)	500
(3) N's gross income from services for machines manufactured by M (without reduction for service expenses)	400
(4) Z's sale receipts for products manufactured by Z (without reduction for Z's cost of goods sold, commissions on sales, and commission sales expenses)	550
(5) Dividends received by N	150
(6) Interest received by N on producer's loans	200
(7) Proceeds received by N representing recognized gain (but not losses) from sales of business assets located outside the United States	250
(8) N's gross receipts	3,550

[T.D. 7514, 42 FR 55468, Oct. 17, 1977]

§ 1.993–7 Definition of United States.

Under section 993(g), the term ''United States'' includes the States, the District of Columbia, the Commonwealth of Puerto Rico, and possessions of the United States. For the requirement that a DISC must be incorporated and existing under the laws of a State or the District of Columbia, see §1.992–1(a)(1).

[T.D. 7514, 42 FR 55468, Oct. 17, 1977]

§ 1.994–1 Inter-company pricing rules for DISC's.

(a) *In general*—(1) *Scope.* In the case of a transaction described in paragraph (b) of this section, section 994 permits a person related to a DISC to determine the allowable transfer price charged the DISC (or commission paid the DISC) by its choice of three methods described in paragraph (c)(2), (3), and (4) of this section: The ''4 percent'' gross receipts method, the ''50–50'' combined taxable income method, and the section 482 method. Under the first two methods, the DISC is entitled to 10 percent of its export promotion expenses as additional taxable income. When the gross receipts method or combined taxable income method is applied to a transaction, the Commissioner may not make distributions, apportionments, or allocations as provided by section 482 and the regulations thereunder. For rules as to certain ''incomplete transactions'' and for computing combined taxable income, see paragraph (c)(5) and (6) of this section. Grouping of transactions for purposes of applying the method chosen is provided by paragraph (c)(7) of this section. The rules in paragraph (c) of this section are directly applicable only in the case of sales or exchanges of export property to a DISC for resale, and are applicable by analogy to leases, commissions, and services as provided in paragraph (d) of this section. For rules limiting the application of the gross receipts method and combined taxable income method so that the supplier related to the DISC will not incur a loss on transactions, see paragraph (e)(1) of this section. Paragraph (e)(2) of this section provides for the applicability of section 482 to resales by the DISC to related persons. Paragraph (e)(3) of this

section provides for the time by which a reasonable estimate of the transfer price (including commissions and other payments) should be paid. The subsequent determination and further adjustments to transfer prices are set forth in paragraph (e)(4) of this section. Export promotion expenses are defined in paragraph (f) of this section. Paragraph (g) of this section has several examples illustrating the provisions of this section. Section 1.994–2 prescribes the marginal costing rules authorized by section 994(b)(2).

(2) *Performance of substantial economic functions.* The application of section 994(a)(1) or (2) does not depend on the extent to which the DISC performs substantial economic functions (except with respect to export promotion expenses). See paragraph (l) of § 1.993–1.

(3) *Related party and related supplier.* For the purposes of this section—

(i) The term ''related party'' means a person which is owned or controlled directly or indirectly by the same interests as the DISC within the meaning of section 482 and § 1.482–1(a).

(ii) The term ''related supplier'' means a related party which singly engages in a transaction directly with the DISC which is subject to the rules of section 994 and this section. However, a DISC may have different related suppliers with respect to different transactions. If, for example, X owns all the stock of Y, a corporation, and of Z, a DISC, and sells a product to Y which is resold to Z, only Y is the related supplier of Z, and, thus, only the resale from Y to Z is subject to section 994 and this section. If, however, X sells directly to Z and Y also sells directly to Z, then, as to the transactions involving direct sales to Z, each of X and Y is a related supplier of Z.

(b) *Transactions to which section 994 applies.* Section 994(a)(3) may be applied, as described in paragraph (a) of this section, to any transaction between a related supplier and a DISC. Section 994(a)(1) or (2) may be applied, as described in paragraph (a) of this section, to a transaction between a related supplier and a DISC only in the following cases:

(1) Where the related supplier sells export property to the DISC for resale or where the DISC is commission agent for the related supplier on sales by the related supplier of export property to third parties whether or not related parties. For purposes of this section, references to sales include exchanges.

(2) Where the related supplier leases export property to the DISC for sublease for a comparable period with comparable terms of payment or where the DISC is commission agent for the related supplier on leases by the related supplier of export property to third parties whether or not related parties.

(3) Where services are furnished by a related supplier which are related and subsidiary to any sale or lease by the DISC, acting as principal or commission agent, of export property under subparagraph (1) or (2) of this paragraph.

(4) Where engineering or architectural services for construction projects located (or proposed for location) outside of the United States are furnished by a related supplier where the DISC is acting as principal or commission agent with respect to the furnishing of such services to a third party whether or not a related party.

(5) Where the related supplier furnishes managerial services in furtherance of the production of qualified export receipts of an unrelated DISC where the related DISC is acting as principal or commission agent with respect to the furnishing of such services to an unrelated DISC.

Transactions are included, for purposes of this paragraph, only if they give rise to qualified export receipts (within the meaning of section 993(a)) in the hands of the related DISC. If a transaction is not included in subparagraph (1), (2), (3), (4), or (5) of this paragraph, the rules of section 994(a)(1) or (2) do not apply. Thus, for example, the rules of section 994(a)(1) or (2) would not apply if a DISC purchased export property from its related supplier and leased such property to a third party.

(c) *Transfer price for sales of export property*—(1) *In general.* Under this paragraph, rules are prescribed for computing the allowable price for a transfer from a related supplier to a DISC in the case of a sale of export property described in paragraph (b)(1) of this section.

(2) *The ''4-percent'' gross receipts method.* Under the gross receipts method of pricing, the transfer price for a sale by the related supplier to the DISC is the price as a result of which the taxable income derived by the DISC from the sale will not exceed the sum of (i) 4 percent of the qualified export receipts of the DISC derived from the sale of the export property (as defined in section 993 (c)) and (ii) 10 percent of the export promotion expenses (as defined in paragraph (f) of this section) of the DISC attributable to such qualified export receipts.

(3) *The ''50–50'' combined taxable income method.* Under the combined taxable income method of pricing, the transfer price for a sale by the related supplier to the DISC is the price as a result of which the taxable income derived by the DISC from the sale will not exceed the sum of (i) 50 percent of the combined taxable income (as defined in subparagraph (6) of this paragraph) of the DISC and its related supplier attributable to the qualified export receipts from such sale and (ii) 10 percent of the export promotion expenses (as defined in paragraph (f) of this section) of the DISC attributable to such qualified export receipts.

(4) *Section 482 method.* If the rules of subparagraphs (2) and (3) of this paragraph are inapplicable to a sale or a taxpayer does not choose to use them, the transfer price for a sale by the related supplier to the DISC is to be determined on the basis of the sale price actually charged but subject to the rules provided by section 482 and the regulations thereunder.

(5) *Incomplete transactions.* (i) For purposes of the gross receipts and combined taxable income methods, where property (encompassed within a transaction or group chosen under subparagraph (7) of this paragraph) is transferred by a related supplier to a DISC during a taxable year of either the DISC or related supplier, but some or all of such property is not sold by the DISC during such year—

(*a*) The transfer price of such property sold by the DISC during such year shall be computed separately from the transfer price of the property not sold by the DISC during such year,

(*b*) With respect to such property not sold by the DISC during such year, the transfer price paid by the DISC for such year shall be the related supplier's cost of goods sold (see subparagraph (6)(ii) of this paragraph) with respect to the property, except that, with respect to such taxable years ending on or before August 15, 1975, the transfer price paid by the DISC shall be at least (but need not exceed) the related supplier's cost of goods sold with respect to the property.

(*c*) For the subsequent taxable year during which such property is resold by the DISC, an additional amount shall be paid by the DISC (to be treated as income for such year by the related supplier) equal to the excess of the amount which would have been the transfer price under this section had the transfer to the DISC by the related supplier and the resale by the DISC taken place during the taxable year of the DISC during which it resold the property over the amount already paid under (*b*) of this subdivision.

(*d*) The time and manner of payment of transfer prices required by (*b*) and (*c*) of this subdivision shall be determined under paragraphs (e)(3), (4), and (5) of this section.

(ii) For purposes of this paragraph, a DISC may determine the year in which it receives property from a related supplier and the year in which it sells property in accordance with the method of identifying goods in its inventory properly used under section 471 or 472 (relating respectively to general rule for inventories and to LIFO inventories). Transportation expense of the related supplier in connection with a transaction to which this subparagraph applies shall be treated as an item of cost of goods sold with respect to the property if the related supplier includes the cost of intracompany transportation between its branches, divisions, plants, or other units in its cost of goods sold (see subparagraph (6)(ii) of this paragraph).

(6) *Combined taxable income.* For purposes of this section, the combined taxable income of a DISC and its related supplier from a sale of export property is the excess of the gross receipts (as defined in section 993(f)) of the DISC from such sale over the total costs of

the DISC and related supplier which relate to such gross receipts. Gross receipts from a sale do not include interest with respect to the sale. Combined taxable income under this paragraph shall be determined after taking into account under paragraph (e)(2) of this section all adjustments required by section 482 with respect to transactions to which such section is applicable. In determining the gross receipts of the DISC and the total costs of the DISC and related supplier which relate to such gross receipts, the following rules shall be applied:

(i) Subject to subdivisions (ii) through (v) of this subparagraph, the taxpayer's method of accounting used in computing taxable income will be accepted for purposes of determining amounts and the taxable year for which items of income and expense (including depreciation) are taken into account. See §1.991–1(b)(2) with respect to the method of accounting which may be used by a DISC.

(ii) Cost of goods sold shall be determined in accordance with the provisions of §1.61–3. See sections 471 and 472 and the regulations thereunder with respect to inventories. With respect to property to which an election under section 631 applies (relating to cutting of timber considered as a sale or exchange), cost of goods sold shall be determined by applying §1.631–1(d)(3) and (e) (relating to fair market value as of the beginning of the taxable year of the standing timber cut during the year considered as its cost).

(iii) Costs (other than cost of goods sold) which shall be treated as relating to gross receipts from sales of export property are (*a*) the expenses, losses, and other deductions definitely related, and therefore allocated and apportioned, thereto, and (*b*) a ratable part of any other expenses, losses, or other deductions which are not definitely related to a class of gross income, determined in a manner consistent with the rules set forth in §1.861–8.

(iv) The taxpayer's choice in accordance with subparagraph (7) of this paragraph as to the grouping of transactions shall be controlling, and costs deductible in a taxable year shall be allocated and apportioned to the items or classes of gross income of such taxable year resulting from such grouping.

(v) If an account receivable arising with respect to a sale of export property is transferred by the related supplier to a DISC which is a member of the same controlled group within the meaning of §1.993–1(k) for an amount reflecting a discount from the selling price taken into account in computing (without regard to this subdivision) combined taxable income of the DISC and its related supplier, then the combined taxable income from such sale shall be reduced by the amount of the discount.

(7) *Grouping transactions.* (i) Generally, the determinations under this section are to be made on a transaction-by-transaction basis. However, at the annual choice of the taxpayer some or all of these determinations may be made on the basis of groups consisting of products or product lines.

(ii) A determination by a taxpayer as to a product or a product line will be accepted by a district director if such determination conforms to any one of the following standards: (*a*) A recognized industry or trade usage, or (*b*) the 2-digit major groups (or any inferior classifications or combinations thereof, within a major group) of the Standard Industrial Classification as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President.

(iii) A choice by the taxpayer to group transactions for a taxable year on a product or product line basis shall apply to all transactions with respect to that product or product line consummated during the taxable year. However, the choice of a product or product line grouping applies only to transactions covered by the grouping and, as to transactions not encompassed by the grouping, the determinations are made on a transaction-by-transaction basis. For example, the taxpayer may choose a product grouping with respect to one product and use the transaction-by-transaction method for another product within the same taxable year.

(iv) For rules as to grouping certain related and subsidiary services, see paragraph (d)(3)(ii) of this section.

(d) *Rules under section 994(a)(1) and (2) for transactions other than sales.* The following rules are prescribed for purposes of applying the gross receipts method or combined taxable income method to transactions other than sales:

(1) *Leases.* In the case of a lease of export property by a related supplier to a DISC for sublease by the DISC to produce gross receipts, for any taxable year the amount of rent the DISC must pay to the related supplier shall be determined under the DISC's lease with its related supplier but must be computed in a manner consistent with the rules in paragraph (c) of this section for computing the transfer price in the case of sales and resales of export property under the gross receipts method or combined taxable income method. For purposes of applying this subparagraph, transactions may not be so grouped on a product or product line basis under the rules of paragraph (c)(7) of this section as to combine in any one group of transactions both lease transactions and sale transactions involving the same product or product line.

(2) *Commissions.* If any transaction to which section 994 applies is handled on a commission basis for a related supplier by a DISC and such commissions give rise to qualified export receipts under section 993(a)—

(i) The amount of the income that may be earned by the DISC in any year is the amount, computed in a manner consistent with paragraph (c) of this section, which the DISC would have been permitted to earn under the gross receipts method, the combined taxable income method, or section 482 method if the related supplier had sold (or leased) the property or service to the DISC and the DISC in turn sold (or subleased) to a third party, whether or not a related party, and

(ii) The maximum commission the DISC may charge the related supplier is the sum of the amount of income determined under subdivision (i) of this subparagraph plus the DISC's total costs for the transaction as determined under paragraph (c)(6) of this section.

(3) *Receipts from services*—(i) *Related and subsidiary services attributable to the year of the export transaction.* The gross receipts for related and subsidiary services described in paragraph (b)(3) of this section shall be treated as part of the receipts from the export transaction to which such services are related and subsidiary, but only if, under the arrangement between the DISC and its related supplier and the accounting method otherwise employed by the DISC, the income from such services is includible for the same taxable year as income from such export transaction.

(ii) *Other services.* In the case of related and subsidiary services to which subdivision (i) of this subparagraph does not apply and other services described in paragraph (b)(4) or (5) of this section performed by a related supplier (relating respectively to engineering and architectural services and certain managerial services), the amount of taxable income which the DISC may derive for any taxable year shall be determined under the arrangement between the DISC and its related supplier and shall be computed in a manner consistent with the rules in paragraph (c) of this section for computing the transfer price in the case of sales for resale of export property under the gross receipts method or combined taxable income method. Related and subsidiary services to which subdivision (i) of this subparagraph does not apply may be grouped, under the rules for grouping of transactions in paragraph (c)(7) of this section, with the products or product lines to which they are related and subsidiary, so long as the grouping of services chosen is consistent with the grouping of products or product lines chosen for the taxable year in which either the product or product lines were sold or in which payment for such services is received or accrued. The rules for grouping of transactions in paragraph (c)(7) of this section shall not apply with respect to the determination of taxable income which the DISC may derive from other services described in paragraph (b)(4) or (5) of this section performed by a related supplier or commissions on such services, and such determination shall be made only on a transaction-by-transaction basis.

(e) *Methods of applying paragraphs (c) and (d) of this section*—(1) *Limitation on DISC income (''no loss'' rule)*—(i) *In general.* Except as otherwise provided in

this subparagraph, neither the gross receipts method nor the combined taxable income method may be applied to cause in any taxable year a loss to the related supplier, but either method may be applied to the extent it does not cause a loss. A loss to a related supplier would result if the taxable income of the DISC would exceed the combined taxable income of the related supplier and the DISC. If, however, there is no combined taxable income of the DISC and the related supplier (because, for example, a combined loss is incurred), a transfer price (or commission) will not be deemed to cause a loss to the related supplier if it allows the DISC to recover an amount not in excess of its costs (if any).

(ii) *Special rule for applying ''4 percent'' gross receipts method to sales.* A transfer price or commission, determined under the ''4 percent'' gross receipts method (determined without regard to subdivision (i) of this subparagraph), for a sale of export property referred to in paragraph (b)(1) of this section, will not be considered to cause a loss for the related supplier if for the DISC's taxable year, the ratio that (a) the taxable income of the DISC derived from such sale by using such price or commission bears to (*b*) the DISC's gross receipts from such sale is not greater than the ratio that (*c*) all of the taxable income of the related supplier and the DISC from all sales of the same product or product line (domestic and foreign) to third parties whether or not related parties bears to (*d*) the total gross receipts of the related supplier and the DISC from such sales. For purposes of the preceding sentence, sales between the DISC and its related suppliers shall not be taken into account under (*c*) or (*d*) of this subdivision. For example, assume that for a taxable year of a DISC the total costs of the related supplier and the DISC with respect to all sales ($150 for domestic and $44 for foreign) of a product line are $194 and the total gross receipts of the related supplier and the DISC with respect to such sales are $200 so that the total taxable income of the related supplier and the DISC with respect to such sales is $6. The parties would thus be entitled to compute a transfer price determined under the gross receipts method on any given sale of product A of such product line by the related supplier to the DISC which would allocate to the DISC taxable income equal to not more than 3 percent (*i.e.*, $6/$200) of its gross receipts derived from its resale of such product. If the DISC were to resell an item of product A for $10, the transfer price paid by the DISC to the related supplier determined under the gross receipts method could be as low as $9.70.

(iii) *Grouping transactions.* For purposes of subdivision (i) of this subparagraph, the basis for grouping transactions chosen by the taxpayer under paragraph (c)(7) of this section for the taxable year shall be applied. For purposes of making the computations of subdivision (ii) (*c*) and (*d*) of this subparagraph, however, the taxpayer may choose any basis for grouping transactions permissible under paragraph (c)(7) of this section, even though it may not be the same basis as that already chosen under paragraph (c)(7) of this section for computing transfer prices or commissions to a DISC. If, for example, the taxpayer has chosen to group transactions on a product basis for computing transfer prices or commissions to a DISC for a taxable year, the taxpayer may still group transactions on a product line basis for purposes of computing taxable income and total gross receipts under subdivision (ii) (*c*) and (*d*) of this subparagraph. For a further example, if the taxpayer computes taxable income for one group of transactions under the gross receipts method and computes taxable income for a second group of transactions under the combined taxable income method, the taxpayer may aggregate these transactions for purposes of computing taxable income and total gross receipts under subdivision (ii) (*c*) and (*d*) of this subparagraph.

(2) *Relationship to section 482.* In applying the rules under section 994, it may be necessary to first take into account the price of a transfer (or other transaction) between the DISC (or related supplier) and a related party which is subject to the arm's length standard of section 482. Thus, for example, where a related supplier sells export property to a DISC which the related supplier purchased from related

parties, the costs taken into account in computing the combined taxable income of the DISC and the related supplier are determined after any necessary adjustment under section 482 of the price paid by the related supplier to the related parties. In applying section 482 to a transfer by a DISC, however, the DISC and its related supplier are treated as if they were a single entity carrying on all the functions performed by the DISC and the related supplier with respect to the transaction and the DISC shall be allowed to receive under the section 482 standard the amount the related supplier would have received had there been no DISC.

(3) *Initial payment of transfer price or commission.* (i) The amount of a transfer price (or reasonable estimate thereof) actually charged by a related supplier to a DISC, or a sales commission (or reasonable estimate thereof) actually charged by a DISC to a related supplier, in a transaction to which section 994 applies must be paid no later than 60 days following the close of the taxable year of the DISC during which the transaction occurred.

(ii) Payment must be in the form of money, property (including accounts receivable from sales by or through the DISC), a written obligation which qualifies as debt under the safe harbor rule of §1.992–1(d)(2)(ii), or an accounting entry offsetting the account receivable against an existing debt owed by the person in whose favor the account receivable was established to the person with whom it engaged in the transaction. The form of the payment to a DISC need not be a qualified export asset under §1.993–2. However, for the requirement that the adjusted basis of the qualified export assets of the DISC at the close of its taxable year must equal or exceed 95 percent of the sum of the adjusted bases of all assets of the DISC at the close of its taxable year, see section 992(a)(1)(B).

(iii) If the district director can demonstrate, based upon the data available as of the 60th day after the close of such taxable year, that the amount actually paid did not represent a reasonable estimate of the transfer price or commission (as the case may be) to be determined under section 994 and this section, an indebtedness will be deemed to arise, from the person required to make the payment in favor of the person to whom the payment is required to be made, in an amount equal to the difference between the amount of the transfer price or commission determined under section 994 and this section and the amount (if any) actually paid and received. Such indebtedness will be deemed to arise as of the date the transaction occurred which gave rise to the indebtedness, except that, if such transaction occurred in a taxable year of the DISC ending on or before August 15, 1975, at the taxpayer's option, the indebtedness will be deemed to arise as of the date by which payment was required under subdivision (i) of this paragraph (e)(3). Such indebtedness owed to a DISC shall be treated as an asset but shall not be treated as a trade receivable or other qualified export asset (see §1.993–2(d)(3)) as of the end of the taxable year of the DISC in which the indebtedness is deemed to arise.

(iv)(*a*) Except with respect to incomplete transactions to which paragraph (c)(5)(i)(*b*) of this section applies, if the amount actually paid results in the DISC realizing at least 50 percent of the DISC's taxable income from the transaction as reported in its tax return for the taxable year the transaction is completed, then the amount actually paid shall be deemed to be a reasonable estimate of such transfer price or commission.

(*b*) With respect to incomplete transactions to which paragraph (c)(5)(i)(*b*) of this section applies and which were initiated during a taxable year ending after August 15, 1975, the amount actually paid shall be deemed to be a reasonable estimate of such transfer price if any one of the following three tests is met:

(*1*) The amount actually paid by the DISC to the related supplier in respect of the property does not exceed the related supplier's cost of goods sold (see paragraph (c)(6)(ii) of this section) with respect to the property.

(*2*) If the transaction is completed by the date on which the DISC's return is required to be filed for the year in which the transaction was initiated, the amount actually paid by the DISC to the related supplier in respect of the

property results in the DISC realizing at least 50 percent of the DISC's taxable income from the transaction when completed.

