

RULES AND REGULATIONS

Flood Hazard Areas and the map number and locations where Flood Hazard Boundary Maps were available for public inspection. This list included the City of Dallas, Texas as an eligible community and included Map No. H 480171 24 which indicates that Lot 2, Block U/8120, Laurel Valley Addition, Dallas, Texas, as recorded in Volume 45, Page 497 of the Plat Books of Dallas County, Texas, is in its entirety within the Special Flood Hazard Area. It has been determined by the Federal Insurance Administration, after further technical review of the above map in light of additional, recently acquired flood information, that the above property is not within the Special Flood Hazard Area. Accordingly, effective December 13, 1974, Map No. H 480171 24 is hereby corrected to reflect that the above property is not within the Special Flood Hazard Area.

(National Flood Insurance Act of 1968 (Title XIII of Housing and Urban Development Act of 1968), effective January 28, 1969 (33 F.R. 17804, November 28, 1968), as amended, 42 U.S.C. 4001-4128; and Secretary's delegation of authority to Federal Insurance Administrator 34 F.R. 2680, February 27, 1969, as amended by 39 F.R. 2787, January 24, 1974).

Issued: June 18, 1975.

J. ROBERT HUNTER,
Acting Federal Insurance
Administrator.

[FR Doc.75-18372 Filed 7-15-75; 8:45 am]

[Docket No. FI-443]

PART 1915—IDENTIFICATION OF SPECIAL HAZARD AREAS Correction

On January 10, 1975, in 40 F.R. 2199, the Federal Insurance Administrator published a list of communities with Special Flood Hazard Areas and the map number and locations where Flood Hazard Boundary Maps were available for public inspection. This list included the City of Dallas, Texas, as an eligible community and included Map No. H 480171 24 which indicates that Lot 21, Block F/1820, Laurel Valley Addition, Second Installment, being 9647 Fieldcrest Drive, Dallas, Texas, as recorded in Volume 50, Page 27 of the Map Records of Dallas County, Texas, is in its entirety within the Special Flood Hazard Area. It has been determined by the Federal Insurance Administration, after further technical review of the above map in light of additional, recently acquired flood information, that the above property is not within the Special Flood Hazard Area. Accordingly, effective December 13, 1974, Map No. H 480171 24 is hereby corrected to reflect that the above property is not within the Special Flood Hazard Area.

(National Flood Insurance Act of 1968 (Title XIII of Housing and Urban Development Act of 1968), effective January 28, 1969 (33 F.R. 17804, November 28, 1968), as amended, 42 U.S.C. 4001-4128; and Secretary's delegation of authority to Federal Insurance Adminis-

trator 34 F.R. 2680, February 27, 1969, as amended by 39 F.R. 2787, January 24, 1974).

Issued: June 24, 1975.

J. ROBERT HUNTER,
Acting Federal Insurance
Administrator.

[FR Doc.75-18452 Filed 7-15-75; 8:45 am]

[Docket No. FI-631]

PART 1915—IDENTIFICATION OF SPECIAL HAZARD AREAS Correction

On July 18, 1970, in 35 F.R. 11586, the Federal Insurance Administrator published a list of communities with Special Flood Hazard Areas and the map number and locations where Flood Hazard Boundary Maps were available for public inspection. This list included Chesapeake, Virginia, as an eligible community and included Map No. H 510034 02 which indicates that Lots 8 through 12, Block 68, and Lots 1, 3, 5, 7, 9, 11, 13, 15, 17, 19, 21, and 23, Block 70, Norfolk Highlands Subdivision 1, Chesapeake, Virginia, as recorded in Map Book 10, Pages 63 and 65 in the office of the Clerk of Chesapeake, Virginia, are in their entirety within the Special Flood Hazard Area. It has been determined by the Federal Insurance Administration, after further technical review of the above map in light of additional, recently acquired flood information, that the above property is not within the Special Flood Hazard Area. Accordingly, effective July 18, 1970, Map No. H 510034 02 is hereby corrected to reflect that the above property is not within the Special Flood Hazard Area.

