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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