

	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