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(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