(National Flood Insurance Act of 1968 (Title XIII of Housing and Urban Development Act of 1968), effective January 28, 1969 (33 F.R. 17804, November 28, 1968), as amended, 42 U.S.C. 4001-4128; and Secretary's delegation of authority to Federal Insurance Administrator 34 F.R. 2680, February 27, 1969, as amended by 39 F.R. 2787, January 24, 1974).

Issued: June 24, 1975.

J. ROBERT HUNTER,
Acting Federal Insurance
Administrator.

[FR Doc.75-18454 Filed 7-15-75; 8:45 am]

[Docket No. FI-443]

PART 1915—IDENTIFICATION OF SPECIAL HAZARD AREAS Correction

On January 10, 1975, in 40 F.R. 2199, the Federal Insurance Administrator published a list of communities with Special Flood Hazard Areas and the map number and locations where Flood Hazard Boundary Maps were available for public inspection. This list included the City of Dallas, Texas, as an eligible community and included Map No. H 480171 24 which indicates that Lot 1,

Block Y/8122, White Rock North, Fifth Installment, being 9505 Highedge, Dallas, Texas, as recorded in Volume 46, Page 137 in the Map Records of Dallas County, Texas, is in its entirety within the Special Flood Hazard Area. It has been determined by the Federal Insurance Administration, after further technical review of the above map in light of additional, recently acquired flood information, that the above property is not within the Special Flood Hazard Area. Accordingly, effective December 13, 1974, Map No. H 480171 24 is hereby corrected to reflect that the above property is not within the Special Flood Hazard Area.

(National Flood Insurance Act of 1968 (Title XIII of Housing and Urban Development Act of 1968), effective January 28, 1969 (33 F.R. 17804, November 28, 1968), as amended, 42 U.S.C. 4001-4128; and Secretary's delegation of authority to Federal Insurance Administrator 34 F.R. 2680, February 27, 1969, as amended by 39 F.R. 2787, January 24, 1974).

Issued: June 20, 1975.

J. ROBERT HUNTER,
Acting Federal Insurance
Administrator.

[FR Doc.75-18372 Filed 7-15-75; 8:45 am]

[Docket No. FI-629]

PART 1916—CONSULTATION WITH LOCAL OFFICIALS

Changes Made in Determinations of Galveston County, Tex., Base Flood Elevations

On April 8, 1971, at 36 FR 6747, the Federal Insurance Administrator published a list of communities with Special Flood Hazard Areas and the map numbers and locations where Flood Insurance Rate Maps were available for public inspection. The list included Flood Insurance Rate Maps for portions of Galveston County.

The Federal Insurance Administrator, after consultation with the Chief Executive Officer of Galveston County, has determined that modification of the base (100-year) flood elevations of some locations in Galveston County, Texas, is appropriate. These modified elevations are currently in effect and amend the Flood Insurance Rate Map. A revised rate map will be published as soon as possible. The modifications are made in accordance with section 206 of the Flood Disaster Protection Act of 1973 (P.L. 93-234) and the National Flood Insurance Act of 1968, as amended (Title XIII of the Housing and Urban Development Act of 1968 P.L. 90-448) 42 U.S.C. 4001-4128, and 24 CFR Part 1916.

For rating purposes, the new community number is 485470 B and must be used for all new policies and renewals.