(*3*) The percentage that (*i*) an amount equal to (*a*) the amount actually paid by the DISC to the related supplier in respect of the property minus (*b*) the related supplier's cost of goods sold with respect to the property, bears to (*ii*) the related supplier's cost of goods sold in respect of the property, is not greater than 50 percent of the percentage that (*iii*) the combined taxable income for completed transactions of the same group as the property during the DISC's taxable year in which the incomplete transaction was initiated, bears to (*iv*) the cost of goods sold of the related supplier and DISC with respect to such transactions.

(*c*) For purposes of this subdivision (iv), whether the transfer price or commission actually paid is deemed a reasonable estimate may be determined on the basis for grouping transactions chosen by the taxpayer under paragraph (c)(5) and (7) of this section.

(v) An indebtedness arising under subdivision (iii) of this subparagraph shall bear interest at an arm's length rate, computed in the manner provided by §1.482–2(a)(2) from the 61st day after the close of the DISC's taxable year in which the transaction occurred which gave rise to the indebtedness to the date of payment. The interest so computed shall be accrued and included in the taxable income of the person to whom the indebtedness is owed for each taxable year during which the indebtedness is unpaid.

(4) *Subsequent determination of transfer price or commission.* The DISC and its related supplier would ordinarily determine under section 994 and this section the transfer price payable by the DISC (or the commission payable to the DISC) for a transaction before the DISC files its return for the taxable year of the transaction. After the DISC has filed its return, a redetermination of the transfer price (or commission) may only be made if permitted by the Code and the regulations thereunder. Such a redetermination would include a redetermination by reason of an adjustment under section 482 and the regulations thereunder or section 861 and §1.861–8 which affects the amounts which entered into the determination of the transfer price or commission.

(5) *Procedure for adjustments to transfer price or commission*—(i)(*a*) If the transfer price (or commission) for a transaction determined under section 994 is different from the price (or commission) actually charged, the person who received too small a transfer price (or commission) or paid too large a transfer price (or commission) shall establish (or be deemed to have established), at the date of the determination or redetermination under subparagraph (4) of this paragraph of the transfer price (or commission) under section 994, an account receivable due the DISC from the person with whom it engaged in the transaction equal to the difference in amount between the transfer price (or commission) so determined and the transfer price (or commission) previously paid and received. If the account receivable is paid within 90 days after the date it is established (or deemed established), then as of the end of the taxable year of the DISC in which the transaction occurred which gave rise to the indebtedness, the account receivable shall be treated as an asset and, under §1.993–2(d)(3) as a trade receivable, and thus as a qualified export asset.

(*b*) If, for example, during 1972, a DISC which uses the calendar year as its taxable year sold a product which it purchased that year from its related supplier and paid a price of $10,000 which price is a reasonable estimate under subparagraph (3)(iii) of this paragraph but is later determined under section 994 to be $8,000 immediately before the DISC filed its return for 1972, the DISC must be paid $2,000 (i.e., $10,000 − $8,000) by its related supplier or establish an account receivable from its related supplier of $2,000. The account receivable may be paid without tax consequences, provided that such account receivable is paid within 90 days after the date it is established (or deemed established). Such account receivable paid within such 90 days will be considered to relate to the taxable year in which the transaction occurred which gave rise thereto rather than the taxable year during which it is established or paid.

(ii) Payment must be in a form specified in subparagraph (3) of this paragraph.

(iii) If an account receivable of a DISC described in subdivision (i) of this paragraph (e)(5) is not paid within 90 days of the date it is established (or deemed established), then, as of the end of the taxable year of the DISC in which the transaction occurred which gives rise to the indebtedness, the account receivable shall be treated as an asset except that, if the account receivable is established (or deemed established) in a taxable year of the DISC ending on or before August 15, 1975, at the taxpayer's option, the account receivable shall be treated as an asset as of the end of such taxable year. However, under §1.993–2(d)(3), an account receivable referred to in the preceding sentence shall not be treated as a trade receivable or other qualified export asset.

(iv) An account receivable established in accordance with subdivision (i) of this subparagraph shall bear interest at an arm's length rate, computed in the manner provided by §1.482–2(a)(2) from the day after the date the account receivable is deemed established to the date of payment. The interest so computed shall be accrued and included in the taxpayer's taxable income for each taxable year during which the account receivable is outstanding.

(v)(*a*) In lieu of establishing an account receivable in accordance with subdivision (i) of this subparagraph for all or part of an amount due a related supplier, the related supplier and DISC are permitted to treat all or part of any distribution which was made by the DISC out of its previously taxed income with respect to the year to which the determination or redetermination relates as an additional payment of transfer price or repayment of commission (and not as a distribution) made as of the date the distribution was made. Any additional amount arising on the determination or redetermination due the related supplier after this treatment shall be represented by an account receivable established under subdivision (i) of this subparagraph. To the extent that a distribution is so treated under this subdivision (v), it shall cease to qualify as distribution for any Federal income tax purpose, and the DISC's account for previously taxed income shall be adjusted accordingly. If all or part of any distribution made to a shareholder other than the related supplier is recharacterized under this subdivision (v), the related supplier shall establish an account receivable from that shareholder for the amount so recharacterized. Such account receivable shall be paid in the time and manner set forth in this paragraph (e)(5). In order to obtain the relief provided by this subdivision (v), the conditions and procedures prescribed by Revenue Procedure 84–3 must be met. The provisions of this paragraph (e)(5)(v) shall apply to all open taxable years ending after December 31, 1971.

(*b*) If, for example, during 1982, a DISC commission from a related supplier with respect to a transaction completed in 1980 was redetermined to be $1,000 less than the commission actually charged by, and paid to, the DISC, the amount of any distribution previously made by the DISC from its 1980 previously taxed income to the related supplies as a shareholder may, to the extent of $1,000, be treated not as a distribution but as a repayment of the commission.

(vi) The procedure for adjustments to transfer price provided by this subparagraph does not apply to incomplete transactions described in paragraph (c)(5)(i)(*b*) of this section. Such procedure will, however, be applied to any such transaction with respect to the taxable year in which the transaction is completed.

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

Example 1. (i) During 1975, a DISC which uses the calendar year as its taxable year purchased a product from its related supplier and made an initial payment of $8,500. If $8,500 were determined to be the transfer price under section 994, the DISC's taxable income from the transaction would be $1,000. Immediately before the DISC filed its return for 1975, under section 994 it is determined that the transfer price is $8,000 and the DISC's taxable income is $1,500. Thus, the requirement of a reasonable estimate under subparagraph (3) of this paragraph was met

because the amount ($8,500) actually paid resulted in the DISC realizing taxable income of $1,000 which is not less than 50 percent of the DISC's taxable income ($1,500) from the transaction as determined under section 994.

(ii) Pursuant to subparagraph (5) of this paragraph, an account receivable due the DISC for $500, i.e., $8,500 − $8,000, is established on September 15, 1976, the date the DISC files its return for 1975, and is paid on December 1, 1976. The account receivable for $500 will be considered to relate to the taxable year (1975) in which the transaction occurred which gave rise thereto and will be a qualified export asset under §1.993–2(d)(3) for the last day of such year.

Example 2. Assume the same facts as in example 1 except that the account receivable for $500 is paid on January 1, 1977. The account receivable for $500 will still be considered to relate to the taxable year (1975) in which the transaction occurred which gave rise thereto. However, such account receivable will be treated as an asset which is not a qualified export asset under §1.993–2(d)(3) for the last day of such year.

(f) *Export promotion expenses*—(1) *Purpose of expense.* (i) In order for an expense or cost of a type described in subparagraph (2) of this paragraph to be an export promotion expense, the expense or cost must be incurred or treated as incurred by the DISC (under subparagraph (7) of this paragraph) to advance the sale, lease, or other distribution of export property for use, consumption, or distribution outside the United States. Costs of services in performing installation (but not assembly) on the site and for meeting warranty commitments if such services are related and subsidiary (within the meaning of §1.993–1(d)) to any qualified sale, lease, or other distribution of export property by the DISC (or with respect to which the DISC received a commission) will be considered to advance the sale, lease, or other distribution of export property. General and administrative expenses attributable to billing customers, other clerical functions of the DISC, or generally operating the DISC, will also be considered to advance the sale, lease, or other distribution of export property.

(ii) Where an expense or cost incurred or treated as incurred by the DISC qualifies only in part as an export promotion expense, such expense or cost must be allocated between the qualified portion and such other portion on a reasonable basis. See §1.994–2(b)(2) for the option of the related supplier not to claim expenses as export promotion expenses.

(2) *Types of expenses.* The only expenses or costs which may be export promotion expenses are those expenses or costs meeting the test of subparagraph (1) of this paragraph which constitute—

(i) Ordinary and necessary expenses of the DISC paid or incurred during the DISC's taxable year in carrying on any trade or business, allowable as deductions under section 162, such as expenses for market studies, advertising, salaries and wages (including contributions or compensations deductible under section 404) of sales, clerical, and other personnel, rentals on property, sales commissions, warehousing, and other selling expenses,

(ii) A reasonable allowance under section 167 for exhaustion, wear and tear, or obsolescence of the property of the DISC,

(iii) Costs of freight (subject to the limitations of subparagraph (4) of this paragraph),

(iv) Costs of packaging for export (as defined in subparagraph (5) of this paragraph), or

(v) Costs of designing and labeling packages exclusively for export markets (under subparagraph (6) of this paragraph).

(3) *Ineligible expenses.* Items ineligible to be export promotion expenses include, for example, interest expenses, bad debt expenses, freight insurance, State and local income and franchise taxes, the cost of manufacture or assembly operations, and items of cost of goods sold (except as otherwise provided in this paragraph in the case of certain freight, packaging, and designing and labeling expenses). Income or similar taxes eligible for a foreign tax credit under sections 901 and 903 are also not eligible to be export promotion expenses.

(4) *Freight expenses*—(i) *In general.* Export promotion expenses include one-half of the freight expense (not including insurance) for shipping export property aboard a U.S.-flag carrier in those cases where law or regulation of the United States or of any State or political subdivision thereof or of any agency or instrumentality of any of these

does not require that the export property be shipped aboard a U.S.-flag carrier. For purposes of this paragraph, the term ''freight expense'' includes charges paid for c.o.d. service, miscellaneous ground charges, such as charges incurred for services normally performed by U.S.-flag carriers, charges for services of loading aboard U.S.-flag carriers normally performed by such carriers, freight forwarders, or independent contractors engaged in loading property, and charges attributable to a freight consolidation function normally performed by freight forwarders. In order for one-half of freight expenses paid to the owner (or the agent of the owner) of a U.S.-flag carrier to be claimed as an export promotion expense, the DISC must obtain a written statement (such as, for example, a bill of lading) from the owner (or the agent) disclosing that the export property was shipped aboard the owner's U.S.-flag carrier or another U.S.-flag carrier, and the DISC must have no reasonable basis for disbelieving such statement of the owner (or the agent). For the requirement of a written statement from a freight forwarder, see subdivision (iv) of this subparagraph.

(ii) *U.S.-flag carrier defined.* For purposes of this paragraph, the term ''U.S.-flag carrier'' is an airplane owned and operated by a U.S. person or persons (as defined in section 7701(a)(30)) or a ship documented under the laws of the United States. Shipment initiated by delivery to the U.S. Postal Service shall be considered shipment aboard a U.S.-flag carrier, but not if shipped to a place to which mail shipments from the United States are ordinarily accomplished by land transportation, such as to Canada or Mexico, unless airmail is specified.

(iii) *Shipment pursuant to law or regulation.* Shipment pursuant to law or regulation includes instances where a U.S.-flag carrier must be used in order to obtain permission from the Government to make the export. If the law or regulation requires a fixed portion of the export property to be shipped aboard a U.S.-flag carrier, the freight expense on that portion of such export property that was so shipped in order to satisfy such requirement cannot qualify as an export promotion expense.

(iv) *Freight forwarders.* A payment to a freight forwarder shall be considered freight expense within the meaning of this paragraph to the extent the forwarder utilizes a U.S.-flag carrier. For purposes of this paragraph, the term ''freight forwarder'' includes air freight consolidators and carriers owned and operated by U.S. persons utilizing U.S.-flag carriers such as non-vessel-owning common carriers. In order for one-half of freight expenses paid to a freight forwarder to be claimed as export promotion expenses, the DISC must obtain a written statement (such as, for example, a bill of lading) from the freight forwarder disclosing that the export property was shipped aboard a U.S.-flag carrier, and the DISC must have no reasonable basis for disbelieving such statement of the freight forwarder.

(v) *Freight within the United States.* A DISC may not claim as export promotion expense any amount that is attributable to carriage of export property between points within the United States. If, however, export property is carried from the United States to a foreign country on a through shipment pursuant to a single bill of lading or similar document aboard one or more U.S.-flag carriers, the freight expense of such carriage shall not be apportioned between the domestic and foreign portions of such carriage, even though a carrier may stop en route within the United States or the export property may be shifted from one carrier to another, and one-half of such freight expense may be claimed as an export promotion expense. Freight expense does not include the cost of transporting the export property to the depot of the U.S.-flag carrier or freight forwarder for shipment abroad. The expense of shipment of export property initiated by delivery to the U.S. Postal Service for ultimate delivery outside the United States shall be considered as attributable entirely to carriage of such property outside the United States.

(5) *Packaging for export.* (i) Export promotion expenses include the direct and indirect cost of packaging export property (including the cost of the package) for export whether or not the

packaging is the same as domestic packaging. Such packaging costs do not include costs of manufacturing (as defined in the regulations under section 993) and assembly. Thus, if a DISC buys and packages export property for resale, its costs of packaging the export property are export promotion expenses. If, however, the process of such packaging by the DISC is physically integrated with the process of manufacturing the export property by the related supplier, the costs of such packaging are not export promotion expenses.

(ii) The cost of containers leased from a shipping company to which the DISC also pays freight for the property packaged is not a cost of packaging. However, in such circumstances, one-half of the rental charge may be allowable as a freight expense if permitted under subparagraph (4) of this paragraph.

(6) *Designing and labeling packages.* Export promotion expenses include the direct and indirect costs of designing and labeling packages, including bottles, cans, jars, boxes, cartons, or containers, to the extent incurred for export markets. Thus, for example, to the extent incurred for supplying export markets, the cost of designing labels in a foreign language and the cost of printing such labels are export promotion expenses.

(7) *DISC must incur export promotion expenses*—(i) *In general.* In order for an expense to be an export promotion expense it must be incurred or treated as incurred under this subparagraph by the DISC. For example, an expense is incurred by a DISC if the expense results from (*a*) the DISC incurring an obligation to pay compensation to its employees, (*b*) depreciation of property owned by the DISC and used by its employees, (*c*) the DISC incurring an obligation to pay for office supplies used by its employees, (*d*) the DISC incurring an obligation to pay space costs for use by its employees, or (*e*) the DISC incurring an obligation to pay other costs supporting efforts by its employees.

(ii) *Payments to independent contractors.* A payment to an independent contractor, directly or indirectly, is treated as incurred by the DISC if the cost of performing the function performed by the independent contractor would be considered an export promotion expense described in subparagraphs (1) and (2) of this paragraph if performed by the DISC, and if, in a case where the services of the independent contractor were engaged by a party related to the DISC, such related party and such DISC agreed in writing before the contract was entered into that a specified portion or all of the contract was for the benefit of the DISC and that all of the expenses of the contract (eligible to be considered as export promotion expenses) with respect to such portion would be borne by the DISC.

(iii) *Expenses incurred by related parties.* Reimbursements or other payments by a DISC to a related party are export promotion expenses only if the expenses of the related party for which reimbursement is made are for space in a building actually used by employees of the DISC or for export property owned by the DISC. Except as otherwise provided in the preceding sentence, expenses incurred by a foreign international sales corporation (FISC) or a real property holding company (as defined in section 993(e)(1) and (2), respectively) shall not be treated as export promotion expenses of its DISC.

(iv) *Selling commissions paid by a DISC.* A commission paid by a DISC to a person other than a related person, with respect to a transaction which gives rise to qualified export receipts of the DISC, is an export promotion expense of the DISC. A commission paid by a DISC to a related person is not an export promotion expense.

(v) *Sales of promotional material.* If a DISC sells promotional material to a buyer of export property from the DISC at a price which is greater than the costs of the DISC for such material, such costs are not export promotion expenses. If, however, the DISC sells promotional material at a price which is less than its costs for such material, the excess of such costs over such price is an export promotion expense. For rules relating to the status of promotional material as qualified export assets and export property, see §§ 1.993–2 and 1.993–3, respectively.

(vi) An expense may be incurred by the DISC under subdivisions (i)

through (v) of this subparagraph even if the accounting for and payment of such expense is handled by a related party and the DISC reimburses the related party for such expenses.

(8) *Incomplete transactions.* Expenses eligible to be treated as export promotion expenses which are attributable to the sale, lease, or other distribution of export property and which are incurred prior to the taxable year of sale, lease, or other distribution by the DISC are not treated as export promotion expenses until the taxable year of sale, lease, or other distribution or until the taxable year in which it is first determined that no transaction is reasonably expected to result from the expense incurred (whether or not a transaction subsequently results). Thus, for example, if a DISC incurs a packaging cost which is otherwise eligible to be treated as an export promotion expense, the DISC may not include such charge as an export promotion expense until the year in which the export property with respect to which the packaging cost was incurred is actually sold by the DISC. If no transaction is reasonably expected to result from the packaging cost, such cost should be allocated as an export promotion expense to the group of transactions to which such cost is most closely related.

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

Example 1. J and K are calendar year taxpayers. J, a domestic manufacturing company, owns all the stock of K, a DISC for the taxable year. During 1972, J manufactures only 100 units of a product (which is eligible to be export property as defined in section 993(c)). J enters into a written agreement with K whereby K is granted a sales franchise with respect to exporting such property and K will receive commissions with respect to such exports equal to the maximum amount permitted to be received under the intercompany pricing rules of section 994. Thereafter, the 100 units are sold for $1,000. J's cost of goods sold attributable to the 100 units is $650. J's direct selling expenses so attributable are $100. Although J has other deductible expenses, for purposes of this example assume that J has no other deductible expenses. K pays $230 to independent contractors which qualify as export promotion expenses under paragraph (f)(7)(ii) of this section. K does not perform functions substantial enough to entitle it to an allocation of income which meets the arm's length standard of section 482. The income which K may earn under section 994 under the franchise is $20, computed as follows:

(1) Combined taxable income:		
(a) K's sales price		$1,000
(b) Less deductions:		
J's cost of goods sold	$650	
J's direct selling expenses	100	
K's export promotion expenses	230	
Total deductions		980
(c) Combined taxable income		20
(2) K's profit under combined taxable income method (before application of loss limitation):		
(a) 50 percent of combined taxable income		10
(b) Plus: 10 percent of K's export promotion expenses (10% of $230)		23
(c) K's profit		33
(3) K's profit under gross receipts method (before application of loss limitation):		
(a) 4 percent of K's sales price (4% of $1,000)		40
(b) Plus: 10 percent of K's export promotion expenses (10% of $230)		23
(c) K's profit		63

Since combined taxable income ($20) is lower than both K's profit under the combined taxable income method ($33) and under the gross receipts method ($63), the maximum income K may earn is $20. Accordingly, the commissions K may receive from J are $250, *i.e.*, K's expenses ($230) plus K's profit ($20).

