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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))

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§ 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