The changes in base flood elevations are as follows:

Previous FIA zone (as on map)	Previous base flood elevation (as on map) (MSL)	New FIA zone	New base flood elevation (MSL)
Zone A11.....	18.5	Zone A12.....	15

These changes apply only to the area described as follows:

All or part of that land which is contained in Zone C and Zone of the County of Galveston, Texas, and which lies East of the City of Dickinson, Texas, and is more particularly described by the following:

Beginning at a point for corner of the perimeter of said area of land in the intersection of Galveston, Houston and Henderson Railroad (G. H. & H. R. R.) and 16th Street and continuing in a Northeasterly direction along 16th Street to the intersection of 16th Street and F. M. 1266 (Dickinson Avenue);

Thence continuing in an Easterly direction in a line which is perpendicular to F. M. 1266, to the intersection of said line and Oasis Road to a point for corner;

Thence South and along the entire length of Oasis Road;

Thence continuing South in a line which is an extension of Oasis Road to a point for corner at the intersection of said line and a County Road which is the First Road South of Dickinson Bayou, and is an approximate distance of 1,250 feet from the end of Oasis Road;

Thence West in a line which is approximately perpendicular to Oasis Road and parallel and approximately 50 feet to the South of Park Avenue and continuing parallel to and approximately 50 feet to the South of Park Avenue to the intersection of Park Avenue and Nichols Street to a point for corner;

Thence Southwest in a line which is perpendicular to Nichols Street to a point for corner at the intersection of said line and S. H. 3 (Avenue "E");

Thence North and along S. H. No. 3 to the Second County Road, from previous point for corner, which is the intersection of S. H. No. 3 and said County Road in which S. H. No. 3 turns toward a Northwesterly direction and is an approximate distance of 600 feet to a point for corner;

Thence Northeast and perpendicular to G. H. & H. R.R. to the intersection of said County Road and G. H. & H. R.R. to a point for corner;

Thence Northwest and along the G. H. & H. R.R. to the Place of Beginning.

Under the above mentioned Acts of 1968 and 1973 the Administrator must develop criteria for flood plain management. In order for the community to continue participation in the National Flood Insurance Program, the community must use the modified elevations to carry out the flood plain man-

agement measures of the Program. These modified elevations will also be used to calculate the appropriate flood insurance premium rates for new buildings and their contents and for the second layer of insurance on existing buildings and contents.

From the date of this notice, any person has 90 days in which he can request through the community that the Federal Insurance Administrator reconsider the changes. Any request for reconsideration must be based on knowledge of changed conditions or new scientific and technical data. All interested parties are on notice that until the 90-day period elapses, the Administrator's new determination of elevations may itself be changed.

Any person having knowledge or wishing to comment on these changes should immediately notify:

Mr. William D. Decker, Attorney for the Commissioners, Court of Galveston County, Texas, 504 First Hutchings-Sealy National Bank Building, Galveston, Texas 77550.

(National Flood Insurance Act of 1968 (Title XIII of the Housing and Urban Development Act of 1968); effective January 28, 1969 (33 F.R. 17804, November 28, 1968), as amended; 42 U.S.C. 4001-4128; and Secretary's delegation of authority to the Federal Insurance Administrator, 34 F.R. 2680, February 27, 1969, as amended 39 F.R. 2787, January 24, 1974.)

Issued: June 30, 1975.

J. ROBERT HUNTER,
Acting Federal Insurance
Administrator.

[FR Doc.75-18374 Filed 7-15-75;8:45 am]

[Docket No. FI-630]

PART 1916—CONSULTATION WITH LOCAL OFFICIALS

Notice of Changes Made in Determinations of Fairfax County, Virginia, Base Flood Elevations

On January 8, 1972, at 37 FR 281, the Federal Insurance Administrator published a list of communities with Special Flood Hazard Areas and the map numbers and locations where Flood Insurance Rate Maps were available for public inspection. The list included Flood Insurance Rate Maps for portions of Fairfax County.

The Federal Insurance Administrator, after consultation with the Chief Executive Officer of Fairfax County, has determined that modification of the base (100-year) flood elevations of some locations in Fairfax County, Virginia, is appropriate. These modified elevations are currently in effect and amend the Flood Insurance Rate Map. A revised rate map will be published as soon as possible. The modifications are made in accordance with Section 206 of the Flood Disaster Protection Act of 1973 (P.L. 93-234) and

the National Flood Insurance Act of 1968, as amended (Title XIII of the Housing and Urban Development Act of 1968 P.L. 90-448) 42 U.S.C. 4001-4128, and 24 CFR Part 1916.