Example 2. M and N are calendar year taxpayers. M, a domestic manufacturing company, owns all the stock of N, a DISC for the taxable year. During 1972, M produces and sells a particular product line of export property to N for $75, a price which can be justified as satisfying the standard of arm's length price of section 482. N performs substantial functions with respect to the transaction and resells the export property for $100. M's cost of goods sold attributable to the export property is $60. M's direct selling expenses so attributable (relating to advertising of the product line in foreign markets) are $12. Although M has other deductible expenses, for purposes of this example, assume that M has no other deductible expenses. N's expenses attributable to resale of the export property are $22 of which $20 are export promotion expenses. The maximum profit which N may earn with respect to the product line is $6, computed as follows:

(1) Combined taxable income:		
(a) N's sales price		$100
(b) Less deductions:		
M's cost of goods sold	$60	
M's direct selling expenses	12	
N's expenses	22	
Total deductions		94

(c) Combined taxable income			6
(2) N's profit under combined taxable income method (before application of loss limitation):			
(a) 50 percent of combined taxable income			3
(b) Plus: 10 percent of N's export promotion expenses (10% of $20)			2
(c) N's profit			5
(3) N's profit under gross receipts method (before application of loss limitation):			
(a) 4 percent of N's sales price (4% of $100)			4
(b) Plus: 10 percent of N's export promotion expenses (10% of $20)			2
(c) N's profit			6
(4) N's profit under section 482 method:			
(a) N's sales price			100
(b) Less deductions:			
N's cost of goods sold (price paid by N to M)	75		
N's expenses	22		
Total deductions			97
(c) N's profit			3

Since the gross receipts method results in greater profit to N ($6) than does the combined taxable income method ($5) or section 482 method ($3), and does not exceed combined taxable income ($6), N may earn a maximum profit of $6. Accordingly, the transfer price from M to N may be readjusted as long as the transfer price is not readjusted below $72, computed as follows:

(5) Transfer price from M to N:			
(a) N's sales price			$100
(b) Less:			
N's expenses	$22		
N's profit	6		
Total subtractions			28
(c) Transfer price			72

Example 3. Q and R are calendar year taxpayers. Q, a domestic manufacturing company, owns all the stock of R, a DISC for the taxable year. During 1972, Q produces and sells a product line of export property to R for $170, a price which can be justified as satisfying the standards of arm's length price of section 482, and R resells the export property for $200. Q's cost of goods sold attributable to the export property is $115 so that the combined gross income from the sale of the export property is $85 (*i.e.*, $200 minus $115). Q's expenses incurred in connection with the property sold are $35. Q's deductible overhead and other supportive expenses allocable to all gross income are $6. Apportionment of these supportive expenses on the basis of gross income does not result in a material distortion of income and is a reasonable method of apportionment. Q's gross income from sources other than the transaction is $170 making total gross income of Q and R (excluding the transfer price paid by R) $255 (i.e., $85 plus $170). R's expenses attributable to resale of the export property are $20, all of which are export promotion expenses. The maximum profit which R may earn with respect to the product line is $16, computed as follows:

(1) Combined taxable income:			
(a) R's sales price			$200
(b) Less deductions:			
(i) Q's cost of goods sold		115	
(ii) Q's expenses incurred in connection with the property sold		35	
(iii) Apportionment of Q's supportive expenses:			
Q's supportive expenses	$6		
Combined gross income from sale of export property	85		
Total gross income of Q and R	255		
Apportionment	$(6 \times 85)/255$	2	
(iv) R's expenses		20	
Total deductions			172
(c) Combined taxable income			28
(2) R's profit under combined taxable income method (before application of loss limitation):			
(a) 50 percent of combined taxable income			14
(b) Plus: 10 percent of R's export promotion expenses (10% of $20)			2
(c) R's profit			16
(3) R's profit under gross receipts method (before application of loss limitation):			
(a) 4 percent of R's sales price (4% of $200)			8
(b) Plus: 10 percent of R's export promotion expenses (10% of $20)			2
(c) R's profit			10
(4) R's profit under section 482 method:			
(a) R's sales price			200
(b) Less deductions:			
R's cost of goods sold (price paid by R to Q)		170	
R's expenses		20	
Total deductions			190
(c) R's profit			10

Since the combined taxable income method results in greater profit to R ($16) than does the gross receipts method ($10) or section 482 method ($10), and does not exceed combined taxable income ($28), R may earn a maximum profit of $16. Accordingly, the transfer price from Q to R may be readjusted as long as the transfer price is not readjusted below $164 computed as follows:

(5) Transfer price from Q to R:			
(a) R's sales price			$200
(b) Less:			
R's expenses		$20	
R's profit		16	
Total			36
(c) Transfer price			164

Example 4. S and T are calendar year taxpayers. S, a domestic manufacturing company, owns all the stock of T, a DISC for the taxable year. During 1972, S produces and sells 100 units of a particular product to T under a written agreement which provides that the transfer price between S and T shall be that price which allocates to T the maximum permitted to be received under the intercompany pricing rules of section 994. Thereafter, the 100 units are sold by T for $950. S's cost of goods sold attributable to the 100 units is $650. S's other deductible expenses so attributable are $300. Although S has other deductible expenses, for purposes of this example, assume that S has no deductible expenses not definitely allocable to any item of gross income. T's expenses attributable to the resale of the 100 units are $50. S chooses not to apply the section 482 method. T may not earn any income under the gross receipts or combined taxable income method with respect to resale of the 100 units because combined taxable income is a negative figure, computed as follows:

(1) Combined taxable income:		
(a) T's sales price		$950
(b) Less deductions:		
S's cost of goods sold	$650	
S's expenses	300	
T's expenses	50	
Total deductions		1,000
(c) Combined taxable income (loss)		($50)

Under paragraph (e)(1)(i) of this section, T is permitted to recover its expenses attributable to the 100 units ($50) even though such recovery results in a loss or increased loss to the related supplier. Accordingly, the transfer price from S to T may be readjusted as long as the transfer price is not readjusted below $900, computed as follows:

(2) Transfer price from S to T:	
(a) T's sales price	$950
(b) Less: T's expenses	50
(c) Transfer price	900

Example 5. Assume the same facts as in example 4 except that S chooses to apply the section 482 method and that under arm's length dealings T would have derived $10 of income. Accordingly, the transfer price from S to T may be set at an amount not less than $890, computed as follows:

(1) Transfer price from S to T:		
(a) T's sales price		$950
(b) Less:		
T's expenses	$50	
T's profit	10	
Total deductions		60
(c) Transfer price		890

Example 6. X and Y are calendar year taxpayers. X, a domestic manufacturing company, owns all the stock of Y, a DISC for the taxable year. During March 1972, X manufactures a particular product of export property which it leases on April 1, 1972, to Y for a term of 1 year at a monthly rental of $1,000, a rent which satisfies the standard of arm's length rental under section 482. Y subleases the product on April 1, 1972, for a term of 1 year at a monthly rental of $1,200. X's cost for the product leased is $40,000. X's other deductible expenses attributable to the product are $900, all of which are incurred in 1972. Although X has other deductible expenses, for purposes of this example, assume that X has no other deductible expenses. Y's expenses attributable to sublease of the export property are $450, all of which are incurred in 1972 and are export promotion expenses. X depreciates the property on a straight line basis without the use of an averaging convention, assuming a useful life of 8 years and no salvage value. The profit which Y may earn with respect to the transaction is $2,895 for 1972 and $1,175 for 1973, computed as follows:

COMPUTATION FOR 1972

(1) Combined taxable income:		
(a) Y's sublease rental receipts for year ($1,200 × 9 months)		$10,800
(b) Less deductions:		
X's depreciation ($40,000 × 1/8 × 9/12)	$3,750	
X's other expenses	900	
Y's expenses	450	
Total deductions		5,100
(c) Combined taxable income		5,700
(2) Y's profit under combined taxable income method (before application of loss limitation):		
(a) 50 percent of combined taxable income		2,850
(b) Plus: 10 percent of Y's export promotion expenses (10% of $450)		45
(c) Y's profit		2,895
(3) Y's profit under gross receipts method (before application of loss limitation):		
(a) 4 percent of Y's sublease rental receipts for year (4% of $10,800)		432
(b) Plus: 10 percent of Y's export promotion expenses (10% of $450)		45
(c) Y's profit		477
(4) Y's profit under section 482 method:		
(a) Y's sublease rental receipts for year		$10,800
(b) Less deductions:		
Y's lease rental payments for year	$9,000	
Y's expenses	450	
Total deductions		9,450
(c) Y's profit		1,350

Since the combined taxable income method results in greater profit to Y ($2,895) than does the gross receipts method ($477) or section 482 method ($1,350), Y may earn a profit of $2,895 for 1972. Accordingly, the monthly

rental payable by Y to X for 1972 may be readjusted as long as the monthly rental payable is not readjusted below $828.33, computed as follows:

(5) Monthly rental payable by Y to X for 1972:		
(a) Y's sublease rental receipts for year		$10,800.00
(b) Less:		
Y's expenses	450.00	
Y's profit	2,895.00	
Total		3,345.00
(c) Rental payable for 1972		7,455.00
(d) Rental payable each month ($7,455 ÷ 9 months)		828.33

COMPUTATION FOR 1973

(1) Combined taxable income:	
(a) Y's sublease rental receipts for year ($1,200 × 3 months)	$3,600
(b) Less: X's depreciation ($40,000 × 1/8 × 3/12)	1,250
(c) Combined taxable income	2,350
(2) Y's profit under combined taxable income method (before application of loss limitation):	
(a) 50 percent of combined taxable income	$1,175
(b) Y's profit	1,175
(3) Y's profit under gross receipts method (before application of loss limitation):	
(a) 4 percent of Y's sublease rental receipts for year (4% of $3,600)	144
(b) Y's profit	144
(4) Y's profit under section 482 method:	
(a) Y's sublease rental receipts for year	3,600
(b) Less: Y's lease rental payments for year	3,000
(c) Y's profit	600

Since the combined taxable income method results in greater profit to Y ($1,175) than does the gross receipts method ($144) or section 482 method ($600), Y may earn a profit of $1,175 for 1973. Accordingly, the monthly rental payable by Y to X for 1973 may be readjusted as long as the monthly rental payable is not readjusted below $808.33, computed as follows:

(5) Monthly rental payable by Y to X for 1973:	
(a) Y's sublease rental receipts for year	$3,600.00
(b) Less: Y's profit	1,175.00
(c) Rental payable for 1973	2,425.00
(d) Rental payable for each month ($2,425 ÷ 3 months)	808.33

(Secs. 995(e)(7), (8) and (10), 995(g) and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1655, 26 U.S.C. 995 (e)(7), (8) and (10); 90 Stat. 1659, 26 U.S.C. 995(g); and 68A Stat 917, 26 U.S.C. 7805))

[T.D. 7364, 40 FR 29827, July 16, 1975, as amended by T.D. 7435, 41 FR 43142, Sept. 30, 1976; T.D. 7854, 47 FR 51741, Nov. 17, 1982; T.D. 7984, 49 FR 40018, Oct. 12, 1984]

§ 1.994–2 Marginal costing rules.

(a) *In general.* This section prescribes the marginal costing rules authorized by section 994(b)(2). If under paragraph (c)(1) of this section a DISC is treated for its taxable year as seeking to establish or maintain a foreign market for sales of an item, product, or product line of export property (as defined in §1.993–3) from which qualified export receipts are derived, the marginal costing rules prescribed in paragraph (b) of this section may be applied to allocate costs between gross receipts derived from such sales and other gross receipts for purposes of computing, under the ''50–50'' combined taxable income method of §1.994–1(c)(3), the combined taxable income of the DISC and related supplier derived from such sales. Such marginal costing rules may be applied whether or not the related supplier manufactures, produces, grows, or extracts (within the meaning of §1.993–3(c)) the export property sold. Such marginal costing rules do not apply to sales of export property which in the hands of a purchaser related under section 954(d)(3) to the seller give rise to foreign base company sales income as described in section 954(d) unless, for the purchaser's year in which it resells the export property, section 954(b)(3)(A) is applicable or such income is under the exceptions in section 954(b)(4). Such marginal costing rules do not apply to leases of property or the performance of any services whether or not related and subsidiary services (as defined in §1.994–1(b)(3).

(b) *Marginal costing rules for allocations of costs*—(1) *In general.* Marginal costing is a method under which only marginal or variable costs of producing and selling a particular item, product, or product line are taken into account for purposes of section 994. Where this section is applicable, costs attributable to deriving qualified export receipts for the DISC's taxable year from sales of an item, product, or product line may be determined in any manner the related supplier (as defined in §1.994–1(a)(3)(ii)) chooses, provided that the requirements of both subparagraphs (2) and (3) of this paragraph are met.

(2) *Variable costs taken into account.* There are taken into account in computing the combined taxable income of

the DISC and its related supplier from sales of an item, product, or product line the following costs:

(i) Direct production costs (as defined in §1.471–11(b)(2)(i)) and

(ii) Costs which are export promotion expenses, but only if they are claimed as export promotion expenses in determining taxable income derived by the DISC under the combined taxable income method of §1.994–1(c)(3).

At the taxpayer's option, all, a part, or none of the costs which qualify as export promotion expenses may be so claimed as export promotion expenses.

(3) *Overall profit percentage limitation.* As a result of such determination of costs attributable to such qualified export receipts for the DISC's taxable year, the combined taxable income of the DISC and its related supplier from sales of such item, product, or product line for the DISC's taxable year does not exceed gross receipts (determined under §1.993–6) of the DISC derived from such sales, multiplied by the overall profit percentage (determined under paragraph (c)(2) of this section).

(c) *Definitions*—(1) *Establishing or maintaining a foreign market.* A DISC shall be treated for its taxable year as seeking to establish or maintain a foreign market with respect to sales of an item, product, or product line of export property from which qualified export receipts are derived if the combined taxable income computed under paragraph (b) of this section is greater than the combined taxable income computed under §1.994–1(c)(6).

(2) *Overall profit percentage.* (i) For purposes of this section, the overall profit percentage for a taxable year of the DISC for a product or product line is the percentage which—

(*a*) The combined taxable income of the DISC and its related supplier plus all other taxable income of its related supplier from all sales (domestic and foreign) of such product or product line during the DISC's taxable year, computed under the full costing method, is of

(*b*) The total gross receipts (determined under §1.993–6) from all such sales.

(ii) At the annual option of the related supplier, the overall profit percentage for the DISC's taxable year for all products and product lines may be determined by aggregating the amounts described in subdivision (i) (*a*) and (*b*) of this subparagraph of the DISC, and all domestic members of the controlled group (as defined in §1.993–1(k)) of which the DISC is a member, for the DISC's taxable year and for taxable years of such members ending with or within the DISC's taxable year.

(iii) For purposes of determining the amounts in subdivisions (i) (*b*) and (ii) of this subparagraph, a sale of property between a DISC and its related supplier or between domestic members of the controlled group shall be taken into account only during the DISC's taxable year (or taxable year of the member ending within the DISC's taxable year) during which the property is ultimately sold to a person which is neither the DISC nor such a domestic member.

(3) *Grouping of transactions.* (i) In general, for purposes of this section, an item, product, or product line is the item or group consisting of the product or product line pursuant to §1.994–1(c)(7) used by the taxpayer for purposes of applying the intercompany pricing rules of §1.994–1.

(ii) However, for purposes of determining the overall profit percentage under subparagraph (2) of this paragraph, any product or product line grouping permissible under §1.994–1(c)(7) may be used at the annual choice of the taxpayer, even though it may not be the same item or grouping referred to in subdivision (i) of this subparagraph, as long as the grouping chosen for determining the overall profit percentage is at least as broad as the grouping referred to in such subdivision (i).

(4) *Full costing method.* For purposes of this section, the term ''full costing method'' is the method for determining combined taxable income set forth in §1.994–1(c)(6).

(d) *Application of limitation on DISC income (''no loss'' rule).* If the marginal costing rules of this section are applied, the combined taxable income method of §1.994–1(c)(3) may not be applied to cause in any taxable year a loss to the related supplier, but such method may be applied to the extent it does not cause a loss. For purposes of

the preceding sentence, a loss to a related supplier would result if the taxable income of the DISC would exceed the combined taxable income of the related supplier and the DISC determined in accordance with paragraph (b) of this section. If, however, there is no combined taxable income (so determined), see the last sentence of §1.994–1(e)(1)(i).

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

Example 1. X and Y are calendar year taxpayers. X, a domestic manufacturing company, owns all the stock of Y, a DISC for the taxable year. During 1973, X manufactures a product line which is eligible to be export property (as defined in §1.993–3). X enters into a written agreement with Y whereby Y is granted a sales franchise with respect to exporting such product line from which qualified export receipts will be derived and Y will receive commissions with respect to such exports equal to the maximum amount permitted to be received under the intercompany pricing rules of section 994. Commissions are computed using the combined taxable income method under §1.994–1(c)(3). For purposes of applying the combined taxable income method, X and Y compute their combined taxable income attributable to the product line of export property under the marginal costing rules in accordance with the additional facts assumed in the table below:

(1) Maximum combined taxable income (determined under paragraph (b)(2) of this section):		
(a) Y's gross receipts from export sales		$95.00
(b) Less:		
(i) Direct materials	40.00	
(ii) Direct labor	20.00	
(iii) Y's export promotion expenses claimed in determining Y's DISC taxable income	5.00	
(iv) Total deductions	65.00	
(c) Maximum combined taxable income		30.00
(2) Overall profit percentage limitation (determined under paragraph (b)(3) of this section):		
(a) Gross receipts of X and Y from all domestic and foreign sales		400.00
(b) Less deductions:		
(i) Direct materials	160.00	
(ii) Direct labor	80.00	
(iii) Other costs (of which $8 are costs of the DISC including $5 of export promotion expenses claimed in determining Y's taxable income)	40.00	
(c) Total deductions		280.00
(d) Total taxable income from all sales computed on a full costing method		120.00
(e) Overall profit percentage (line (d) ($120) divided by line (a) ($400)) (percent)		30%
(f) Multiply by gross receipts from Y's export sales (line (1)(a))		$95.00
(g) Overall profit percentage limitations		28.50

Since the overall profit percentage limitation under line (2)(g) ($28.50) is less than maximum combined taxable income under line (1)(c) ($30), combined taxable income under marginal costing is limited to $28.50. Since under the franchise agreement Y is to earn the maximum commission permitted under the intercompany pricing rules of section 994, combined taxable income on the transactions is $28.50. Accordingly, the costs attributable to export sales (other than for direct material, direct labor, and export promotion expenses) are $1.50, *i.e.*, line (1)(c) ($30) minus line (2)(g) ($28.50). Under the combined taxable income method of §1.994–1(c)(3), Y will have taxable income attributable to the sales of $14.75, i.e., the sum of ½ of combined taxable income (1/2 of $28.50) and 10 percent of Y's export promotion expenses claimed in determining Y's taxable income (10 percent of $5). Accordingly, the commissions Y receives from X are $22.75, i.e., Y's costs ($8, see line (2)(b)(iii)) plus Y's profit ($14.75).

Example 2. (1) Assume the same facts as in example 1, except that gross receipts from export sales are only $85 and gross receipts from all sales remain at $400. For purposes of applying the combined taxable income method, X and Y may compute their combined taxable income attributable to the product line of export property under the marginal costing rules as follows:

(1) Maximum combined taxable income (determined under paragraph (b)(2) of this section):		
(a) Y's gross receipts from export sales		$85.00
(b) Less:		
(i) Direct materials	40.00	
(ii) Direct labor	20.00	
(iii) Y's export promotion expenses claimed in determining Y's taxable income	5.00	
(iv) Total deductions		65.00
(c) Maximum combined taxable income		20.00
(2) Overall profit percentage limitation (determined under paragraph (b)(3) of this section):		
(a) Gross receipts from Y's export sales (line (1)(a))		85.00
(b) Multiply by overall profit percentage (as determined in example 1) (percent)		30%
(c) Overall profit percentage limitation		25.50

Since maximum combined taxable income under line (1)(c) ($20) is less than the overall profit percentage limitation under line (2)(c) ($25.50), combined taxable income under marginal costing is limited to $20. Since under the franchise agreement Y is to earn the maximum commission permitted under the

intercompany pricing rules of section 994, combined taxable income on the transactions is $20. Accordingly, no costs (other than for direct material, direct labor, and export promotion expenses) will be attributed to export sales. Under the combined taxable income method of §1.994–1(c)(3), Y will have taxable income attributable to the sales of $10.50, i.e., the sum of ½ of combined taxable income (1/2 of $20) and 10 percent of Y's export promotion expenses claimed in determining Y's taxable income (10 percent of $5). Accordingly, the Commissions Y receives from X are $18.50, *i.e.*, Y's costs ($8, see line (2)(b)(iii) of example 1) plus Y's profit ($10.50).

(2) If export promotion expenses are not claimed in determining taxable income of Y under the combined taxable income method, the taxable income of Y would be increased to $12.50 and commissions payable to Y would be increased to $20.50, computed as follows:

(3) Maximum combined taxable income (determined under paragraph (b)(2) of this section):		
(a) Y's gross receipts from export sales	$85.00	
(b) Less:		
(i) Direct materials	40.00	
(ii) Direct labor	20.00	
(iii) Total deductions		60.00
(c) Maximum combined taxable income		25.00
(4) Overall profit percentage limitation (line (2)(c))		25.50

Since maximum combined taxable income under line (3)(c) ($25) is less than the overall profit percentage under line (4) ($25.50), combined taxable income under marginal costing is limited to $25. Since under the franchise agreement Y is to earn the maximum commission permitted under the intercompany pricing rules of section 994, combined taxable income on the transactions is $25. Accordingly, no costs (other than for direct material and direct labor) will be attributed to export sales. Under the combined taxable income method of §1.994–1(c)(3), Y will have taxable income attributable to the sales of $12.50, i.e., ½ of combined taxable income (½ of $25). Accordingly, the commissions Y receives from X are $20.50, *i.e.*, Y's costs ($8, see line (2)(b)(iii) of example 1) plus Y's profit ($12.50).

Example 3. (1) Assume the same facts as in example 1, except that gross receipts from export sales are only $85, gross receipts from all sales remain at $400, and Y has costs of $40 consisting of Y's export promotion expenses of $35 and costs of $5 other than for direct material, direct labor, or export promotion expenses. For purposes of applying the combined taxable income method, X and Y may compute their combined taxable income attributable to the product line of export property under the marginal costing rules as follows:

(1) Maximum combined taxable income (determined under paragraph (b)(2) of this section):		
(a) Y's gross receipts from export sales	$85.00	
(b) Less:		
(i) Direct materials	40.00	
(ii) Direct labor	20.00	
(iii) Y's export promotion expenses claimed in determining Y's taxable income	35.00	
(iv) Total deductions		95.00
(c) Maximum combined taxable income (loss)		(10.00)
(2) Overall profit percentage limitation (as determined in example 2)		25.50

Since maximum combined taxable income under line (1)(c) (which is a loss of $10) is less than the overall profit percentage limitation under line (2)(c) ($25.50), combined taxable income under marginal costing is a loss of $10 and, under the combined taxable income method of §1.994–1(c)(3), Y will have no taxable income or loss attributable to the sales. Accordingly, the commissions Y receives from X are $40, *i.e.*, Y's costs ($40).

(2) If export promotion expenses are not claimed in determining Y's taxable income under the combined taxable income method, the taxable income of Y would be increased to $12.50 and commissions payable to Y would be increased to $52.50 computed as follows:

(3) Maximum combined taxable income (determined under paragraph (b)(2) of this section) (line (3)(c) of example 2)	$25.00
(4) Overall profit percentage limitation (as determined in example 2)	25.50

The results would be the same as in part (2) of example 2, except that the commissions Y receives from X are $52.50, *i.e.*, Y's costs ($40) plus Y's profit ($12.50).

[T.D. 7364, 40 FR 29836, July 16, 1975; 40 FR 33972, Aug. 13, 1975]

§ 1.995–1 Taxation of DISC income to shareholders.

(a) *In general.* (1) Under §1.991–1(a), a corporation which is a DISC for a taxable year is not subject to any tax imposed by subtitle A of the Code (sections 1 through 1564) for the taxable year, except for the tax imposed by chapter 5 thereof (sections 1491 through 1494) on certain transfers to avoid tax.

(2) Under section 995(a), the shareholders of a DISC, or a former DISC, are subject to taxation on the earnings and profits of the DISC in accordance with the provisions of chapter 1 of the

Code generally applicable to shareholders, but subject to the modifications provided in sections 995, 996, and 997.

