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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,