For rating purposes, the new community number is 515525 A and must be used for all new policies and renewals.

The changes in base flood elevations are as follows:

Previous FIA zone (as on map)	Previous base flood elevation (MSL)	New FIA zone	New base flood elevation (MSL)
FIA Map No. H 515525 08 (Tripps Run—1300 feet north of U.S. route 50)			
Zone A2.....	260	Zone A.....	238

Under the above mentioned Acts of 1968 and 1973 the Administrator must develop criteria for floodplain management. In order for the community to continue participation in the National Flood Insurance Program, the community must use the modified elevation to carry out the flood plain management measures of the Program. This modified elevation will also be used to calculate the appropriate flood insurance premium rates for new buildings and their contents and for the second layer of insurance on existing buildings and contents.

However, from the date of this notice, any person has 90 days in which he can request through the community that the Federal Insurance Administrator reconsider the changes. Any request for reconsideration must be based on knowledge of changed conditions or new scientific and technical data. All interested parties are on notice that until the 90-day period elapses, the Administrator's new determination of elevations may itself be changed.

Any person having knowledge or wishing to comment on these changes should immediately notify:

Office of the Director
Public Works Department
Fairfax County, Virginia
4100 Chain Bridge Road
Fairfax, Virginia 22030

(National Flood Insurance Act of 1968 (Title XIII of the Housing and Urban Development Act of 1968); effective January 28, 1969 (33 F.R. 17804, November 28, 1968), as amended; 42 U.S.C. 4001-4128; and Secretary's delegation of authority to the Federal Insurance Administrator, 34 F.R. 2680, February 27, 1969, as amended 39 F.R. 2787, January 24, 1974.)

Issued: June 24, 1975.

J. ROBERT HUNTER,
Acting Federal Insurance
Administrator.

[FR Doc.75-18451 Filed 7-15-75;8:45 am]

Title 26—Internal Revenue

CHAPTER I—INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY

SUBCHAPTER A—INCOME TAX

[T.D. 7364]

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Intercompany Pricing Rules, Including Marginal Costing Rules, for DISC's

Preamble. By two notices of proposed rule making, one notice appearing in the FEDERAL REGISTER for Thursday, September 21, 1972 (37 F.R. 19625) and the other notice appearing in the FEDERAL REGISTER for Wednesday, December 20, 1972 (37 F.R. 28065), amendments to the Income Tax Regulations (26 CFR Part 1) under section 994 of the Internal Revenue Code of 1954 were proposed in order to provide intercompany pricing rules for DISC's. After consideration of all such relevant matter as was presented by interested persons regarding the rules proposed, certain changes were made, and the proposed amendments of the regulations, subject to such changes, are adopted by this document. The general intercompany pricing rules are provided by § 1.994-1 and the marginal costing rules are provided by § 1.994-2.

The contents of § 1.994-1 and the more important changes in such section made by this document may be summarized as follows:

1. Paragraph (a) describes the scope of the section and defines the terms "related party" (which has been substituted for "related person") and "related supplier". It is made clear that the DISC's taxable income does not include amounts attributable to the profits of related parties who supply the related supplier.

2. Paragraph (b) describes the types of transactions involving the DISC, a related supplier, and a third party customer to which the intercompany pricing rules may be applied. These transactions do not include sales of property to the DISC which the DISC in turn leases to third parties or leases of property to the DISC which the DISC in turn subleases to third parties for a period or upon terms of payment which are not comparable to the principal lease to the DISC.