(3) Under §1.996–3, three divisions of earnings and profits of a DISC, or former DISC, are defined: ''accumulated DISC income'', ''previously taxed income'', and ''other earnings and profits''. Under §1.995–2, certain amounts of the DISC's earnings and profits are deemed to be distributed as dividends to shareholders of the DISC at the close of the DISC's taxable year in which such earnings were derived. Such deemed distributions do not cause a reduction in the DISC's earnings and profits, but are taken into account in §1.996–3(c) as an increase in previously taxed income. To the extent the DISC's earnings and profits are paid out in a subsequent distribution which is, under §1.996–1, treated as made out of such ''previously taxed income,'' they will not be taxable to the shareholders a second time.

(4) In general, ''accumulated DISC income'' is the earnings and profits of the DISC which have not been deemed distributed and which may be deferred from taxation so long as they are not actually distributed with respect to its stock. However, deferral of taxation on ''accumulated DISC income'' may be terminated, in whole or in part, in the event of: (i) Certain foreign investment attributable to producer's loans (see §1.995–2(a)(5) and §1.995–5); (ii) revocation of the election to be treated as a DISC or other disqualification (see §1.995–3); and (iii) certain dispositions of DISC stock in which gain is realized (see §1.995–4).

(5) Since a DISC is not taxed on its taxable income, section 246(d) and §1.246–4 provide that the deduction otherwise allowed under section 243 shall not be allowed with respect to a dividend from a DISC, or former DISC, paid or treated as paid out of accumulated DISC income or previously taxed income or with respect to a deemed distribution in a qualified year under §1.995–2(a).

(b) *Amounts and character of amounts includible in shareholder's gross income.* Each shareholder of a corporation which is a DISC, or former DISC, shall include in his gross income—

(1) Amounts actually distributed to him that are includible in his gross income in accordance with paragraph (c) of this section.

(2) Amounts which, pursuant to §1.995–2, he is deemed to receive as a distribution taxable as a dividend on the last day of each of the corporation's taxable years for which it qualifies as a DISC,

(3) Amounts which, pursuant to §1.995–3, he is deemed to receive as a distribution taxable as a dividend in the event the corporation revokes its election to be treated as a DISC or otherwise is disqualified as a DISC, and

(4) Gain realized on certain dispositions of stock in the corporation which, under §1.995–4, is includible in his gross income as a dividend.

(c) *Treatment of actual distributions.* (1) Except as provided in subparagraph (3) of this paragraph, amounts actually distributed to a shareholder of a DISC, or former DISC, with respect to his stock are includible in his gross income in accordance with section 301.

(2) Since a deemed distribution does not reduce the earnings and profits of a DISC, it does not affect the determination as to whether a subsequent actual distribution is a ''dividend'' under section 316(a). Since, however, the amount of a deemed distribution increases ''previously taxed income'', it does affect the determination as to whether a subsequent actual distribution is excluded (as described in subparagraph (3) of this paragraph) from gross income.

(3) Under §1.996–1(c), the amount of any actual distribution (including a deficiency distribution made pursuant to §1.992–3), with respect to stock in a DISC, or former DISC, which is treated under §1.996–1 as made out of previously taxed income, is excluded by the distributee from gross income, but only to the extent that such amount does not exceed the adjusted basis of the distributee's stock. Under §1.996–5(b), that portion of any actual distribution which is treated as made out of previously taxed income shall be applied against and reduce the adjusted basis of the stock and, to the extent that it exceeds the adjusted basis of the stock, it shall be treated as gain from the sale or exchange of property.

(4) A deficiency distribution pursuant to §1.992–3 may be made after the close of the DISC's taxable year with respect to which it is made. The determinations as to whether such deficiency distribution is a dividend under section 301 and as to which division of earnings and profits is the source thereof depend upon the status of the DISC's earnings and profits account and divisions thereof at the time the distribution is actually made. See §1.996–1(d) for the priority of such deficiency distribution over other actual distributions made during the same taxable year.

(d) *Personal holding company income.* (1) Any amount includible in a shareholder's gross income as a dividend with respect to the stock of a DISC, or former DISC, pursuant to paragraph (b) of this section shall be treated as a dividend for all purposes of the Code, except that for purposes of determining whether such shareholder is a personal holding company within the meaning of section 542 any amount deemed distributed for qualified years under §1.995–2 or upon disqualification under §1.995–3, any amount of gain on certain dispositions of DISC stock to which §1.995–4 applies, and any amount treated under §1.996–1 as distributed out of accumulated DISC income or previously taxed income shall not be treated as a dividend or any other kind of income described in section 543(a).

(2) Notwithstanding subparagraph (1) of this paragraph, the shareholder may treat as an item of income described under section 543 (for example, rents) any amount to which the exception in such subparagraph (1) applies, if it establishes to the satisfaction of the district director that such amount is attributable to earnings and profits derived from such item of income.

[T.D. 7324, 39 FR 35109, Sept. 30, 1974]

§1.995–2 Deemed distributions in qualified years.

(a) *General rule.* Under section 995 (b)(1), each shareholder of a DISC shall be treated as having received a distribution taxable as a dividend with respect to his stock on the last day of each taxable year of the DISC, in an amount which is equal to his pro rata share of the sum (as limited by paragraph (b) of this section), of the following seven items:

(1) An amount equal to the gross interest derived by the DISC during such year from producer's loans (as defined in §1.993–4).

(2) An amount equal to the lower of—

(i) Any gain recognized by the DISC during such year on the sale or exchange of property (other than property which in the hands of the DISC is a qualified export asset) which was previously transferred to it in a transaction in which the transferor realized gain which was not recognized in whole or in part, or

(ii) The amount of the transferor's gain which was not recognized on the previous transfer of the property to the DISC.

For purposes of this subparagraph, each item of property shall be considered separately. See paragraph (d) of this section for special rules with respect to certain tax-free acquisitions of property by the DISC.

(3) An amount equal to the lower of—

(i) Any gain recognized by the DISC during such year on the sale or exchange of property which in the hands of the DISC is a qualified export asset (other than stock in trade or property described in section 1221(1)) and which was previously transferred to the DISC in a transaction in which the transferor realized gain which was not recognized in whole or in part, or

(ii) The amount of the transferor's gain which was not recognized on the previous transfer of the property to the DISC and which would have been includible in the transferor's gross income as ordinary income if its entire realized gain had been recognized upon the transfer.

For purposes of this subparagraph, each item of property shall be considered separately. See paragraph (d) of this section for special rules with respect to certain tax-free acquisitions of property by the DISC.

(4) For taxable years beginning after December 31, 1975, an amount equal to 50 percent of the taxable income of the DISC for the taxable years attributable to military property (as defined in §1.995–6).

(5) For taxable years beginning after December 31, 1975, the taxable income for the taxable year attributable to base period export gross receipts (as defined in §1.995–7).

(6) The sum of—

(i)(A) In the case of a corporate share holder, an amount equal to 57.5 percent of the excess (if any) (one-half for DISCs' taxable years beginning before January 1, 1983) of the taxable income of the DISC for such year (computed as provided in §1.991–1(b)(1)) over the sum of the amounts deemed distributed for the taxable year in accordance with subparagraphs (1), (2), (3), (4) and (5) of this paragraph, or

(B) In the case of a non-corporate share holder, an amount equal to one-half of the excess (if any) of the taxable income of the DISC for such year (computed as provided in §1.991–1(b)(1)) over the sum of the amounts deemed distributed for the taxable year in accordance with subparagraphs (1), (2), (3), (4), and (5) of this paragraph.

(ii)(A) An amount equal to the amount under subdivision (i) of paragraph (a)(6) of this section multiplied by the international boycott factor as determined under section 999 (c)(1) , or

(B) In lieu of the amount determined under subdivision (ii)(A) of paragraph (a)(6) of this section, the amount described under section 999 (c)(2) of such international boycott income, and

(iii) An amount equal to the sum of any illegal bribes, kickbacks, or other payments paid by or on behalf of the DISC directly or indirectly to an official, employee, or agent in fact of a government. An amount is paid by a DISC where it is paid by any officer, director, employee, shareholder, or agent of the DISC for the benefit of such DISC. For purposes of this section, the principles of section 162 (c) and the regulations thereunder shall apply. The fair market value of an illegal payment made in the form of property or services shall be considered the amount of such illegal payment.

(7) The amount of foreign investment attributable to producer's loans of the DISC, as of the close of the ''group taxable year'' ending with such taxable year of the DISC, determined in accordance with §1.995–5. The amount of such foreign investment attributable to producer's loans so determined for any taxable year of a former DISC shall be deemed distributed as a dividend to the shareholders of such former DISC on the last day of such taxable year. See §1.995–3(e) for the effect that such deemed distribution has on scheduled installments of deemed distributions of accumulated DISC income under §1.995–3(a) upon disqualification.

(b) *Limitation on amount of deemed distributions under section 995(b)(1).* (1) The sum of the amounts described in paragraph (a)(1) through (a)(6) of this section which is deemed distributed pro rata to the DISC's shareholders a dividend for any taxable year of the corporation shall not exceed the DISC's earnings and profits for such year.

(2) The amount of foreign investment attributable to producer's loans of the DISC (as described in paragraph (a)(7) of this section) which is deemed to be distributed pro rata to the DISC's shareholders as dividends for any taxable year of the corporation shall not exceed the lower of the corporation's accumulated DISC income at the beginning of such year or the corporation's accumulated earnings and profits at the beginning of such year (but not less than zero)—

(i) Increased by any DISC income of the corporation for such year as defined in §1.996–3(b)(2) (*i.e.*, any excess of the DISC's earnings and profits for such year over the sum of the amounts described in paragraph (a)(1) through (a)(6) of this section), or

(ii) Decreased by any deficit in the corporation's earnings and profits for such year.

Thus, for example, if a DISC has a deficit in accumulated earnings and profits at the beginning of a taxable year of $10,000, current earnings and profits of $12,000, no amounts described in paragraphs (a)(1) through (a)(6) of this section for the year, and foreign investment attributable to producer's loans for the taxable year of $5,000, the DISC would have a deemed distribution described in paragraph (a)(7) of this section of $5,000 for the taxable year. On the other hand, suppose the DISC had accumulated earnings and profits of $13,000 at the beginning of the taxable year, accumulated DISC income of $10,000 at the beginning of the taxable

year, a deficit in earnings and profits for the taxable year of $12,000, no amounts described in paragraphs (a)(1) through (a)(6) of this section for the taxable year, and foreign investment attributable to producer's loans for the taxable year of $5,000. Under these facts the DISC would have no deemed distribution described in paragraph (a)(7) of this section because the corporation had no DISC income for the taxable year and the current year's deficit in earnings and profits subtracted from the DISC's accumulated DISC income at the beginning of the year produces a negative amount. For rules relating to the carryover to a subsequent year of the $5,000 of foreign investment attributable to producer's loans, see § 1.995–5(a)(6).

(3) If, by reason of the limitation in subparagraph (1) of this paragraph, less than the sum of the amounts described in paragraphs (a)(1) through (a)(6) of this section is deemed distributed, then the portion of such sum which is deemed distributed shall be attributed first to the amount described in subparagraph (1) of such paragraph, to the extent thereof; second to the amount described in subparagraph (2) of such paragraph, to the extent thereof; third to the amount described in subparagraph (3) of such paragraph, to the extent thereof; and so forth, and finally to the amount described in paragraph (b)(6) of this paragraph.

(c) *Examples.* Paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example 1. Y is a corporation which uses the calendar year as its taxable year and which elects to be treated as a DISC beginning with 1972. X is its sole shareholder. In 1972, X transfers certain property to Y in exchange for Y's stock in a transaction in which X does not recognize gain or loss by reason of the application of section 351(a). Included in the property transferred to Y is depreciable property described in paragraph (a)(3) of this section on which X realizes, but does not recognize by reason of the application of section 1245(b)(3), a gain of $20,000. If X had sold such property for cash, the $20,000 gain would have been recognized as ordinary income under section 1245. Also included in the transfer to Y is 100 shares of stock in a third corporation (which is not a related foreign export corporation) on which X realizes, but does not recognize, a gain of $5,000. In 1973, Y sells such property and recognizes a gain of $25,000 on the depreciable property and $8,000 on the 100 shares of stock. Y has accumulated earnings and profits at the beginning of 1973 of $5,000, earnings and profits for 1973 of $72,000, and taxable income for 1973 of $100,000. At the beginning of 1973, Y has $6,000 of accumulated DISC income, no previously taxed income, and a deficit of $1,000 of other earnings and profits. Under these facts and the additional facts assumed in the table below, X is treated as having received a deemed distribution taxable as a dividend of $76,000 on December 31, 1973, determined as follows:

(1) Gross interest derived by Y in 1973 from producer's loans	$7,000
(2) Amount of gain on depreciable property (lower of Y's recognized gain ($25,000) or X's gain not recognized on section 1245 property ($20,000))	20,000
(3) Amount of gain on stock (lower of X's gain not recognized or Y's recognized gain ($8,000) ($5,000))	5,000
(4) One-half excess of taxable income for 1973 over the sum of lines (1), (2), and (3) (1/2 of ($100,000 minus $32,000))	34,000
(5) Limitation on lines (1) through (4):	
(a) Sum of lines (1) through (4)	66,000
(b) Earnings and profits for 1973	72,000
(c) Lower of lines (a) and (b)	66,000
(6) Amount under paragraph (a)(5) of this section:	
(a) Foreign investment attributable to producer's loans under § 1.995–5	10,000
(b) Sum of the lower of accumulated earnings and profits at beginning of 1973 ($5,000) or accumulated DISC income at beginning of 1973 ($6,000) and excess of earnings and profits for 1973 over line (5)(c) ($72,000 minus $66,000)	11,000
(c) Lower of lines (a) and (b)	10,000
(7) Total deemed distribution (sum of lines (5)(c) and (6)(c))	76,000

Example 2. Assume the facts are the same as in example 1, except that earnings and profits for 1973 amount to only $60,000. Under these facts, X is treated as receiving a deemed distribution taxable as a dividend of $65,000 on December 31, 1973, determined as follows:

(5) Limitation on lines (1) through (4):	
(a) Line (5)(a) of example 1	$66,000
(b) Earnings and profits for 1973	60,000
(c) Lower of lines (a) and (b)	60,000
(6) Amount under paragraph (a)(5) of this section:	
(a) Line (6)(a) of example 1	10,000
(b) Sum of the lower of accumulated earnings and profits at beginning of 1973 ($5,000) or accumulated DISC income at beginning of 1973 ($6,000) plus excess of earnings and profits for 1973 over line (5)(c) ($60,000 minus $60,000)	5,000
(c) Lower of lines (a) and (b)	5,000

(7) Total deemed distribution (sum of lines (5)(c) and (6)(c))	65,000

Example 3. Assume the facts are the same as in example 1, except that Y has a deficit in accumulated earnings and profits at the beginning of 1973 of $4,000. Such deficit is comprised of accumulated DISC income of $1,000, no previously taxed income, and a deficit in other earnings and profits of $5,000. Under these facts, X is treated as receiving a deemed distribution taxable as a dividend in the amount of $72,000 on December 31, 1973, determined as follows:

(5) Limitation on lines (1) through (4):	
(a) Line (5)(a) of example 1	$66,000
(b) Earnings and profits for 1973	72,000
(c) Lower of lines (a) and (b)	66,000
(6) Amount under paragraph (a)(5) of this section:	
(a) Line (6)(a) of example 1	10,000
(b) Sum of accumulated earnings and profits at beginning of 1973 (not less than $0), and excess of earnings and profits for 1973 over amount in line (5)(c) ($72,000 minus $66,000)	6,000
(c) Lower of lines (a) and (b)	6,000
(7) Total deemed distribution sum of lines (5)(c) and (6)(c)	72,000

(d) *Special rules for certain tax-free acquisitions of property by the DISC.* (1) For purposes of paragraph (a)(2)(i) and (3)(i) of this section, if—

(i) A DISC acquires property in a first transaction and in a second transaction it disposes of such property in exchange for other property, and

(ii) By reason of the application of section 1031 (relating to like-kind exchanges) or section 1033 (relating to involuntary conversions), the basis in the DISC's hands of the other property acquired in such second transaction is determined in whole or in part with reference to the basis of the property acquired in the first transaction,

then upon a disposition of such other property in a third transaction by the DISC such other property shall be treated as though it had been transferred to the DISC in the first transaction. Thus, if the first transaction is a purchase of the property for cash, then paragraphs (a)(2) and (3) of this section will not apply to a sale by the DISC of the other property acquired in the second transaction.

(2) For purposes of paragraphs (a)(2)(i) and (3)(i) of this section, if a DISC acquires property in a first transaction and it transfers such property to a transferee DISC in a second transaction in which the transferor DISC's gain is not recognized in whole or in part, then such property shall be treated as though it had been transferred to the transferee DISC in the same manner in which it was acquired in the first transaction by the transferor DISC. For example, if X and Y both qualify as DISC's and X transfers property to Y in a second transaction in which gain or loss is not recognized, paragraph (a)(2) or (3) of this section does not apply to a sale of such property by Y in a third transaction if X had acquired the property in a first transaction by a purchase for cash. If, however, X acquired the property from a transferor other than a DISC in the first transaction in which the transferor's realized gain was not recognized, then paragraph (a)(2) or (3) of this section may apply to the sale by Y if the other conditions of such paragraph (a)(2) or (3) are met.

(3) If a DISC acquires property in a second transaction described in subparagraph (1) or (2) of this paragraph in which it (or, in the case of a second transaction described in subparagraph (2) of this paragraph, the transferor DISC) recognizes a portion (but not all) of the realized gain, then the amount described in paragraph (a)(2)(ii) or (a)(3)(ii) of this section with respect to a disposition by the DISC of such acquired property in a third transaction shall not exceed the transferor's gain which was not recognized on the first transaction minus the amount of gain recognized by the DISC (or transferor DISC) on the second transaction.

(4) The provisions of this paragraph may be illustrated by the following examples:

Example 1. X and Y are corporations each of which qualifies as a DISC and uses the calendar year as its taxable year. In 1972, X acquires section 1245 property in a first transaction in which the transferor's entire realized gain of $17 is not recognized. In 1973, X transfers such property to Y in a second transaction in which X realizes a gain of $20 of which only $4 is recognized. (On December 31, 1973, X's shareholders are treated as having received a deemed distribution of a dividend which includes such $4 under paragraph (a)(3) of this section, provided the limitation in paragraph (b) of this section is met.) In a

third transaction in 1974, Y sells such property and recognizes a gain of $25. With respect to Y's shareholders on December 31, 1974, the amount described in paragraph (a)(3)(ii) of this section would be limited to $13, which is the amount of the transferor's gain which was not recognized on the first transaction ($17) minus the amount of gain recognized by X on the second transaction ($4).

Example 2. Z is a DISC using the calendar year as its taxable year. In a first transaction in 1972, in exchange for its stock, Z acquires section 1245 property from A, an individual who is its sole shareholder, in a transaction in which A's realized gain of $30 is not recognized by reason of the application of section 351(a). In a second transaction in 1973, Z exchanges such property for other property in a like-kind exchange to which section 1031(b) applies and recognizes $10 of a realized gain of $35. (On December 31, 1973, A is treated as having received a deemed distribution of a dividend which includes such $10 under paragraph (a)(3) of this section, provided the limitation in paragraph (b) of this section is met.) In a third transaction in 1974, Z sells the property acquired in the like-kind exchange and recognizes a gain of $25. With respect to A on December 31, 1974, the amount described in paragraph (a)(3)(ii) of this section is limited to $20, which is the amount of A's gain which was not recognized on the first transaction ($30) minus the amount of gain recognized by Z on the second transaction ($10).

(e) *Carry back of net operating loss and capital loss to prior DISC taxable year.* For purposes of sections 991, 995, and 996, the amount of the deduction for the taxable year under section 172 for a net operating loss carryback or carryover or under section 1212 for a capital loss carryback or carryover shall be determined in the same manner as if the DISC were a domestic corporation which had not elected to be treated as a DISC. Thus, the amount of the deduction will be the same whether or not the corporation was a DISC in the year of the loss or in the year to which the loss is carried. For provisions setting forth adjustments to the DISC's, or former DISC's, deemed distributions, adjustments to its divisions of earnings and profits, and other tax consequences arising from such carrybacks, see §1.996–8.

(Secs. 995(e)(7), (8) and (10), 995(g) and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1655, 26 U.S.C. 995 (e)(7), (8) and (10); 90 Stat. 1659, 26 U.S.C. 995(g); and 68A Stat 917, 26 U.S.C. 7805))

[T.D. 7324, 39 FR 35110, Sept. 30, 1974, as amended by T.D. 7862, 47 FR 56492, Dec. 17, 1982; T.D. 7984, 49 FR 40018, Oct. 12, 1984]

§1.995–3 Distributions upon disqualification.

(a) *General rule.* Under section 995(b)(2), a shareholder of a corporation which is disqualified from being a DISC, either because pursuant to §1.992–2(e)(2) it revoked its election to be treated as a DISC or because it has failed to satisfy the requirements as set forth in §1.992–1 to be a DISC for a taxable year, shall be deemed to have received (at the times specified in paragraph (b) of this section) distributions taxable as dividends aggregating an amount equal to his pro rata share of the accumulated DISC income (as defined in §1.996–3(b)) of such corporation which was accumulated during the immediately preceding consecutive taxable years for which the corporation was a DISC. The pro rata share referred to in the preceding sentence shall be determined as of the close of the last of such consecutive taxable years for which the corporation was a DISC. See §1.996–7(c) for rules relating to the carryover of, and maintaining a separate account for, such accumulated DISC income in certain reorganizations.

(b) *Time of receipt of deemed distributions.* Distributions described in paragraph (a) of this section shall be deemed to be received in equal installments on the last day of each of the 10 taxable years of the corporation following the year of the disqualification described in paragraph (a) of this section, except that in no case may the number of equal installments exceed the number of the immediately preceding consecutive taxable years for which the corporation was a DISC.

