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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).