3. Paragraph (c) sets forth the three methods by which intercompany prices may be determined. These methods are the 4-percent gross receipts method, the 50-50 combined taxable income method, and the section 482 method. Special rules are provided with respect to incomplete transactions which have the effect of postponing the realization of taxable income until a transaction with a third party customer is consummated. With respect to incomplete transactions, in the case of taxable years ending after August 15, 1975, the transfer price paid by the DISC to the related supplier for the year must be the related supplier's cost of goods sold for the property transferred. For earlier years such transfer price may exceed the related supplier's cost of goods sold for the property. The

provision sets forth the manner of determining the combined taxable income of the DISC and its related supplier which determination is necessary to application of both the 4-percent gross receipts method and 50-50 combined taxable income method. Such combined taxable income does not include interest derived from postponed payment of sales prices from third parties. Concerning timber to which an election under section 631 applies (relating to cutting of timber considered as a sale or exchange), cost of goods sold must be determined by reference to the fair market value as of the beginning of the year of the standing timber cut during the year. The rules with respect to grouping of transactions for purposes of determining intercompany prices on the basis of aggregations of transactions have been expanded to permit groupings on the basis of two-digit major groups, or inferior classifications or combinations within a major group, of the Standard Industrial Classification of products and product lines as prepared by the Statistical Policy Division of the Office of Management and Budget. It is believed that such rule for grouping will provide taxpayers a greater degree of certainty in their selection of a grouping system and will permit sufficiently broad groupings of products or product lines to promote efficiency in determining intercompany prices. Subdivision (v) of paragraph (c) (6), which is reserved and is the subject of an additional notice of proposed rule making published elsewhere in today's Federal Register, deals with a transfer of accounts receivable by a related supplier to a DISC for an amount less than face value.

4. Paragraph (d) describes the application of the intercompany pricing rules to leases, commission transactions, and services. In general, rents, commissions, and compensation for services are determined under the same theories and similar rules as are involved in determining intercompany prices on sales. However, lease and sale transactions may not be grouped together for purposes of determining transfer prices and rents. Rules for grouping of related and subsidiary services have been liberalized to permit grouping of such services the income from which is reportable for a year following the year in which the income from the export transaction is reportable.

5. Paragraph (e) sets forth in subparagraph (1) a limitation on DISC income (the "no loss" rule). Subdivision (1) of subparagraph (1) makes explicit that the special rule of that subdivision for applying the 4-percent gross receipts method to sales may apply even where there is no loss to a related supplier determined under subdivision (i) of such subparagraph. Paragraph (e) (2) describes the relationship between sections 482 and 994. Subparagraphs (3), (5), and (6) of paragraph (e) are reserved and are the subject of an additional notice of proposed rule making published elsewhere in today's FEDERAL REGISTER. These subparagraphs deal, respectively, with initial payment of transfer price by a

DISC or commission to a DISC, procedure for adjustment to transfer price or commission, and examples which illustrate initial payments of and later adjustments to transfer prices and commissions. Subparagraphs (3) and (5) as published in the notice of proposed rule making on September 21, 1972, are withdrawn by this document.

6. Paragraph (f) defines in some length the term "export promotion expenses". Provision is made for allocation of expenses or costs where only a portion of an expense or cost may qualify as an export promotion expense. It is made clear that contributions or compensations deductible under section 404 of the Code may be treated as export promotion expenses, but State and local income and franchise taxes may not be so treated. One-half of freight expense attributable to carriage pursuant to a single bill of lading by one or more U.S. flag carriers may be claimed as an export promotion expense even though the freight is shifted between carriers. An expense may still qualify as an export promotion expense even if it is accounted for and paid by a related party if the DISC reimburses the related party for its payment of the expense. The time export promotion expenses may be claimed with respect to transactions which are not consummated is set forth in an added rule.

7. Paragraph (g) illustrates the various rules of the section through a series of examples.

The contents of § 1.994-2 (relating to marginal costing rules) and the more important changes in such section made by this document may be summarized as follows:

1. Paragraph (a) describes the scope of the marginal costing section and the transactions to which the marginal costing rules may not be applied. Marginal costing may be applied in the determination of combined taxable income where the 50-50 combined taxable income method is used to determine intercompany prices, whether or not the related supplier of the DISC manufactures, produces, grows, or extracts the export property sold. Marginal costing may not be applied to transactions giving rise to foreign base company sales income under section 954(d) of the Code, except as provided to the contrary.