(c) *Transfer of shares.* Deemed distributions are includible under paragraphs (a) and (b) of this section in a shareholder's gross income as a dividend only so long as he continues to hold the shares with respect to which

the distribution is deemed made. Thus, the transferee of such shareholder will include in his gross income under paragraphs (a) and (b) of this section the remaining installments of the deemed distribution which the transferor would have included in his gross income as a dividend had he not transferred the shares. However, if the transferee acquires the shares in a transaction in which the transferor's gain is treated under §1.995–4 in whole or in part as a dividend, then under §1.996–4(a) such transferee does not include subsequent installments in his gross income to the extent that the transferee treats such subsequent installments as made out of previously taxed income.

(d) *Effect of requalification.* Deemed distributions under paragraphs (a) and (b) of this section continue and are includible in gross income as dividends by the shareholders whether or not the corporation subsequently requalifies and is treated as a DISC.

(e) *Effect of actual distributions and deemed distributions under section 995(b)(1)(G).* If, during the period a shareholder of a DISC, or former DISC, is taking into account deemed distributions under paragraphs (a) and (b) of this section, an actual distribution is made to him out of accumulated DISC income or a deemed distribution because of foreign investment attributable to producer's loans is made under §1.995–2(a)(5) out of accumulated DISC income, such actual or deemed distribution shall first reduce the last installment of the deemed distributions scheduled to be included in the shareholder's gross income as a dividend, and then the preceding scheduled installments in reverse order. If deemed distributions are scheduled to be included in gross income for two or more disqualifications, an actual distribution or a deemed distribution under §1.995–2 (a)(5) which is treated as made out of accumulated DISC income reduces the deemed distributions resulting from the earlier disqualification first.

(f) *Examples.* This section may be illustrated by the following examples:

Example 1. X Corporation, which uses the calendar year as its taxable year, elects to be treated as a DISC beginning with 1972. X qualifies as a DISC for taxable years 1972 through 1975, but, pursuant to §1.992–2(e)(2), revokes its election as of January 1, 1976, and is disqualified as a DISC. On that date, X has $24,000 of accumulated DISC income. X's shareholders will be deemed to receive $6,000 in distributions taxable as a dividend on the last day of each of X's four succeeding taxable years (1977, 1978, 1979, and 1980).

Example 2. Assume the same facts as in example 1, except that in 1978 X makes an actual distribution of $22,000 to its shareholders of which $10,000 is treated under §1.996–1 as made out of accumulated DISC income. (The remaining $12,000 of such distribution is treated as made out of previously taxed income.) The actual distribution would first reduce the $6,000 deemed distribution scheduled for 1980 to zero and then reduce the $6,000 deemed distribution scheduled for 1979 to $2,000. Thus, X's shareholders include in 1978 $16,000 is gross income as dividends ($10,000 of actual distributions and the $6,000 deemed distribution scheduled for that year) and $2,000 as a dividend in 1979.

Example 3. Assume the same facts as in example 2, except that X requalifies as a DISC for taxable year 1977 during which it derives $7,000 of DISC income (computed after taking into account a deemed distribution under §1.995–2(a)(4) of $7,000), but is again disqualified in 1978. In addition X makes an actual distribution in 1977 equal to the deemed distribution of $7,000. Such actual distribution is excluded from gross income under §1.996–1(c). In 1977. X's shareholders include in gross income as dividends the $6,000 deemed distribution upon disqualification (in addition to the deemed distributions of $7,000 under §1.995–2 for 1977 when it was treated as a DISC). The actual distribution in 1978 still reduces the installments resulting from the earlier disqualification. Thus, in 1978, X's shareholders include $16,000 in gross income as dividends. In 1979, X's shareholders include $9,000 in gross income as dividends (the final installment of $2,000 from the earlier disqualification plus the single deemed distribution of $7,000 resulting from the later disqualification).

[T.D. 7324, 39 FR 35112, Sept. 30, 1974, as amended by T.D. 7854, 47 FR 51741, Nov. 17, 1982]

§ 1.995–4 Gain on disposition of stock in a DISC.

(a) *Disposition in which gain is recognized*—(1) *In general.* If a shareholder disposes, or is treated as disposing, of stock in a DISC, or former DISC, then any gain recognized on such disposition shall be included in the shareholder's gross income as a dividend, notwithstanding any other provision of the Code, to the extent of the accumulated

DISC income amount (described in paragraph (d) of this section). To the extent the recognized gain exceeds the accumulated DISC income amount, it is taxable as gain from the sale or exchange of the stock.

(2) *Nonapplication of subparagraph (1).* The provisions of subparagraph (1) of this paragraph do not apply (i) to the extent gain is not recognized (such as, for example, in the case of a gift or an exchange of stock to which section 354 applies) and (ii) to the amount of any recognized gain which is taxable as a dividend (such as, for example, under section 301 or 356(a)(2)) or as gain from the sale or exchange of property which is not a capital asset. The amount taxable as a dividend under section 301 or 356(a)(2) is subject to the rules provided in §1.995–1(c) for the treatment of actual distributions by a DISC.

(b) *Disposition in which separate corporate existence of DISC is terminated—*(1) *General.* If stock in a corporation that is a DISC, or former DISC, is disposed of in a transaction in which its separate corporate existence as a DISC, or former DISC, is terminated, then, notwithstanding any other provision of the Code, an amount of realized gain shall be recognized and included in the transferor's gross income as a dividend. The realized gain shall be recognized to the extent that such gain—

(i) Would not have been recognized but for the provisions of this paragraph, and

(ii) Does not exceed the accumulated DISC income amount (described in paragraph (d) of this section).

(2) *Cessation of separate corporate existence as a DISC, or former DISC.* For purposes of subparagraph (1) of this paragraph, separate corporate existence as a DISC, or former DISC, will be treated as having ceased if, as a result of the transaction, there is no separate entity which is a DISC and to which is carried over the accumulated DISC income and other tax attributes of the DISC, or former DISC, the stock of which is disposed of. Thus, for example, if stock in a DISC, or former DISC, is exchanged in a transaction described in section 381(a) (relating to carryovers in certain corporate acquisitions), the gain realized on the transfer of such stock will not be recognized under subparagraph (1) of this paragraph if the assets of such DISC, or former DISC, are acquired by a corporation which immediately after the acquisition qualifies as a DISC. For a further example, if a DISC, or former DISC, is liquidated in a transaction to which section 332 (relating to complete liquidations of subsidiaries) applies, the transaction will be subject to subparagraph (1) of this paragraph if the basis to the transferee corporation of the assets acquired on the liquidation is determined under section 334(b)(2) (as in effect prior to amendment by the Tax Equity and Fiscal Responsibility Act of 1982) or if immediately after such liquidation the transferee of such assets does not qualify as a DISC. However, separate corporate existence as a DISC, or former DISC, will not be treated as having ceased in the case of a mere change in place of organization, however effected. See §1.996–7 for rules for the carryover of the divisions of a DISC's earnings and profits to one or more DISC's.

(c) *Disposition to which section 311, 336, or 337 applies*—(1) *In general.* If, after December 31, 1976, a shareholder distributes, sells, or exchanges stock in a DISC, or former DISC, in a transaction to which section 311, 336, or 337 applies, then an amount equal to the excess of the fair market value of such stock over its adjusted basis in the hands of the shareholder shall, notwithstanding any other provision of the Code, be included in gross income of the shareholder as a dividend to the extent of the accumulated DISC income amount (described in paragraph (d) of this section).

(2) *Nonapplication of subparagraph (1).* Subparagraph (1) shall not apply if the person receiving the stock in the disposition has a holding period for the stock which includes the period for which the stock was held by the shareholder disposing of such stock.

(d) *Accumulated DISC income amount—*(1) *General.* For purposes of this section, the accumulated DISC income amount is the accumulated DISC income of the DISC or former DISC which is attributable to the stock disposed of and which was accumulated in taxable years of such DISC or former DISC during the period or periods such

stock was held by the shareholder who disposed of such stock.

(2) *Period during which a shareholder has held stock.* For purposes of this section, the period during which a shareholder has held stock includes the period he is considered to have held it by reason of the application of section 1223 and, if his basis is determined in whole or in part under the provisions of section 1014(d) (relating to special rule for DISC stock acquired from decedent) or section 1022 (relating to property acquired from certain decedents who died in 2010), the holding period of the decedent. Such holding period is to exclude the day of acquisition but include the day of disposition. Thus, for example, if A purchases stock in a DISC on December 31, 1972, and makes a gift of such stock to B on June 30, 1973, then on December 31, 1974, B will be treated as having held the stock for 2 full years. If the basis of the stock in C's hands is determined under section 1014(d) upon a transfer from B's estate on December 31, 1976, by reason of B's death on June 30, 1974, then on December 31, 1976, C will be treated as having held the stock for 4 full years.

(e) *Accumulated DISC income allocable to shareholder under section 995(c)(2)*—(1) *In general.* Under this paragraph, rules are prescribed for purposes of paragraph (d) of this section as to the manner of determining, with respect to the stock of a DISC, or former DISC, disposed of, the amount of accumulated DISC income which is attributable to such stock and which was accumulated in taxable years of the corporation during the period or periods the stock disposed of was held or treated under paragraph (d)(2) of this section as held by the transferor. Subparagraphs (2), (3), and (4) of this paragraph set forth a method of computation which may be employed to determine such amount. Any other method may be employed so long as the result obtained would be the same as the result obtained under such method.

(2) *Step 1.* Determine the increase (or decrease) in accumulated DISC income for each taxable year of the DISC, or former DISC, by subtracting from the amount of accumulated DISC income (as defined in § 1.996–3(b)) at the close of each taxable year the amount thereof as of the close of the immediately preceding taxable year.

(3) *Step 2.* (i) Determine for each taxable year of the DISC, or former DISC, the increase (or decrease) in accumulated DISC income per share by dividing such increase (or decrease) for the year by the number of shares outstanding or deemed outstanding on each day of such year.

(ii) If the number of shares of stock in the corporation outstanding on each day of a taxable year of the DISC, or former DISC, is not constant, then the number of such shares deemed outstanding on each day of such year shall be the sum of the fractional amounts in respect of each share which was outstanding on any day of the taxable year. The fractional amount in respect of a share shall be determined by dividing the number of days in the taxable year on which such share was outstanding (excluding the day the share became outstanding, but including the day the share ceased to be outstanding), by the total number of days in such taxable year.

(iii) If for any taxable year of a DISC, or former DISC, the share disposed of was not held (or treated under paragraph (d)(2) of this section as held) by the disposing shareholder for the entire year, then the amount of increase (or decrease) in accumulated DISC income attributable to such share for such year is the amount determined as if he held the share until the end of such year multiplied by a fraction the numerator of which is the number of days in the taxable year on which the shareholder held (or under paragraph (d)(2) of this section is treated as having held) such share and the denominator of which is the total number of days in the taxable year.

(4) *Step 3.* Add the amounts computed in step 2 for each taxable year of the DISC, or former DISC, in which the shareholder held such share of stock.

(5) *Examples.* This paragraph may be illustrated by the following examples:

Example 1. X Corporation uses the calendar year as its taxable year and elects to be a DISC for the first time for 1973. On January 1, 1973, X has 20 shares issued and outstanding. A and B each own 10 shares. On July 1, 1976, X issues 10 shares to C. On December 31, 1977, A sells his 10 shares to D and recognizes a gain of $120. Under these facts

and other facts assumed in the table below, A includes in his gross income for 1977 a dividend under paragraph (b) of this section of $61.30 and long-term capital gain of $58.70.

Year	(a)—Year end accumulated DISC income	(b)—Increase (decrease) in accumulated DISC income	(c)—Shares outstanding	(d)—Increase (decrease) per share (column (b) divided by column (c))
1973	$80	$80	20	$4.00
1974	50	(30)	20	(1.50)
1975	80	30	20	1.50
1976	100	20	[1]25	.80
1977	140	40	30	1.33
(1) Total increase in accumulated DISC income for each share disposed of (sum of amounts in column (d))				6.13
Multiply by number of shares disposed of				10
(2) Total amount of accumulated DISC income attributable to A's shares disposed of				61.30
(3) A's gain				120.00
(4) Portion of A's gain taxable as a dividend (lower of lines (2) and (3))				61.30
(5) Portion of A's gain taxable as long-term capital gain (line (3) minus line (4))				58.70

[1] Under subparagraph (3)(ii) of this paragraph, the aggregate fractional amounts of the 10 shares issued on July 1, 1976, is 5 shares, i.e., 10 shares, multiplied by (183 days/366 days). Thus, the number of shares deemed outstanding for 1976 is 25 shares, i.e., 20 shares plus 5 shares.

Example 2. Assume the same facts as in example 1, except that A sells his 10 shares to D on July 1, 1977. Under subparagraph (3)(iii) of this paragraph, the amount of increase in accumulated DISC income for 1977 which is attributable to each share disposed of is limited to $.67, *i.e.*, $1.33 multiplied by 182 days/365 days. Therefore, the sum of the yearly increases (and decreases) in accumulated DISC income for each share is reduced by $.66 (*i.e.*, $1.33 minus $.67). The total increase in accumulated DISC income for each share disposed of is $5.47 (i.e., $6.13 minus $.66). Under these facts, A would include in his gross income for 1977 a dividend of $54.70 and long-term capital gain of $65.30 determined as follows:

(1) Total increase in accumulated DISC income for each share disposed of	$5.47
Multiplied by number of shares disposed of	10
(2) Total amount of accumulated DISC income attributable of to all shares disposed of	54.70
(3) A's gain	120.00
(4) Portion of A's gain taxable as a dividend (lower of lines (2) and (3))	54.70
(5) Portion of A's gain taxable as long-term capital gain (line (3) minus line (4))	65.30

(f) *Effective/applicability date.* This section applies on and after January 19, 2017. For rules before January 19, 2017, see § 1.995–4 as contained in 26 CFR part 1 revised as of April 1, 2016.

[T.D. 7324, 39 FR 35112, Sept. 30, 1974, as amended by T.D. 7854, 47 FR 51741, Nov. 17, 1982; T.D. 9811, 82 FR 6240, Jan. 19, 2017]

§ 1.995–5 Foreign investment attributable to producer's loans.

(a) *In general*—(1) *Limitation.* Under section 995(d), the amount as of the close of a ''group taxable year'' (as defined in subparagraph (3) of this paragraph) of foreign investment attributable to producer's loans of a DISC for purposes of section 995(b)(1)(G) shall be the excess (as of the close of such year) of—

(i) The smallest of—

(*a*) The amount of the net increase in foreign assets (as defined in paragraph (b) of this section) by domestic and foreign members of the controlled group which includes the DISC,

(*b*) The amount of the actual foreign investment by the domestic members of such group (as determined under paragraph (c) of this section), or

(*c*) The amount of outstanding producer's loans (as determined under § 1.993–4) by such DISC to members of such controlled group, over

(ii) The amount (determined under § 1.995–2 (a)(5) and (b)(2)) of foreign investment attributable to producer's loans treated under section 995(b)(1)(G) as deemed distributions by the particular DISC taxable as dividends for prior taxable years of that particular DISC.

Thus, for example, if the shareholders of a DISC which uses the calendar year as its taxable year (and which is a member of a controlled group in which all of the members use the calendar year as their taxable year) are treated under section 995(b)(1)(G) as receiving foreign investment attributable to producer's loans of a DISC of $0 in 1972, $10 in 1973, and $30 in 1974, or a total of $40, and if the smallest of the amounts described in subdivision (i) of this subparagraph at the end of 1975 is $90, then the amount of the foreign investment attributable to producer's loans of a DISC at the end of 1975 is $50, *i.e.*, the excess (as of the close of 1975) of the smallest of the amounts described in subdivision (i) of this subparagraph ($90) over the sum of the amounts of foreign investment attributable to producer's loans treated under section 995(b)(1)(G) as deemed distributions by the DISC taxable as dividends for prior taxable years of the DISC ($40). If the separate corporate existence of the DISC as to which the amount described in subdivision (ii) of this subparagraph relates ceases to exist within the meaning of §1.995–4(c)(2), then such amount shall no longer be taken into account by the group for any purpose. For inclusion of amounts because of certain corporate acquisitions, see paragraph (d) of this section.

(2) *Controlled group; domestic and foreign member.* For purposes of this section—

(i) The term ''controlled group'' has the meaning assigned to such term by §1.993–1(k).

(ii) The term *domestic member* means a domestic corporation which is a member of a controlled group, and the term *foreign member* means a foreign corporation which is a member of a controlled group.

(3) *Group taxable year.* (i) The term *group taxable year* refers collectively to the taxable year of the DISC and to the taxable year of each corporation in the controlled group which includes the DISC ending with or within the taxable year of the DISC. Thus, for example, if a corporation has a subsidiary which uses the calendar year as its taxable year and which elects to be treated as a DISC, and if the parent has a taxable year ending on October 31, the ''group taxable year'' for 1973 would refer to calendar year 1973 for the DISC and to the parent's taxable year ending October 31, 1973.

(ii) In cases in which the DISC makes a return for a short taxable year, that is, for a taxable year consisting of a period of less than 12 months, pursuant to section 443 and the regulations thereunder, or §1.991–1(b)(3), the following rules shall apply—

(*a*) In the case of a change in the annual accounting period of the DISC resulting in a short taxable year, the *group taxable year* refers collectively to the short taxable year and to the taxable year of each corporation in the controlled group which includes the DISC ending with or within the short taxable year.

(*b*) In the case of a DISC which is in existence during only part of what would otherwise be its taxable year, the *group taxable year* refers collectively to the short period during which the DISC was in existence and to the taxable year of each corporation in the controlled group which includes the DISC ending with or within the 12-month period ending on the last day of the short period.

(iii) With respect to periods prior to the first taxable year for which a member of the group qualified (or is treated) as a DISC, each group taxable year shall be determined under subdivision (i) of this subparagraph as if such member was in existence, it qualified as a DISC, and its taxable year ended on that date corresponding to the date such member's first taxable year ended after it qualified (or is treated) as a DISC whether or not the corporation which qualifies (or is treated) as a DISC used the same taxable year before it so qualified (or is so treated). Thus, for example, if a corporation which is organized on March 3, 1975, uses the calendar year as its taxable year, and is a member of a controlled group which does not include a DISC, first qualifies (or is treated) as a DISC for calendar year 1975, then the term ''group taxable year'' with respect to years prior to 1975 refers collectively to such prior calendar years and to the taxable year of each corporation in the group ending with or within such prior calendar years.

(iv) For special rules in the case of a group which includes more than one DISC, see paragraph (g) of this section.

(4) *Amounts determined for prior years.* Unless the 3-year limitation is properly elected under subparagraph (5) of this paragraph, the amounts described in paragraphs (b) (relating to net increase in foreign assets) and (c) (relating to actual foreign investments by domestic members) of this section reflect, as of the close of a group taxable year, amounts for all taxable years of members of the group beginning after December 31, 1971 (and amounts arising after December 31, 1971, or such other date prescribed in paragraph (b)(7) of this section), provided that such amounts relate to such group taxable year and preceding group taxable years. Thus, for example, if all members of a controlled group use the calendar year as the taxable year, and 1980 is the first taxable year for which any member of the group qualifies (or is treated) as a DISC, then, unless the 3-year limitation is elected under subparagraph (5) of this paragraph, the amounts described in paragraphs (b) and (c) of this section will be taken into account beginning with the dates specified in the preceding sentence. For rules as to carryovers on certain corporate acquisitions and reorganizations, see paragraph (d) of this section.

(5) *Three-year elective limitation.* (i) A DISC may elect to take into account only amounts described in paragraphs (b) (relating to net increase in foreign assets) and (c) (relating to actual foreign investment by domestic members) of this section for the 3 taxable years of each member immediately preceding its taxable year included in that first group taxable year which includes a member's first taxable year during which it qualifies (or is treated) as a DISC. For purposes of the preceding sentence, determinations shall be made by reference to the taxable year of the issuer or transferor (as the case may be). If an election is made under this subdivision, the offset for uncommitted transitional funds under paragraph (b)(7) of this section is not allowed. If an election is made under this subdivision, the 3-year limitation applies to amounts described in paragraphs (b)(4) and (c)(1) and (2) of this section.

(ii) An election under subdivision (i) of this subparagraph shall not apply with respect to amounts which must be carried over under paragraph (d) of this section in the case of certain corporate acquisitions and reorganizations.

(iii) An election under subdivision (i) of this subparagraph shall be made by the DISC attaching to its first return, filed under section 6011(e)(2), a statement to the effect that the 3-year limitation is being elected under §1.995–5(a)(5)(i).

(6) *Cumulative basis.* Pursuant to section 995(d)(5), all determinations of amounts specified in this section are to be made on a cumulative basis from the 1st year (or date) provided for in this section. Thus, each such determination shall take into account a net increase or a net decrease during the year, as the case may be. However, if the 3-year limitation is elected under subparagraph (5) of this paragraph, then only amounts with respect to periods specified in such subparagraph (5) are amounts taken into account for years before a member of the group qualifies (or is treated) as a DISC. The computations described in this section may be made in any way chosen by the DISC (including a corporation being tested as to whether it qualifies as a DISC), provided such method results in the amount prescribed by this section.

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

Example. X Corporation, which uses the calendar year as its taxable year, is a member of a controlled group (within the meaning of subparagraph (2) of this paragraph). X elects to be treated as a DISC beginning with 1972. The amount of foreign investment attributable to X's producer's loans treated under section 995(b)(1)(G) as a distribution taxable as a dividend as of the close of each group taxable year with respect to each taxable year of X from 1972 through 1975 are set forth in the table below, computed on the basis of the facts assumed (the amounts on lines (1), (2), (3), and (5) being running balances):

Taxable year of X	1972	1973	1974	1975
(1) Net increase (or decrease) in foreign assets since January 1, 1972, at close of group taxable year	($30)	$10	$100	$150

Taxable year of X	1972	1973	1974	1975
(2) Actual foreign investment at close of group taxable year	20	60	80	140
(3) Outstanding producer's loans of X (the DISC) as of the close of group taxable year	0	40	90	120
(4) Smallest of lines (1), (2), or (3) (not less than zero)	0	10	80	120
(5) Less section 995(b)(1)(G) deemed distributions for prior taxable years (sum of lines (5) and (6) from prior year)	0	0	10	80
(6) Section 995(b)(1)(G) deemed distribution as of close of taxable year	0	10	70	40

(b) *Net increase in foreign assets*—(1) *In general.* (i) The term *net increase in foreign assets* when used in this section means the excess for the controlled group (as of the close of the group taxable year) of (*a*) the investment in foreign assets to be taken into account under subparagraph (2) of this paragraph over (*b*) the aggregate of the five offsets allowed by subparagraphs (3) through (7) of this paragraph.