2. Paragraph (b) sets forth the marginal costing rules for allocations of costs. Only costs for direct material and direct labor and export promotion expenses claimed by the DISC which costs and expenses are attributable to the export property sold are taken into account in determining combined taxable income of the DISC and its related supplier. The overall profit percentage limitation has been retained without substantial change.

3. Paragraph (c) defines the terms "establishing or maintaining a foreign market", "overall profit percentage", and "full costing method". Under the overall profit percentage limitations, the combined taxable income of the DISC and its related supplier may not as a per-

centage of gross receipts, when marginal costing is applied, exceed the percentage which such persons' combined taxable income from all sales is of gross receipts from all sales. The overall profit percentage may be determined by taking into account sales of persons related to the DISC or its related supplier. Of course, rules for grouping of transactions are provided with respect to application of marginal costing rules.

4. Paragraph (d) sets forth a limitation on DISC income (the "no loss" rule). A similar limitation appears at § 1.994-1(e)(1) with respect to the application of the general intercompany pricing rules.

5. Paragraph (e) illustrates the various rules of the marginal costing section through a series of examples.

Where these regulations under section 994 refer to regulations under section 993 of the Code, the reference is intended to refer to such regulations as will be finally adopted. This procedure is being followed because of the need for immediate guidance with respect to the provisions contained in this Treasury decision. Proposed regulations corresponding to a reference to regulations under section 993, which can be used for informational purposes, have been published with a notice of proposed rule making in the FEDERAL REGISTER for Wednesday, October 4, 1972 (37 F.R. 20853). Section 1.993-1(l)(1) of such regulations was amended by a further notice of proposed rule making published in the FEDERAL REGISTER for Friday, March 9, 1973 (38 F.R. 6395). In addition, new proposed regulations under § 1.861-8, which can be used for informational purposes, have been published with a notice of proposed rule making in the FEDERAL REGISTER for Monday, June 18, 1973 (38 F.R. 15840).

Adoption of amendments to the regulations. On Thursday, September 21, 1972, and Wednesday, December 20, 1972, notices of proposed rule making were published in the FEDERAL REGISTER (37 F.R. 19625 and 37 F.R. 28065, respectively) in order to conform the Income Tax Regulations (26 CFR Part 1) to section 994 of the Internal Revenue Code of 1954. After consideration of all such relevant matters as were presented by interested persons regarding the rules proposed, the amendment of the regulations as proposed in both such notices is hereby adopted, subject to the changes set forth below, except that paragraph (e) (3) and (5) of § 1.994-1 are withdrawn and proposed regulations in lieu thereof are published elsewhere in today's FEDERAL REGISTER:

PARAGRAPH 1. Section 1.994-1, as set forth in the appendix to the notice of proposed rule making appearing in the FEDERAL REGISTER for Thursday, September 21, 1972 (37 F.R. 19625) and as revised by amendment set forth in paragraph 1 of the appendix to the notice of proposed rule making appearing in the FEDERAL REGISTER for Wednesday, December 20, 1972 (37 F.R. 28065), is amended by—

1. Revising paragraph (a) by adding a sentence at the end of paragraph (a) (1) and revising paragraph (a) (3),
2. Revising paragraph (b) (1), (2), and (4),
3. Revising paragraph (c),
4. Revising paragraph (d),
5. Revising paragraph (e) (1) (ii), adding a sentence at the end of paragraph (e) (1) (iii), revising paragraph (e) (2), reserving paragraph (e) (3), adding a sentence at the end of paragraph (e) (4), and by reserving paragraph (e) (5) and (6),
6. Revising paragraph (f) (1), (2), (3), (4) (i), (iv), and (v), (5), and (7) (ii), (iii), and (v), adding a new paragraph (f) (7) (vi), and revising paragraph (f) (4), and
7. Revising paragraph (g) by revising examples (3), (4), and (5) and by adding additional material at the end of example (6).