(ii) No amount described in this paragraph (other than amounts described in subparagraphs (4) and (7) of this paragraph) with respect to a member of the group (or foreign branch of a member) shall be taken into account unless it is attributable to a taxable year of such member beginning after December 31, 1971. For a 3-year elective limitation with respect to the first taxable year for which a member qualifies (or is treated) as a DISC, see paragraph (a)(5) of this section. For manner of determining amounts on a cumulative basis, see paragraph (a)(6) of this section.

(2) *Investments made in foreign assets.* (i) For purposes of subparagraph (1) of this paragraph, there shall be taken into account as investment in foreign assets the aggregate of the amounts expended (within the meaning of subdivision (ii) of this subparagraph) during the period described in subparagraph (1)(ii) of this paragraph by all members of the controlled group which includes the DISC to acquire assets described in section 1231(b) (determined without regard to any holding period therein provided) which are located outside the United States (as defined in §1.993–7) reduced by the aggregate of the amounts received by all such members of the controlled group from the sale, exchange, or involuntary conversion of such assets described in section 1231(b) which are located outside the United States. For purposes of this section, amounts expended for assets which are qualified export assets (as defined in §1.993–2) of a DISC (or which would be qualified export assets if owned by a DISC) shall not be taken into account. Thus, for example, if a DISC acquires a qualified export asset located outside the United States, the asset is not to be taken into account for purposes of determining the net increase in foreign assets.

(ii) As used in subdivision (i) of this subparagraph, the term *amounts expended* (or amounts received) means the amount of any money or the fair market value (on the date of acquisition, sale, exchange, or involuntary conversion) of any property (other than money) used to acquire (or received for) the assets described in such subdivision (i).

(iii) For purposes of this subparagraph, an asset (other than an aircraft or vessel) is considered as located outside the United States if it was used predominantly outside the United States during the group taxable year. The determination as to whether such an asset is used predominantly outside the United States during the group taxable year in which it was acquired or sold, exchanged, or involuntarily converted shall be made by applying the rules of §1.993–3(d) except that an aircraft described in section 48(a)(2)(B)(i) or a vessel described in section 48(a)(2)(B)(iii) shall be considered located in the United States and all other aircraft or vessels shall be considered located outside the United States. Thus, for example, if a member of a controlled group which includes a DISC acquires a vessel which is documented under the laws of a foreign

country, the amount expended to acquire that vessel is an amount described in subdivision (i) of this subparagraph.

(iv) *Examples.* The provisions of this subparagraph may be illustrated by the following examples:

Example 1. X Corporation, which uses the calendar year as its taxable year, is a domestic member of a controlled group (within the meaning of paragraph (a)(2) of this section). During 1972, in a transaction to which section 1031 applies, X acquires a warehouse located outside the United States and having a fair market value of $100. As consideration, X transfers $20 in cash and a warehouse located within the United States and having a fair market value of $80. Under these facts, $100 will be taken into account as investment in foreign assets.

Example 2. The facts are the same as in example 1, except that the warehouse transferred by X as consideration is located outside the United States. Under these facts, only $20 will be taken into account as investment in foreign assets because the amount expended for such assets (*i.e.*, $100) is reduced by the fair market value of any property located outside the United States received in exchange for such assets (*i.e.*, $80).

(3) *Depreciation with respect to all foreign assets of a controlled group.* (i) An offset allowed by this subparagraph is the depreciation (determined under subdivision (ii) of this subparagraph) or depletion (determined under subdivision (iii) of this subparagraph) attributable to taxable years of the member beginning after December 31, 1971, with respect to all of the group's foreign assets described in subparagraph (2) of this paragraph including such assets acquired prior to the date provided in such subparagraph (2), and without regard to whether the 3-year election in paragraph (a)(5) of this section is made. Thus, for example, depreciation for a taxable year of a member beginning after December 31, 1971, with respect to an asset described in section 1231(b) which is located outside of the United States and which was acquired during a taxable year of the member beginning before January 1, 1972, is an offset allowed by this subparagraph. For a further example, depreciation with respect to a qualified export asset is not such an offset.

(ii) The depreciation taken into account under subdivision (i) of this subparagraph shall be—

(*a*) In the case of an asset owned by a domestic member, only the amount allowed under section 167(b)(1) (relating to the allowance of the straight-line method of depreciation) and §1.162–11 (b) (relating to amortization in lieu of depreciation), but not the amount allowed under section 179 (relating to the additional first-year depreciation allowance).

(*b*) In the case of an asset owned by a foreign member, the depreciation and amortization (referred to in (*a*) of this subdivision) allowable for purposes of computing earnings and profits under subparagraph (5)(i) of this paragraph.

(iii) The depletion taken into account under subdivision (i) of this subparagraph shall be limited to cost depletion computed under sections 611 and 612 and the regulations thereunder. Thus, percentage depletion is not to be taken into account in computing the offset under this subparagraph.

(4) *Amount of outstanding stock or debt.* (i) An offset allowed by this subparagraph is the outstanding amount of stock (including treasury stock) or debt obligations of any member of the group issued, sold, or exchanged after December 31, 1971, by any member (whether or not the same member) to persons who (on the date of such issuance, sale, or exchange) were neither United States persons (within the meaning of section 7701(a)(30)) nor members of the group: *Provided,* That, in the case of a debt obligation, such obligation is not repaid within 12 months after such issuance, sale, or exchange. Thus, for example, if stock is issued to a member of the group before January 1, 1972, and after December 31, 1971, it is sold to a person who is neither a United States person nor a member of the group, an offset allowed by this subparagraph includes the outstanding amount of such stock. For purposes of this subparagraph, foreign branches of United States banks are not considered to be United States persons.

(ii) The outstanding amount of stock or debt obligations shall be determined in accordance with the following provisions:

(*a*) The outstanding amount of stock or debt obligations described in subdivision (i) of this subparagraph is

equal to the net amount described in (*b*) of this subdivision reduced (but not below zero) by the amount described in (*c*) of this subdivision.

(*b*) The net amount described in this subdivision (*b*) is the excess of (*1*) the aggregate of the amount of money and the fair market value of property (other than money) transferred by persons who are not members of the group and who are not U.S. persons as consideration for such stock and debt obligations over (*2*) fees and commission expenses borne by the issuer or transferror with respect to their issuance, sale, or exchange.

(*c*) The amount described in this subdivision (*c*) is the aggregate amount of money and fair market value of property (other than money) distributed to such persons on distributions in respect of such stock from other than earnings and profits or on distributions in redemption of such stock and the amount of principal paid pursuant to such debt obligations.

(*d*) For purposes of this subdivision (ii), in the case of a redemption, the stock or debt redeemed shall be charged against the earliest of such stock or debt issued, sold, or exchanged in order to determine the amount by which the balance of outstanding stock or debt is to be reduced. For purposes of this subparagraph, the fair market value of property received as consideration shall be determined as of the date the transaction occurs, and a contribution to capital within the meaning of section 118 shall be treated as the issuance of stock.

(iii) The provisions of subdivision (i) of this subparagraph apply regardless of the treatment under the Code of the transaction in which the stock or debt was issued, sold, or exchanged. Thus, for example, if X Corporation, a member of a controlled group which includes a DISC, acquires from a nonresident alien individual in exchange solely for X's voting stock all of the stock of Y Corporation pursuant to a reorganization as defined in section 368(a)(1)(B), the fair market value of the Y stock on the date of the exchange would be an offset allowed by this subparagraph.

(iv) The provisions of this subparagraph may be illustrated by the following example:

Example. X Corporation is a member of a controlled group (within a meaning of paragraph (a)(2) of this section) every member of which uses the calendar year as its taxable year. On January 1, 1972, X issues in a public offering its stock to persons described in subdivision (i) of this subparagraph who, in the aggregate, pay $1,000 as consideration. X pays $100 in underwriting fees. On the same date, X receives $425 upon issuing a $500 debt obligation to such persons at a discount of $75 and pays $25 in underwriting fees. On December 31, 1972, the offset allowed under this subparagraph is $1,300, i.e., ($1,000 minus $100) plus ($425 minus $25). If, during 1973, X makes a distribution of $150 (not in redemption) from other than earnings and profits with respect to such stock, then the offset is reduced to $1,150.

(5) *Earnings and profits.* (i) An offset allowed by this subparagraph is one-half the aggregate of the earnings and profits accumulated for all taxable years beginning after December 31, 1971, computed (without regard to any distributions from earnings and profits by a foreign corporation to a domestic corporation in accordance with §1.964–1 (relating to a controlled foreign corporation's earnings and profits), of each foreign member of the group which is controlled directly or indirectly (as determined under the principles of section 958 and the regulations thereunder) by a domestic member of the group and each foreign branch of a domestic member of the group (computed as if the branch were a foreign corporation). The DISC is bound by any action on behalf of a foreign member that was taken pursuant to §1.964–1(c)(3) or by any failure to take action by or on behalf of a foreign member within the time specified in §1.964–1(c)(6). With respect to a foreign member for which action was not previously required under §1.964–1(c)(6) to be taken, the DISC may take action on behalf of such member by attaching a statement to that effect to the return of the DISC under section 6011(e)(2) for the first taxable year during which it qualifies (or is treated) as a DISC and there is outstanding a producer's loan made by such DISC to a member of the controlled group which includes the DISC.

(ii) If the aggregate of the accumulated earnings and profits described in subdivision (i) of this subparagraph is a deficit, the amount allowable as an offset under this subparagraph is zero.

(6) *Royalties and fees.* An offset allowed by this subparagraph is one-half the royalties and fees paid by foreign members of the group to domestic members of the group and by foreign branches of domestic members of the group to domestic members of the group during the taxable years of such members beginning after December 31, 1971.

(7) *Uncommitted transitional funds.* (i) An offset allowed by this subparagraph for the uncommitted transitional funds of the group is the sum described in subdivision (ii) of this subparagraph of the amount of certain capital raised under the foreign direct investment program and the amounts described in subdivision (iv) of this subparagraph of certain foreign excess working capital held on October 31, 1971.

(ii) The amount described in this subdivision of certain capital raised under the foreign direct investment program is the excess (if any) of—

(*a*) The amount of the offset allowed by subparagraph (4) of this paragraph, determined, however, with respect to the stock and debt obligations of domestic members of the group outstanding on December 31, 1971 (including amounts treated as stock outstanding by reason of a contribution to capital), whether or not outstanding after such date, which were issued, sold, or exchanged on or after January 1, 1968, by any member (whether or not the same member) to persons who (on the date of such issuance, sale, or exchange) were neither United States persons (within the meaning of section 7701(a)(30)) nor members of the group, but only to the extent the taxpayer establishes that such amount constitutes a long-term borrowing (see 15 CFR 1000.324[1]) for purposes of the foreign direct investment program (see 15 CFR part 1000[1]), over

(*b*) The amount (determined under paragraph (c) of this section) of actual foreign investment by the domestic members of the group during the portion of the period such stock or debt obligations have been outstanding prior to January 1, 1972, such determination to be made by substituting January 1, 1968, for the December 31, 1971, date specified in such paragraph (c) and by not taking into account the earnings and profits described in paragraph (c)(3) of this section.

For purposes of this subparagraph, foreign branches of United States banks are not considered to be United States persons.

(iii)(*a*) A taxpayer may establish that an amount under subdivision (ii) (*a*) of this subparagraph constitutes a long-term borrowing for purposes of the foreign direct investment program by keeping records sufficient to demonstrate that appropriate reports were filed with the Office of Foreign Direct Investment of the Department of Commerce with respect to the foreign borrowing or by any other method satisfactory to the district director.

(*b*) The amounts described in subdivision (ii) (*a*) of this subparagraph include amounts with respect to which an election under section 4912(c), to subject certain obligations of a United States person to the interest equalization tax, has been made: *Provided,* That the obligations to which such amounts relate were issued by an ''overseas financing subsidiary'' described in 15 CFR part 1000[1] and were assumed by a United States person from such overseas financing subsidiary. Thus, for example, if an overseas financing subsidiary issues its notes to a foreign person in 1968, and such notes are assumed by its United States parent in 1973, which parent elects under section 4912(c) to have the notes subject to the interest equalization tax, then the amount of money received by the subsidiary is an amount described in subdivision (ii)(*a*) of this subparagraph.

(iv) The amount described in this subdivision of foreign excess working capital is the amount of liquid assets held by the foreign members of such group and foreign branches of domestic members of such group on October 31, 1971 (whether or not so held after such date) in excess of their reasonable working capital needs (as defined in

[1] EDITORIAL NOTE: 15 CFR part 1000 was removed at 39 FR 30481, Aug. 23, 1974.

§1.993–2 (e)) on that date, but only to the extent not included in subdivision (ii) of this subparagraph. For purposes of this subdivision, the term *liquid assets* means money, bank deposits (not including time deposits), and indebtedness of any kind (including time deposits) which on the day acquired had a maturity of 2 years or less.

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

Example. X Corporation, which uses the calendar year as its taxable year is a member of a controlled group (within the meaning of paragraph (a)(2) of this section). X elects to be treated as a DISC beginning with 1972. The amount of net increase in foreign assets of the group at the close of each group taxable year with respect to each taxable year of X from 1972 through 1975 are set forth in the table below, computed on the basis of the facts assumed (the amounts on each line being running balances):

Taxable year of X	1972	1973	1974	1975
(1) Investment in foreign assets	$150	$165	$260	$300
(2) Depreciation with respect to foreign assets of group	20	40	60	80
(3) Amount of stock or debt outstanding issued after December 31, 1971	30	30	30	30
(4) One-half earnings and profits of foreign members	40	70	100	130
(5) Royalties and fees paid by foreign members to domestic members	10	15	20	20
(6) Uncommitted transitional funds	10	10	10	10
(7) Sum of lines (2) through (6)	110	165	220	270
(8) Net increase in foreign assets (line (1) minus line (6))	40	0	40	30

(c) *Actual foreign investment by domestic members.* For purposes of determining the limitation in paragraph (a) of this section, the amount of the actual foreign investment by domestic members of a controlled group is the sum (as of the close of the group taxable year) determined on a cumulative basis (see paragraph (a)(6) of this section) of—

(1) *Outstanding stock or debt (including contributions to capital).* The outstanding amount (determined in accordance with the principles of paragraph (b)(4)(ii) of this section, applied with respect to stock or debt obligations described in this subparagraph) of stock (including treasury stock) or debt obligations (other than normal trade indebtedness) of foreign members of the group issued, sold, or exchanged after December 31, 1971, by any person (whether or not a member) which is not a domestic member to domestic members of the group: *Provided,* That the outstanding amount of debt obligations of any foreign member shall be the greater of such amount outstanding at the close of the taxable year of such member or the highest such amount outstanding at any time during the immediately preceding 90 days,

(2) *Transfers to foreign branches.* The amount of money or the fair market value of property (other than money) transferred by domestic members of the group after December 31, 1971, to foreign branches of such members in transactions which would, if the branch were a corporation, be in consideration for the sale of stock or debt obligations of (or a contribution of capital to) such foreign branches (as determined under subparagraph (1) of this paragraph), and

(3) *Earnings and profits of foreign members.* One-half of the earnings and profits (computed in accordance with paragraph (b)(5) of this section for purposes of computing net increase in foreign assets) of foreign members of the group which are controlled directly or indirectly (as determined under the principles of section 958 and the regulations thereunder) by a domestic member of the group and foreign branches (treated for this purpose as a corporation) of domestic members of the group accumulated during the taxable years of such foreign members (or branches) beginning after December 31, 1971, or, if later, the taxable year referred to in paragraph (a)(5)(i) of this section if the 3-year election provided for in such paragraph (a)(5)(i) is made.

(d) *Carryovers on certain corporate acquisitions and reorganizations*—(1) *Certain corporate acquisitions.* (i) If—

(*a*) A member of a controlled group (''first controlled group'') acquires in a transaction to which section 381 applies the assets of a corporation which

is a member of a second controlled group or acquires stock in such a corporation pursuant to a reorganization as defined in section 368(a)(1)(B) to which section 361 applies, or

(*b*) A member or combination of members of the first controlled group acquire in a transaction not described in (*a*) of this subdivision a majority interest (as defined in paragraph (e)(2) of this section) in the stock of a corporation which is a member of a second controlled group which includes a DISC so that such DISC after the acquisition is a member of the new controlled group,

then, for purposes of computing foreign investment attributable to producer's loans with respect to the new controlled group as constituted after such acquisition, all amounts described in paragraphs (a) through (c) of this section, including the amount specified in paragraph (a)(1)(ii) of this section (relating to amounts treated under section 995(b)(1)(G) as deemed distributions by the DISC taxable as dividends for prior taxable years of the DISC), with respect to members of the second controlled group which become members of the new controlled group shall carry over to such new controlled group. For purposes of this subdivision (i), a controlled group may consist of only one member. With respect to certain transactions involving foreign corporations, see section 367.

(ii) If a member or combination of members of a controlled group, immediately after an acquisition of stock to which subdivision (i) of this subparagraph applies, do not control the total combined voting power (determined under §1.957–1(b)) of the corporation whose stock was acquired, proper apportionment consistent with the principles of paragraph (e)(5) of this section shall be made with respect to amounts to which paragraphs (a) through (c) of this section apply.

(iii)(*a*) If subdivision (i) of this subparagraph applies, then for purposes of determining the application of the 3-year elective limitation provided for in paragraph (a)(5) of this section, the rules in (*b*), (*c*), and (*d*) of this subdivision (iii) apply.

(*b*) If both the ''first controlled group'' and the ''second controlled group'' (as those terms are defined in subdivision (i) of this subparagraph) include a DISC, and a DISC in either group has elected the 3-year limitation provided in paragraph (a)(5) of this section, then only those amounts taken into account under such paragraph (a)(5) by the electing DISC or DISC's shall be taken into account.

(*c*) If one of the groups includes a DISC and the other does not, and if the DISC has elected the 3-year limitation provided in paragraph (a)(5) of this section, then, for purposes of computing foreign investment attributable to producer's loans with respect to the new controlled group as constituted after the acquisition, all amounts described in paragraphs (a) through (c) of this section with respect to members of the controlled group which did not include the DISC shall carry over to such new controlled group, but only to the extent provided in such paragraph (a)(5), computed as if the group taxable year in which the acquisition occurred was the first group taxable year which includes a member's first taxable year during which it qualifies (or is treated) as a DISC.

(*d*) If (*c*) of this subdivision (iii) applies, except that the DISC has not elected the 3-year limitation provided in paragraph (a)(5) of this section, then the DISC in the new controlled group as constituted after the acquisition may, with respect to members of the controlled group which did not include the DISC, make the election provided in such paragraph (a)(5), and treat the year in which the acquisition occurred as if it were the first group taxable year which includes a member's first taxable year during which it qualifies (or is treated) as a DISC.

(iv) If a majority interest, or an interest in addition to a majority interest, is acquired in a transaction other than a transaction described in subdivision (i) of this subparagraph, then the rules in paragraph (e) of this section (relating to the acquisition of the foreign assets of a corporation) apply.

(2) *Corporation ceasing to be a member.* As of the date a corporation which is a member of a controlled group ceases to be a member of such group, the amounts of such group described in

paragraphs (a) through (c) of this section will be reduced by such amounts which are attributable to the corporation which is no longer a member of the group.

(e) *Acquisition of a majority interest in a corporation*—(1) *In general.* If paragraph (d)(1)(i) of this section (relating to certain corporate acquisitions in which all amounts described in paragraphs (a) through (c) of this section carry over) does not apply, then, for purposes of determining under paragraph (b)(2) of this section the investments made in foreign assets by a controlled group, the acquisition of a majority interest (as defined in subparagraph (2) of this paragraph) or an interest in addition to a majority interest in a corporation by any member or combination of members of the controlled group is considered an acquisition of the assets (to the extent provided in subparagraph (5) of this paragraph) of the acquired corporation by the group, including the assets of any foreign corporation in which the acquired corporation owns a majority interest (to the extent provided in subparagraph (5) of this paragraph). For the rules concerning the date upon which an acquisition of a majority interest is considered to have occurred, see subparagraph (3) of this paragraph.

(2) *Majority interest.* For purposes of this section, a majority interest is more than 50 percent of the total combined voting power of all classes of a corporation's stock entitled to vote, as determined under §1.957–1(b).

(3) *Acquisition date.* For purposes of this paragraph, an acquisition of a majority interest shall be considered to have occurred on the day on which the combined voting power of the group first reached the percentage required in subparagraph (2) of this paragraph.

(4) *Valuation of assets.* For purposes of this section, the amount of a corporation's assets deemed acquired is the fair market value of the assets on the date a majority interest, or an interest in addition to a previously held majority interest, is acquired.

(5) *Apportionment in the case of the acquisition of less than all of the voting stock.* (i) If the acquisition described in subparagraph (1) of this paragraph of a majority interest is of less than 100 percent of the total combined voting power of all classes of stock of the acquired corporation entitled to vote, then for purposes of subparagraph (1) of this paragraph the amount of the foreign assets of the corporation deemed acquired as of the day the majority interest is considered acquired shall be an amount equal to the fair market value of all of the corporation's foreign assets described in paragraph (b)(2) of this section as of such day multiplied by the percentage of the total combined voting power (determined under §1.957–1(b)) held by members of the group on the day the majority interest is considered acquired.

(ii) If any member or combination of members of the controlled group hold a majority interest in a corporation, then for purposes of subparagraph (1) of this paragraph the acquisition of additional combined voting power by members of the controlled group shall be considered an acquisition of its foreign assets described in paragraph (b)(2) of this section in an amount equal to the fair market value of all such assets held by the foreign corporation on the date of the acquisition, multiplied by the increase (expressed in percentage points) in total combined voting power (as determined under §1.957–1(b)) which occurred.