PAR. 2. Section 1.994-2, as set forth in paragraph 2 of the appendix to the notice of proposed rule making appearing in the FEDERAL REGISTER for Wednesday, December 20, 1972 (37 F.R. 28065), is amended by revising paragraph (a), paragraph (b) (2), and paragraph (c) (2) (i) (a) and (iii) and (3) (ii).

(Sec. 7805, Internal Revenue Code of 1954; 68A Stat. 917; 26 U.S.C. 7805)

[SEAL] DONALD C. ALEXANDER,
Commissioner of Internal Revenue.

Approved: June 20, 1975.

FREDERIC W. HICKMAN,
Assistant Secretary
of the Treasury.

In order to conform the Income Tax Regulations (26 CFR Part 1) to section 994 of the Internal Revenue Code of 1954, as added by section 501 of the Revenue Act of 1971 (85 Stat. 543), such regulations are amended by adding the following new sections immediately after § 1.992-4. The amendments in general are effective for taxable years ending after December 31, 1971.

§ 1.994 Statutory provisions; inter-company pricing rules.

SEC. 994. Intercompany pricing rules—
(a) *In general.* In the case of a sale of export property to a DISC by a person described in section 482, the taxable income of such DISC and such person shall be based upon a transfer price which would allow such DISC to derive taxable income attributable to such sale (regardless of the sales price actually charged) in an amount which does not exceed the greatest of—

- (1) 4 percent of the qualified export receipts on the sale of such property by the DISC plus 10 percent of the export promotion expenses of such DISC attributable to such receipts,
- (2) 50 percent of the combined taxable income of such DISC and such person which is attributable to the qualified export receipts on such property derived as the result of a sale by the DISC plus 10 percent of the export promotion expenses of such DISC attributable to such receipts, or
- (3) Taxable income based upon the sale price actually charged (but subject to the rules provided in section 482).

(b) *Rules for commissions, rentals, and marginal costing.* The Secretary or his dele-

gate shall prescribe regulations setting forth—

(1) Rules which are consistent with the rules set forth in subsection (a) for the application of this section in the case of commissions, rentals, and other income, and

(2) Rules for the allocation of expenditures in computing combined taxable income under subsection (a) (2) in those cases where a DISC is seeking to establish or maintain a market for export property.

(c) *Export promotion expenses.* For purposes of this section, the term "export promotion expenses" means those expenses incurred to advance the distribution or sale of export property for use, consumption, or distribution outside of the United States, but does not include income taxes. Such expenses shall also include freight expenses to the extent of 50 percent of the cost of shipping export property aboard airplanes owned and operated by U.S. persons or ships documented under the laws of the United States in those cases where law or regulations does not require that such property be shipped aboard such airplanes or ships.

[Sec. 994 as added by sec. 501, Rev. Act 1971 (85 Stat. 543)]

§ 1.994-1 Inter-company pricing rules for DISC's.

(a) *In general—*(1) *Scope.* In the case of a transaction described in paragraph (b) of this section, section 994 permits a person related to a DISC to determine the allowable transfer price charged the DISC (or commission paid the DISC) by its choice of three methods described in paragraph (c) (2), (3), and (4) of this section: The "4 percent" gross receipts method, the "50-50" combined taxable income method, and the section 482 method. Under the first two methods, the DISC is entitled to 10 percent of its export promotion expenses as additional taxable income. When the gross receipts method or combined taxable income method is applied to a transaction, the Commissioner may not make distributions, apportionments, or allocations as provided by section 482 and the regulations thereunder. For rules as to certain "incomplete transactions" and for computing combined taxable income, see paragraph (c) (5) and (6) of this section. Grouping of transactions for purposes of applying the method chosen is provided by paragraph (c) (7) of this section. The rules in paragraph (c) of this section are directly applicable only in the case of sales or exchanges of export property to a DISC for resale, and are applicable by analogy to leases, commissions, and services as provided in paragraph (d) of this section. For rules limiting the application of the gross receipts method and combined taxable income method so that the supplier related to the DISC will not incur a loss on transactions, see paragraph (e) (1) of this section. Paragraph (e) (2) of this section provides for the applicability of section 482 to resales by the DISC to related persons. Paragraph (e) (3) of this section provides for the time by which a reasonable estimate of the transfer price (including commissions and other payments) should be paid. The subsequent determination and further adjustments to transfer prices are set forth in paragraph (e) (4) of this section. Export pro-