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

Example 1. M Corporation uses the calendar year as its taxable year. On November 18, 1973, M acquires from A, an individual United States person, for $1 million cash all 10,000 shares of the voting stock of N, a foreign corporation. N's only asset is a warehouse located in France with a fair market value on the date of acquisition of $1 million. Under subparagraph (1) of this paragraph, the controlled group of which M is a member is considered to have expended $1 million for the acquisition of foreign assets described in paragraph (b)(2) of this section.

Example 2. The facts are the same as in example 1, except that on November 18, 1973, M acquires only 80 percent of N's voting stock. M is considered to have expended $800,000 for the acquisition of assets described in paragraph (b)(2) of this section, computed as follows:

(1) Fair market value of N's foreign assets described in paragraph (b)(2) of this section	$1,000,000

(2) Multiply by percentage of total combined voting power of all classes of N stock entitled to vote acquired by M	.8
(3) Amount considered expended	$800,000

Example 3. The facts are the same as in example 2, except that individual A is not a United States person, and M acquires the 80 percent of N voting stock in exchange for cash of $100,000 and M stock having a fair market value on the date of the acquisition of $700,000. M is considered to have acquired assets described in paragraph (b)(2) of this section in the amount of $800,000 (see computations in example 2) and to have an offset under paragraph (b)(4) of this section (relating to outstanding stock or debt) of $700,000 (the fair market value of the M stock transferred to A who is not a United States person). However, the controlled group of which M is a member is not considered to have acquired any other amounts described in paragraphs (a) through (c) of this section with respect to N for taxable years prior to the taxable year of N during which the acquisition occurred.

Example 4. P Corporation, which uses the calendar year as its taxable year, is a member of a controlled group which includes a DISC. During 1973, P acquires from B, an individual United States person, for cash, 30 percent of the total combined voting power of all classes of stock entitled to vote of Q, a foreign corporation. All of Q's assets are assets described in paragraph (b)(2) of this section. No additional interest in Q is acquired by members of the group during 1973. The controlled group of which Q is a member is not considered to have made any investments in foreign assets described in such paragraph (b)(2) as of the close of 1973.

Example 5. Assume the same facts as in example 4. Assume further that during 1974, R Corporation, a member of the controlled group which includes P, acquires for cash 40 percent of the total combined voting power of all classes of stock of Q entitled to vote as follows: 20 percent on July 31, and 20 percent on December 31. Thus, on December 31, 1974, members of the controlled group own 70 percent of Q's voting power (30 + 20 + 20) and on that date are considered to have acquired a majority interest in Q. The fair market value of Q's assets on December 31, 1974, is $5 million. The group is considered to have expended $3,500,000 for the acquisition of assets described in paragraph (b)(2) of this section computed as follows:

(1) Fair market value of Q's foreign assets described in paragraph (b)(2) of this section as of the date the acquisition is deemed to have occurred under subparagraph (3) of this paragraph (December 31, 1974)	$5,000,000
(2) Multiply by percentage of total combined voting power of all classes of Q stock entitled to vote held by members of the group on such date	.7
	$3,500,000

Example 6. The facts are the same as in example 5. Assume further that on July 15, 1975, P acquires the remaining 30 percent of the total combined voting power of all classes of Q stock entitled to vote, and on such date the fair market value of Q's assets is $5,500,000. The group is considered to have expended $5,150,000 for the acquisition of assets described in paragraph (b)(2) of this section as of the close of 1975, computed as follows:

(1) Amount of prior years' investment	$3,500,000
(2) Investment during 1975:	
(a) Fair market value of Q's foreign assets described in paragraph (b)(2) of this section on July 15, 1975	$5,500,000
(b) Multiply by additional percentage acquired of total combined voting power of all classes of Q stock entitled to vote	.3
(c) Investment during 1975	$1,650,000
(3) Amount considered expended for foreign assets described in paragraph (b)(2) of this section by reason of the acquisition of Q stock	$5,150,000

(f) *Records.* A DISC shall keep or be readily able to produce such permanent books of account or records as are sufficient to establish the transactions and amounts described in this section. Where applicable, such books of account or records shall be cumulative and shall show transactions and amounts of the members of the controlled group which includes the DISC which occurred prior to the date the DISC qualified (or is treated) as a DISC.

(g) *Multiple DISC's*—(1) *Allocation among DISC's.* In the case of a controlled group which includes more than one DISC, the amounts described in paragraphs (b) and (c) of this section shall be allocated among the DISC's in order to determine the limitation in paragraph (a) of this section. Each DISC's allocable portion of these amounts shall be equal to the total of such amounts multiplied by a fraction the numerator of which is the individual DISC's outstanding producer's loans to members of the group, and the denominator of which is the aggregate amounts of outstanding producer's loans to members of the group by all DISC's which are members of the group.

(2) *Different taxable years.* If all of the DISC's which are members of the controlled group do not have the same taxable year, then one such DISC shall on behalf of all such DISC's elect to make all computations under section 995(d) as if all DISC's that are members of the group use the same taxable year as the actual taxable year of any one of the DISC's. The election as to which DISC's taxable year is to be used shall be made by the electing DISC attaching to its first return, filed under section 6011(e)(2), a statement indicating which such taxable year will be used. Once such an election is made it may not be revoked until such time as all of the DISC's which are members of the group use the same taxable year. If this subparagraph applies, books and records must be kept by the group which are adequate to show the necessary computations under section 995(d).

(3) This paragraph may be illustrated by the following example:

Example. Corporation X and corporation Y are members of the same controlled group and each has elected to be treated as a DISC. X uses a taxable year ending March 31, and Y uses a taxable year ending November 30. Notwithstanding the fact that all other members of the group use the calendar year as their taxable year, all computations for purposes of determining the amount of foreign investment attributable to producer's loans under section 995(d) must be made as if both DISC's use a taxable year ending either March 31 (X's taxable year) or November 30 (Y's taxable year).

[T.D. 7324, 39 FR 35114, Sept. 30, 1974, as amended by T.D. 7420, 41 FR 20655, May 20, 1976; T.D. 7854, 47 FR 51742, Nov. 17, 1982]

§ 1.995–6 Taxable income attributable to military property.

(a) *Gross income attributable to military property.* For purposes of section 995(b)(3)(A)(i), the term ''gross income which is attributable to military property'' includes income from the sale, exchange, lease, or rental of military property (as described in paragraph (c) of this section). The term also includes gross income from the performance of services which are related and subsidiary (as defined in §1.993–1(d)) to any qualified sale, exchange, lease, or rental of military property. Where gross income cannot be determined on an item by item basis, the gross income with respect to those items not so determinable shall be apportioned. Such apportionment shall be accomplished using appropriate facts and circumstances, so that the gross income apportioned to sale of military property bears a reasonably close factual relationship to the actual gross income earned on such sales. The apportionment shall be based on methods which include the fair market value of property sold or exchanged, the fair rental value of any leaseholds granted, the fair market value of any related or subsidiary services performed in connection with such sale or leases or methods based on gross receipts or costs of goods sold, where appropriate.

(b) *Deductions.* For purposes of section 995(b)(3)(A)(ii), deductions shall be properly allocated and apportioned to gross income, described in paragraph (a) of this section, in accordance with the rules of §1.861–8. These deductions include all applicable deductions from gross income provided under part VI of subchapter B of chapter 1 of the Code.

(c) *Military property.* For purposes of this section, the term *military property* means any property which is an arm, ammunition, or implement of war designated in the munitions list published pursuant to section 38 of the International Security Assistance and Arms Export Control Act of 1976 (22 U.S.C. 2778 which superseded 22 U.S.C. 1934) and the regulations thereunder (22 CFR 121.01).

(d) *Illustration.* The principles of this section may be illustrated by the following example:

Example. X Corporation elects to be a DISC for the first time in 1976. X has taxable income of $50,000, of which $30,000 is attributable to military property and $10,000 to interest on producer's loans. The total deemed distributions with respect to X are as follows:

(1) Gross interest from Producer's loans in 1976	$10,000
(2) 50 percent of the taxable income of the DISC attributable to military property in 1976	15,000
(3) One-half of the excess of taxable income for 1976 over the sum of lines (1) and (2) (½ of ($50,000 minus $25,000))	12,500
(4) Total deemed distributions (sum of total lines (1), (2), and (3))	37,500

(Secs. 995(e)(7), (8) and (10), 995(g) and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1655, 26 U.S.C. 995 (e)(7), (8) and (10); 90 Stat. 1659, 26 U.S.C. 995(g); and 68A Stat 917, 26 U.S.C. 7805))

[T.D. 7984, 49 FR 40019, Oct. 12, 1984]

§ 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 includible 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

received deduction under section 243 is available only with respect to such $30.

Example 3. Y Corporation, which uses the calendar year as its taxable year, elects to be treated as a DISC beginning with 1972. As of the end of 1975, Y had failed to meet the gross receipts test for that year. In 1975 Y had $100 of taxable income, $80 of which was attributable to qualified export receipts and $20 of which was attributable to receipts that did not qualify as qualified export receipts. As of the beginning of 1976, Y had $300 of accumulated earnings and profits, which consisted of $70 of accumulated DISC income, $40 of previously taxed income, and $190 of other earnings and profits. In 1976 Y makes a cash distribution of $20 pursuant to §1.992–3 in order to satisfy the gross receipts test for 1975. For 1976 Y has no earnings and profits and no deemed distributions. The entire $20 distribution is a dividend under section 316. Under §1.996–1(b)(2), half of the $20 cash distribution is treated pursuant to §1.996–1(b)(1) and half is treated pursuant to §1.996–1(a). Thus, $10 is treated as distributed out of accumulated DISC income and is includible in gross income. The other $10 is treated as made out of previously taxed income and is thus excluded from gross income. As of the beginning of 1977, Y has $280 of accumulated earnings and profits, which consists of $60 of accumulated DISC income, $30 of previously taxed income, and $190 of other earnings and profits.

[T.D. 7324, 39 FR 35120, Sept. 30, 1974, as amended by T.D. 7854, 47 FR 51742, Nov. 17, 1982]

§ 1.996–2 Ordering 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

of $70. Such deficit is charged to the divisions of X's earnings and profits pursuant to paragraph (a) of this section in the manner set forth in such table.

	Accumulated DISC income	Previously taxed income	Other earnings and profits
Balance January 1, 1976	.....	.....	$50
Increase for 1976	$10	$8	
Increase for 1977	10	8	
Increase for 1978	10	8	
Balance January 1, 1979	30	24	50
Deficit for 1979 of $70:			
Charge No. 1	.....	.....	(50)
Charge No. 2	(20)		
Balance January 1, 1980	10	.....	0

Example 2. Assume the same facts as in example 1, except that effective for taxable years beginning with 1979, X revokes its election to be treated as a DISC. Under §1.995–3, X has $30 of accumulated DISC income which is to be deemed distributed $10 per year in 1980, 1981, and 1982. The deficit in earnings and profits for 1979 is charged to the divisions of X's earnings and profits pursuant to paragraph (b) of this section in the manner set forth in the table below:

	Accumulated DISC income	Previously taxed income	Other earnings and profits
Balance January 1, 1979	$30	$24	$50
Deficit for 1979 of $70:.			
Charge No. 1	.....	.....	(50)
Charge No. 2	.....	(20)	
Balance January 1, 1980	30	4	0

Example 3. Assume the same facts as in example 2, except that the deficit in earnings and profits for 1979 is $120. Assume further that for 1980, 1981, and 1982, during which years X's shareholders are receiving scheduled installments of the deemed distributions of accumulated DISC income under §1.995–3, X, a former DISC, has neither earnings and profits nor a deficit in earnings and profits. The $120 deficit for 1979 is charged to the divisions of X's earnings and profits pursuant to paragraph (b) of this section in the manner set forth in the table below:

	Accumulated DISC income	Previously taxed income	Other earnings and profits	Accumulated earnings and profits
Balance January 1, 1979	$30	$24	$50	$104
Deficit for 1979 of $120	.....	.....	.....	(120)
Charge No. 1	.....	.....	(50)	
Charge No. 2	.....	(24)		
Charge No. 3	.....	.....	(46)	
Balance January 1, 1980	30	0	(46)	(16)
Deemed distributions in 1980 under §1.995–3	(10)	10		
Balance January 1, 1981	20	10	(46)	(16)

Example 4. Assume the same facts as in example 3, except that on December 31, 1980, X makes an actual distribution of $10 out of previously taxed income. On January 1, 1981, X has $20 of accumulated DISC income, no previously taxed income, and a deficit of $36 in other earnings and profits. The deficit of $16 in accumulated earnings and profits remains the same.

[T.D. 7324, 39 FR 35120, Sept. 30, 1974]

§ 1.996–3 Divisions of earnings and profits.

(a) *In general.* For purposes of sections 991 through 997, the earnings and profits of a DISC, or former DISC, shall be treated as composed of the following three divisions:

(1) Accumulated DISC income (as defined in paragraph (b) of this section),

(2) Previously taxed income (as defined in paragraph (c) of this section), and

(3) Other earnings and profits (as defined in paragraph (d) of this section),

(b) *Accumulated DISC income defined.* (1) Accumulated DISC income is that portion of a corporation's earnings and profits which were derived during taxable years for which it qualified as a DISC and which were deferred from taxation. Accumulated DISC income as of the close of each taxable year of the corporation is—

(i) The amount of accumulated DISC income as of the close of the immediately preceding taxable year increased by,

(ii) The amount of DISC income for the year (as determined in subparagraph (2) of this paragraph) and reduced (but not below zero) by,

(iii) The items enumerated in subparagraph (3) of this paragraph.

(2) Under section 996(f)(1), DISC income is (i) the earnings and profits derived by the corporation during a taxable year for which such corporation is a DISC minus (ii) amounts deemed distributed under §1.995–2 other than the amount of foreign investment attributable to producer's loans described in §1.995–2(a)(5). For example, the earnings and profits of a DISC for a taxable year include any amounts includible in such DISC's gross income pursuant to section 951(a) (relating to controlled foreign corporations). Deemed distributions under §1.995–2(a)(5) are taken into account under subparagraph (3) of this paragraph as a reduction in computing accumulated DISC income.

(3) The accumulated DISC income (as increased by DISC income for the year determined under subparagraph (2) of this paragraph) is reduced by each of the following items in the following order:

(i) Any amount deemed distributed for such year under §1.995–3 (relating to deemed distributions upon disqualification),

(ii) Any amount of foreign investment attributable to producer's loans deemed distributed for such year under §1.995–2(a)(5) to the extent it is charged to accumulated DISC income under §1.996–1(b)(1)(i),

(iii) The amount of any adjustment to accumulated DISC income for such year under §1.966–4(b)(1), and

(iv) To the extent they are treated, under §1.996–1 (a) or (b) (relating to ordering rules for distributions), as made out of accumulated DISC income, the amounts of any actual qualifying distributions pursuant to §1.992–3 in the order in which they are made, and thereafter by the amounts of any other actual distributions in the order in which they are made, except that, prior to each actual distribution, accumulated DISC income shall be reduced by the portion of any deficit in earnings and profits for the taxable year chargeable at that time under §1.996–2(a)(2) to accumulated DISC income.

(4) Every distribution or other reduction in accumulated DISC income pursuant to subparagraph (3) of this paragraph shall be charged to the most recently accumulated DISC income.

(c) *Previously taxed income.* Under section 996(f)(2), previously taxed income as of the close of each taxable year of the corporation is an amount equal to—

(1) The sum of—

(i) The amount of previously taxed income as of the close of the immediately preceding taxable year,

(ii) Amounts deemed distributed for the current year under §1.995–2 (relating to deemed distributions in qualified years),

(iii) Amounts deemed distributed for the current year under §1.995–3 (relating to deemed distributions upon disqualification),

(iv) With respect to a distribution in redemption to which §1.996–4(b)(1) applies, an amount equal to the excess (if any) of (*a*) the amount of the reduction under §1.996–4(b)(1) in accumulated DISC income over (*b*) the reduction in the corporation's earnings and profits (see section 312(e)), and

(v) Any amount by which accumulated DISC income is reduced under paragraph (b)(3)(ii) of this section by reason of a deemed distribution as a dividend, under §1.995–2(a)(5), of an amount of foreign investment attributable to producer's loans,

(2) Decreased (but not below zero), to the extent they are treated, under §1.996–1 (a) or (b) (relating to ordering rules for distributions), as made out of previously taxed income, by the amounts of any actual qualifying distributions pursuant to §1.992–3 in the order in which they are made, and thereafter by the amounts of any other actual distributions in the order in which they are made, except that, prior to any actual distribution, previously taxed income shall be reduced by the portion of any deficit in earnings and profits for the taxable year chargeable at that time under §1.996–2(a)(3) to previously taxed income.

(d) *Other earnings and profits.* Under section 996(f)(3), other earnings and profits consist of earnings and profits other than accumulated DISC income and previously taxed income described respectively in paragraphs (b) and (c) of this section. Other earnings and profits as of the close of each taxable year of the corporation is (subject to paragraph (e) of this section) an

amount equal to the amount of other earnings and profits as of the close of the immediately preceding taxable year decreased (if necessary, below zero) in the following order by—

(1) To the extent they are treated, under §1.996–1 (a) or (b) (relating to ordering rules for distributions), as made out of other earnings and profits, the amounts of any actual qualifying distributions pursuant to §1.992–3 in the order in which they are made, and thereafter the amounts of any other actual distributions in the order in which they are made, except that, prior to any actual distribution, other earnings and profits shall be reduced by the portion of any deficit in earnings and profits for the taxable year chargeable at that time under §1.996–2(a)(1) to other earnings and profits, and

(2) With respect to a distribution in redemption to which §1.996–4(b)(1) applies, an amount equal to the excess (if any) of (*a*) the reduction in the corporation's earnings and profits (see section 312(e)) over (*b*) the amount of the reduction under §1.996–4(b)(1) in accumulated DISC income.

(e) *Distributions in kind.* (1) For purposes of determining, under paragraphs (b), (c), and (d) of this section, the amount by which any division of earnings and profits is reduced by reason of a distribution of property (other than money or the DISC's, or former DISC's, own obligations), the amount of such distribution is the fair market value of such property at the time of the distribution.

(2) For any taxable year in which the DISC makes a distribution of such property, the amount of other earnings and profits determined under paragraph (d) of this section (without regard to this subparagraph) shall be—

(i) Increased by the excess (if any) of the amount of such distribution treated as a dividend under section 316(a) over the adjusted basis of such property, and

(ii) Decreased by the excess (if any) of the adjusted basis of such property over the amount of such distribution treated as a dividend under section 316 (a).

Each item of property shall be considered separately for purposes of making the adjustment under this subparagraph.

(f) *Examples.* The provisions of §§1.996–1, 1.996–2, and this section may be illustrated by the following examples:

Example 1. M Corporation, which uses the calendar year as its taxable year, elects to be treated as a DISC beginning with 1974. During 1975, M derives no earnings and profits and makes no deemed or actual distributions, except that on December 31, 1975, M's shareholders are treated as having received a dividend distribution of $100 under §1.995–2 (a)(5) (relating to foreign investment attributable to producer's loans). M's earnings and profits are adjusted as shown on line (2) of the table below on the basis of facts assumed therein.

	Accumulated earnings and profits	Accumulated DISC income	Previously taxed income	Other earnings and profits
(1) Balance January 1, 1975	$450	$100	$250	$100
(2) Adjustments (see paragraphs (b)(3)(ii) and (c)(1)(v) of this section)	0	(100)	100	0
(3) Balance January 1, 1976	450	0	350	100

Example 2. N Corporation, which uses the calendar year as its taxable year, elects to be treated as a DISC beginning with 1972. During 1973, N derives no earnings and profits for the year and makes no deemed or actual distributions, except that A, a shareholder, realized $200 of gain upon receiving an actual cash distribution of $300 in redemption of N stock having an adjusted basis of $100 in his hands. The redemption is treated as an exchange under section 302(a) but, under section 995(c), A includes the $200 of gain in his gross income as a dividend. Assuming that, under section 312(e), $240 is properly chargeable to capital account of N and that, under §1.996–4(b), accumulated DISC income is reduced by $200, N's accounts are adjusted on line (2) of the table below on the basis of facts assumed therein.

	Capital	Accumulated earnings and profits	Accumulated DISC income	Previously taxed income	Other earnings and profits
(1) Balance January 1, 1973	$2,000	$400	$300	$100	0
(2) Adjustments (see § 1.996–4(b) and paragraph (c)(1)(iv) of this section)	(240)	(60)	(200)	140	0
(3) Balance January 1, 1974	1,760	340	100	240	0

Example 3. P Corporation, which uses the calendar year as its taxable year, elects to be treated as a DISC beginning with 1973. During 1974, P derives no earnings and profits for the year and makes no deemed or actual distributions, except for a distribution to B, its sole shareholder, of property with a fair market value of $100 and an adjusted basis in P's hands of $40. Under § 1.996–1(a)(1), B treats the entire amount of the distribution as being made out of previously taxed income and, under § 1.996–1(c), excludes it from his gross income. P's earnings and profits, divisions are adjusted on lines (2) and (3) of the table below on the basis of facts assumed therein.

	Accumulated earnings and profits	Accumulated DISC income	Previously taxed income	Other earnings and profits
(1) Balance January 1, 1974	$200	$80	$120	0
(2) Adjustment under paragraphs (c)(2) and (e)(1) this section	(40)	0	(100)	0
(3) Adjustment under paragraph (e)(2)(i) of this section	0	0	0	$60
(4) Balance January 1, 1975	160	80	20	60

Example 4. Q Corporation, which uses the calendar year as its taxable year, elects to be treated as a DISC beginning with 1974. On January 1, 1975, Q has accumulated earnings and profits of $1,200 and, during 1975, Q incurs a deficit in earnings and profits of $365. The amount of such deficit incurred as of any date before the close of 1975 cannot be shown. On July 1, 1975, Q makes a cash distribution of $650, with respect to its stock to C, Q's sole shareholder. C subsequently transfers by gift all of his Q stock to D. On December 31, 1975, Q makes a cash distribution of $650, with respect to its stock, to D. Under these facts and additional facts assumed in the table below, C is treated as having received a dividend of $650 of which $320 is treated as distributed out of previously taxed income and excluded from gross income. D is treated as receiving a dividend of $186. Adjustments to Q's earnings and profits accounts are illustrated in the table below:

	Accumulated earnings and profits	Accumulated DISC income	Previously taxed income	Other earnings and profits
(1) Balance January 1, 1975	$1,200	$800	$320	$80
(2) Portion of 1975 deficit of $365 chargeable as of June 30, 1975, pursuant to § 1.996–2(a)	(181)	(101)	0	(80)
(3) Balance July 1, 1975	1,019	699	320	0
(4) $650 distributed to C on July 1, 1975	(650)	(330)	(320)	0
(5) Portion of 1975 deficit of $365 chargeable as of December 30, 1975, pursuant to § 1.996–2(a)	(183)	(183)	0	0
(6) Balance December 31, 1975	$186	$186	0	0
(7) $650 distributed to D on December 31, 1975 [1]	(186)	(186)	0	0
(8) Balance January 1, 1976	0	0	0	0

[1] $60 treated as return of capital pursuant to section 301(c)(2).

Example 5. (1) *Facts.* R Corporation, which uses the calendar year as its taxable year elects to be treated as a DISC beginning with 1972. X Corporation is its sole shareholder. At the beginning of 1974, R has a deficit in earnings and profits of $60 all of which is composed of ''other earnings and profits''.

For 1974, R has earnings and profits of $80 before reduction for any distributions and taxable income of $70. On June 15, 1974, R makes a cash distribution to X of $60, with respect to its stock, to which section 301 applies. On August 15, 1974, R makes a cash distribution to X of $30 designated as a distribution to meet qualification requirements pursuant to §1.992–3. Under §1.995–2(a), X is deemed to receive, on December 31, 1974, a distribution of a dividend of $35, i.e., one-half of R's taxable income of $70. The tax consequences of these facts to X and their effect on R's earnings and profits are set forth in the subsequent subparagraphs of this example.

(2) *Dividend treatment of actual distributions.* Since R had $80 of earnings and profits for 1974 and a deficit in accumulated earnings and profits at the beginning of 1974, only $80 of the actual distributions ($90) are treated as dividends under sections 301(c)(1) and 316(a)(2). ($10 of the actual distribution, which is not treated as a dividend is treated in the manner specified in section 301(c) (2) and (3).) Thus, under §1.316–2(b), $26.67 of the actual qualifying distribution made on August 15, 1974 ($30 × $80/$90), and $53.33 of the actual distribution made on June 15, 1974 ($60 × $80/$90), are considered made out of earnings and profits.

(3) *Priority of distributions.* Under §1.996–1(d), for purposes of adjusting the divisions of R's earnings and profits and determining the treatment of subsequent distributions, the sequence in which each distribution is treated as having been made is—

(i) First, the deemed distribution of $35,

(ii) Second, the actual qualifying distribution of $30 made on August 15, 1974, pursuant to §1.992–3, and

(iii) Finally, the actual distribution of $60 made on June 15, 1974.

(4) *Treatment and effect of deemed distribution.* Under §1.995–2(a), on December 31, 1974, X includes the deemed distribution of $35 in its gross income as a dividend. Under paragraph (c)(1)(ii) of this section, R's previously taxed income is increased by $35 as shown on line (3) of the table in subparagraph (7) of this example. Under paragraph (b)(1)(ii) and (2) of this section, accumulated DISC income is increased by $45 of DISC income, i.e., R's earnings and profits for 1974, $80, minus the deemed distribution of $35, as shown on line (4) of the table.

(5) *Treatment and effect of actual qualifying distribution of $30.* As indicated in subparagraph (2) of this example, $26.67 of the $30 qualifying distribution on August 15, 1974, is treated as made out of earnings and profits for 1974. Under §1.996–1(b)(1)(i), the entire $26.67 is treated as distributed out of accumulated DISC income. Thus, on August 15, 1974, X includes $26.67 in its gross income as a dividend. No deduction is allowable under section 243. Under paragraph (b)(3)(iv) of this section, R's accumulated DISC income is reduced by $26.67 as shown on line (6) of the table in subparagraph (7) of this example.

(6) *Treatment and effect of actual distribution of $60.* As indicated in subparagraph (2) of this example, $53.33 of the $60 distribution on June 15, 1974, is treated as made out of earnings and profits for 1974. Under §1.996–1(a), the $53.33 is treated as distributed out of previously taxed income to the extent thereof, $35, and then out of accumulated DISC income, $18.33. Thus, on June 15, 1974, X includes $18.33 in its gross income as a dividend. Under §1.996–1(c), the distribution of $35 out of previously taxed income is excluded from gross income. No deduction is allowable under section 243 with respect to the actual distribution of $53.33. Under paragraph (b)(3)(iv) of this section, accumulated DISC income is reduced by $18.33 and, under paragraph (c)(2) of this section, previously taxed income is reduced by $35, as shown on line (7) of the table in subparagraph (7) of this example.

(7) *Summary.* The effects on earnings and profits and the divisions of earnings and profits are summarized in the following table:

	Earnings and profits for year	Accumulated earnings and profits	Accumulated DISC income	Previously taxed income	Other earnings and profits
(1) Balance January 1, 1974	.....	($60.00)	.....	.....	($60.00)
(2) Earnings and profits for year before reduction for distributions	$80.00				
(3) Deemed distribution of $35 to X on December 31, 1974, under §1.995–2(a)	.....	.....	.....	$35.00	
(4) DISC income for 1974 of $45 as defined in paragraph (b)(2) of this section (line 2 ($80) minus line 3 ($35))	.....	.....	$45.00		
(5) Balance before actual distributions	80.00	(60.00)	45.00	35.00	(60.00)
(6) Qualifying distribution of $30 to X on August 15, 1974, pursuant to §1.992–3	(26.67)	.....	(26.67)		
(7) Actual distribution to P of $60 on June 15, 1974	(53.33)	.....	(18.33)	(35.00)	
(8) Balance January 1, 1975	0	(60.00)	0	.....	(60.00)

Example 6. Assume the facts are the same as in example 5, except that at the beginning of 1974 R's accumulated earnings and profits amount to $60 consisting of accumulated DISC income of $20, previously taxed income of $10, and other earnings and profits of $30. In addition, on August 1, 1974, X transfers all R's stock to Y Corporation in a reorganization described in section 368(a)(1)(B) in which under section 354 X recognizes no gain or loss. Under these facts, X includes in its gross income for 1974 a dividend of $15 which is attributable to the actual distribution of $60 paid out of earnings and profits on June 15, 1974. X excludes from gross income the balance of the $60 distribution ($45) paid out of earnings and profits because, under §1.996–1(a), it is treated as paid out of previously taxed income. Y includes in its gross income for 1974 a dividend of $65 of which $35 is attributable to the deemed distribution of a dividend to Y on December 31, 1974, under §1.995–2(a) and $30 is attributable to the qualifying distribution paid out of earnings and profits to Y on August 15, 1974. The adjustments to R's earnings and profits are summarized in the following table:

	Earnings and profits for year	Accumulated earnings and profits	Accumulated DISC income	Previously taxed income	Other earnings and profits
(1) Balance January 1, 1974	.....	$60	$20	$10	$30
(2) Earnings and profits for year before reduction for distributions	$80				
(3) Deemed distribution of $35 to Y on December 31, 1974, under §1.995–2(a)	.....	.....	.....	35	
(4) DISC income for 1974 of $45 as defined in paragraph (b)(2) of this section (line 2 ($80) minus line 3 ($35))	.....	.....	45		
(5) Balance before actual distributions	80	60	65	45	30
(6) Qualifying distribution of $30 to Y on August 15, 1974, pursuant to §1.992–3	(26.67)	(3.33)	(30)		
(7) Actual distribution to X of $60 on June 15, 1974	(53.33)	(6.67)	(15)	(45)	
(8) Balance January 1, 1975	.....	50	20	0	30

(g) *DISCs having corporate and noncorporate shareholders.* In the case of a DISC having one or more corporate shareholders but less than all of its shareholders subject to the special rules of section 291(a)(4), relating to certain deferred DISC income as a corporate preference item, accumulated DISC income and previously taxed income of the DISC are divided between the corporate shareholders, as a class, and the other shareholders, as a class, in proportion to amounts of DISC income not deemed distributed and amounts deemed distributed to each class. Subsequent taxation of actual and qualifying distributions shall be based upon this division. Thus, if a DISC is owned 50 percent by corporate shareholders and 50 percent by individual shareholders and has undistributed taxable income of $2,000 for its year, the division is made as follows:

Corporate shareholders:

Previously taxed income (57.5% of $2,000 ÷ 2)	$575
Accumulated DISC income (42.5% of $2,000 ÷ 2)	425

Individual shareholders:

Previously taxed income (50% of $2,000 ÷ 2)	500
Accumulated DISC income (50% of $2,000 ÷ 2)	500

(Secs. 995(e)(7), (8) and (10), 995(g) and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1655, 26 U.S.C. 995 (e)(7), (8) and (10); 90 Stat. 1659, 26 U.S.C. 995(g); and 68A Stat. 917, 26 U.S.C. 7805))

[T.D. 7324, 39 FR 35121, Sept. 30, 1974, as amended by T.D. 7854, 47 FR 51742, Nov. 17, 1982; T.D. 7984, 49 FR 40024, Oct. 12, 1984]

§ 1.996–4 Subsequent effect of previous disposition of DISC stock.

(a) *Shareholder adjustment for previously taxed income.* (1) Under section 996(d)(1), except as provided in subparagraph (2) of this paragraph, if—

(i) Gain with respect to a share of stock of a DISC, or former DISC, is treated under §1.995–4 as a dividend, and

(ii) With respect to such share, any person subsequently receives an actual distribution made out of accumulated DISC income, or a deemed distribution made, pursuant to §1.995–3, by reason of

disqualification, out of accumulated DISC income,

then such person shall treat such distribution in the same manner as a distribution from previously taxed income (and thus excludable from gross income under §1.996–1(c)) to the extent that the gain referred to in subdivision (i) of this subparagraph exceeds the aggregate amount of any other distributions with respect to such share which were treated under this subparagraph as made from previously taxed income.

(2) In applying subparagraph (1) of this paragraph with respect to a share of stock in a DISC, or former DISC, the gain referred to in subparagraph (1)(i) of this paragraph does not include any gain to a shareholder on a redemption of such share which qualifies as an exchange under section 302(a) or any gain on a disposition of such share prior to such redemption. Distributions described in subparagraph (1)(ii) of this paragraph do not include a distribution in a redemption which qualifies as an exchange under section 302(a). For adjustments to accumulated DISC income by reason of dividend treatment under §1.995–4 with respect to gain upon a redemption of DISC stock to which section 302(a) applies and upon a prior disposition of such stock, see paragraph (b) of this section.

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

Example. In 1974, under §1.995–4, A, a shareholder of a DISC, on the sale of his DISC stock to B, is required to treat $20 of his gain as a dividend. The DISC has no previously taxed income and $40 of accumulated DISC income. Subsequently in the same year, B, the purchaser of the stock, receives an actual dividend distribution of $15 with respect to such stock which, under §1.996–1(a), is treated as made out of accumulated DISC income. The amounts of the DISC's previously taxed income and accumulated DISC income were not adjusted by reason of the $20 treated as a dividend on the prior sale. However, even though the DISC had no previously taxed income, the purchaser would treat the $15 as though it had been paid out of previously taxed income and, therefore would not include the $15 in gross income. If in 1975, B receives another actual distribution of $9 with respect to such stock, $5 (*i.e.*, $20 dividend on A's sale less the $15 distribution to B in 1974 which was treated under subparagraph (1) of this paragraph as made from previously taxed income) is treated as made from previously taxed income and excluded from gross income. The result would be the same if, on January 1, 1975, B had transferred such stock to C by gift and the $9 distribution had been made to C.

(b) *Corporate adjustment upon redemption.* (1) Under section 996(d)(2), if by reason of §1.995–4 gain on a redemption of stock in a DISC, or former DISC, is included in the shareholder's gross income as a dividend, then the accumulated DISC income shall be reduced by an amount equal to the sum of—

(i) The amount of gain on such redemption which, under §1.995–4, is treated as a dividend, and

(ii) The amount of any gain with respect to such redeemed stock which, under §1.995–4, was treated as a dividend on a disposition prior to such redemption minus the amount of distributions with respect to such stock which have been treated as made out of previously taxed income by reason of the application of paragraph (a)(1) of this section.

(2) The provisions of this paragraph may be illustrated by the following examples:

Example 1. The entire stock of a DISC, which uses the calendar year as its taxable year, has been owned equally by A, B, C, and D since it was organized. At the close of 1976, when the DISC has $100 of accumulated DISC income, it redeems all of A's shares in a transaction qualifying as an exchange under section 302(a) and A, under §1.995–4, includes $25 in his gross income as a dividend. The redemption has the effect of reducing accumulated DISC income by $25 to $75.

Example 2. Assume the same facts as in example 1 except that the stock of the DISC has not been held equally by A, B, C, and D since its organization. A purchased his shares from X in 1974 in a transaction in which X, under §1.995–4, included in his gross income $30 as a dividend. In 1975, A receives a distribution of $10 out of accumulated DISC income which, under paragraph (a)(1) of this section, is treated as made out of previously taxed income. Under these facts, the redemption of A's stock in 1976 has the effect of reducing accumulated DISC income by $45 to $55 determined as follows:

(a) Accumulated DISC income	.....	$100
(b) Minus sum of:		
(1) Dividend on redemption of A's stock	$25	
(2) Excess of dividend on X's sale ($30) over distribution to A treated as made out of previously taxed income ($10)	$20	

Total	45
(c) Accumulated DISC income on 12/31/76	55

[T.D. 7324, 39 FR 35121, Sept. 30, 1974]

§ 1.996–5 Adjustment to basis.

(a) *Addition to basis.* Under section 996(e)(1) amounts representing deemed distributions as provided in section 995(b) shall increase the basis of the stock with respect to which the distribution is made.

(b) *Reductions of basis.* Under section 996(e)(2), the portion of an actual distribution treated as made out of previously taxed income shall reduce the basis of the stock with respect to which it is made and, to the extent that it exceeds the adjusted basis of such stock, shall be treated as gain from the sale or exchange of property. In the case of stock includible in the gross estate of a decedent for which an election is made under section 2032 (relating to alternate valuation), this paragraph shall not apply to any distribution made after the date of the decedent's death and before the alternate valuation date provided by section 2032. See section 1014(d) for a special rule for determining the basis of stock in a DISC, or former DISC, acquired from a decedent.

[T.D. 7324, 39 FR 35124, Sept. 30, 1974]

§ 1.996–6 Effectively connected income.

In the case of a shareholder who is a nonresident alien individual or a foreign corporation, trust, or estate, amounts taxable as dividends by reason of the application of §1.995–4 (relating to gain on disposition of stock in a DISC), amounts treated under §1.996–1 as distributed out of accumulated DISC income, and amounts deemed distributed under §1.995–2(a) (1) through (4) shall be treated as gains and distributions which are effectively connected with the conduct of a trade or business conducted through a permanent establishment of such shareholder within the United States, and shall be subject to tax in accordance with the provisions of section 871(b) and the regulations thereunder in the case of nonresident alien individuals, trusts, or estates, or section 882 and the regulations thereunder in the case of foreign corporations. In no case, however shall other income of such shareholder be taxable as effectively connected with the conduct of a trade or business through a permanent establishment in the United States solely because of the application of this section.

[T.D. 7324, 39 FR 35124, Sept. 30, 1974]

§ 1.996–7 Carryover of DISC tax attributes.

(a) *In general.* Carryover of a DISC's divisions of earnings and profits to acquiring corporations in nontaxable transactions shall be subject to rules generally applicable to other corporate tax attributes. For example, a DISC which acquires the assets of another DISC in a transaction to which section 381(a) applies shall succeed to, and take into account, the divisions of the earnings and profits of the transferor DISC in accordance with section 381(c)(2).

(b) *Allocation of divisions of earnings and profits in corporate separations.* (1) If one DISC transfers part of its assets to a controlled DISC in a transaction to which section 368(a)(1)(D) applies and immediately thereafter the stock of the controlled DISC is distributed in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies, then—

(i) The earnings and profits of the distributing DISC immediately before the transaction shall be allocated between the distributing DISC and the controlled DISC in accordance with the provisions of §1.312–10.

(ii) Each of the divisions of such earnings and profits, namely previously taxed income, accumulated DISC income, and other earnings and profits, shall be allocated between the distributing DISC and the controlled DISC on the same basis as the earnings and profits are allocated.

(iii) Any assets of the distributing DISC whose status as qualified export assets is limited by its accumulated DISC income (e.g., producer's loans described in §1.993–4, Export-Import Bank and other obligations described in §1.993–2(h), and financing obligations described in §1.993–2(i)) shall be treated as having been allocated, for the purpose of determining the classification of such assets in the hands of the distributing DISC or the controlled DISC,

on the same basis as the earnings and profits are allocated regardless of how such assets are actually allocated.

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

Example. On January 1, 1974, P Corporation transfers part of its assets to S Corporation, a newly organized subsidiary of P, in a transaction described in section 368(a)(1)(D) and distributes all the S stock in a transaction which qualifies under section 355. Immediately before such transfer, P had earnings and profits of $120,000 of which $100,000 constitutes accumulated DISC income. The unpaid balance of P's producer's loans is $80,000 all of which is retained by P. Pursuant to §1.312–10, 25 percent of P's accumulated DISC income is allocated to S (*i.e.*, $25,000). P's producer's loans will be treated as allocated to S in the same proportion. Accordingly, for purposes of determining, under §1.993–4(a)(3), the amount of producer's loans which S is entitled to make, S is treated as having an unpaid balance of producer's loans of $20,000 (*i.e.*, 25% × $80,000) and P is treated as having an unpaid balance of $60,000 (*i.e.*, 75% × $80,000).

(c) *Accumulated DISC income accounts of separate DISC's maintained after corporate combination.* If two or more DISC's combine to form a new DISC, or if the assets of one DISC are acquired by another DISC, in a transaction described in section 381(a), accumulated DISC income of the acquired DISC or DISC's shall carry over and be taken into account by the acquiring or new DISC, except that a separate account shall be maintained for the accumulated DISC income of any DISC scheduled to be received as a deemed distribution by its shareholders under §1.995–3 (relating to deemed distributions upon disqualification). If, as a part of such transaction, the stock of the DISC which has accumulated DISC income scheduled to be deemed distributed is exchanged for stock of the acquiring or new DISC to which such accumulated DISC income is carried over and which maintains a separate account, then such accumulated DISC income shall be deemed distributed pro rata to shareholders of the acquiring or new DISC on the basis of stock ownership immediately after the exchange.

[T.D. 7324, 39 FR 35125, Sept. 30, 1974]

§ 1.996–8 Effect of carryback of capital loss or net operating loss to prior DISC taxable year.

(a) Under §1.995–2(e), the deduction under section 172 for a net operating loss carryback or under section 1212 for a capital loss carryback is determined as if the DISC were a domestic corporation which had not elected to be treated as a DISC. A carryback of a net operating loss or of a capital loss of any corporation which reduces its taxable income for a preceding taxable year for which it qualified as a DISC will have the consequences enumerated in paragraphs (b) through (e) of this section.

(b) For such preceding taxable year, the amount of a deemed distribution of one-half of certain taxable income described in §1.995–2(a)(4) will ordinarily be reduced in effect (but not below zero) by one-half of the sum of the amount of the deduction under section 172 for such year for net operating loss carrybacks and the amount of the deduction under section 1212 for such year for capital loss carrybacks.

(c) The amount of reduction in the deemed distribution under paragraph (b) of this section will have the effect of increasing the limitation, provided in §1.995–2(b)(2), on the amount of foreign investment attributable to producer's loans which is deemed distributed under §1.995–2(a)(5).

(d) If the amount of a deemed distribution for a preceding taxable year is reduced as described in paragraph (b) of this section, then for such preceding taxable year the previously taxed income (as defined in §1.996–3(c)) shall be decreased by the amount of such reduction and the accumulated DISC income (as defined in §1.996–3(b)) shall be increased by the amount of such reduction. Such adjustments shall be made as of the time the deemed distribution for such preceding taxable year is treated as having occurred. See §1.996–1(d) for the priority of such deemed distribution in relation to other distributions made in that preceding taxable year.

(e) The amount and treatment of any actual distribution made in such preceding taxable year or a year subsequent to such preceding year, and the treatment of gain on a disposition (in any such year) of the DISC's stock to

which §1.995–4 applies, shall be properly adjusted to reflect the adjustments to previously taxed income and accumulated DISC income described in paragraph (d) of this section.

[T.D. 7324, 39 FR 35125, Sept. 30, 1974]

§ 1.997–1 Special rules for subchapter C of the Code.

(a) For purposes of applying the provisions of sections 301 through 395 of the Code, any distribution in property to a corporation by a DISC, or former DISC, which is made out of previously taxed income or accumulated DISC income shall be treated as a distribution in the same amount as if such distribution of property were made to an individual, and have a basis, in the hands of the recipient corporation, equal to such amount treated as having been distributed.

(b) This section may be illustrated by the following example:

Example. X Corporation is the sole shareholder of Y Corporation which is a DISC. Y makes an actual distribution of property to X with respect to X's stock in Y. The property has a basis of $50 and a fair market value of $100. The distribution is treated as made out of accumulated DISC income under section 996(a) and is taxable as a dividend under section 301(c)(1). Even though X is a corporation, the amount of the distribution is $100 notwithstanding the provisions of section 301(b)(1)(B) and the basis the property in X's hands is $100 notwithstanding the provisions of section 301(d)(2).

[T.D. 7324, 39 FR 35125, Sept. 30 1974]

§§ 1.998–1.1000 [Reserved]