motion expenses are defined in paragraph (f) of this section. Paragraph (g) of this section has several examples illustrating the provisions of this section. Section 1.994-2 prescribes the marginal costing rules authorized by section 994 (b) (2).

(2) *Relationship to section 993.* If the minimum requirements of paragraph (1) of § 1.993-1 that must be met for a DISC to be subject to section 994 have been satisfied, the application of section 994 (a) (1) or (2) does not depend on the extent to which the DISC performs substantial economic functions, except with respect to export promotion expenses.

(3) *Related party and related supplier.* For the purposes of this section—

(i) The term "related party" means a person which is owned or controlled directly or indirectly by the same interests as the DISC within the meaning of section 482 and § 1.482-1(a).

(ii) The term "related supplier" means a related party which singly engages in a transaction directly with the DISC which is subject to the rules of section 994 and this section. However, a DISC may have different related suppliers with respect to different transactions. If, for example, X owns all the stock of Y, a corporation, and of Z, a DISC, and sells a product to Y which is resold to Z, only Y is the related supplier of Z, and, thus, only the resale from Y to Z is subject to section 994 and this section. If, however, X sells directly to Z and Y also sells directly to Z, then, as to the transactions involving direct sales to Z, each of X and Y is a related supplier of Z.

(b) *Transactions to which section 994 applies.* Section 994(a)(3) may be applied, as described in paragraph (a) of this section, to any transaction between a related supplier and a DISC. Section 994(a)(1) or (2) may be applied, as described in paragraph (a) of this section, to a transaction between a related supplier and a DISC only in the following cases:

(1) Where the related supplier sells export property to the DISC for resale or where the DISC is commission agent for the related supplier on sales by the related supplier of export property to third parties whether or not related parties. For purposes of this section, references to sales include exchanges.

(2) Where the related supplier leases export property to the DISC for sublease for a comparable period with comparable terms of payment or where the DISC is commission agent for the related supplier on leases by the related supplier of export property to third parties whether or not related parties.

(3) Where services are furnished by a related supplier which are related and subsidiary to any sale or lease by the DISC, acting as principal or commission agent, of export property under subparagraph (1) or (2) of this paragraph.

(4) Where engineering or architectural services for construction projects located (or proposed for location) outside of the United States are furnished by a related supplier where the DISC is acting as principal or commission agent

with respect to the furnishing of such services to a third party whether or not a related party.

(5) Where the related supplier furnishes managerial services in furtherance of the production of qualified export receipts of an unrelated DISC where the related DISC is acting as principal or commission agent with respect to the furnishing of such services to an unrelated DISC.

Transactions are included, for purposes of this paragraph, only if they give rise to qualified export receipts (within the meaning of section 993(a)) in the hands of the related DISC. If a transaction is not included in subparagraph (1), (2), (3), (4), or (5) of this paragraph, the rules of section 994(a)(1) or (2) do not apply. Thus, for example, the rules of section 994(a)(1) or (2) would not apply if a DISC purchased export property from its related supplier and leased such property to a third party.

(c) *Transfer price for sales of export property.* (1) *In general.* Under this paragraph, rules are prescribed for computing the allowable price for a transfer from a related supplier to a DISC in the case of a sale of export property described in paragraph (b)(1) of this section.

(2) *The "4-percent" gross receipts method.* Under the gross receipts method of pricing, the transfer price for a sale by the related supplier to the DISC is the price as a result of which the taxable income derived by the DISC from the sale will not exceed the sum of (i) 4 percent of the qualified export receipts of the DISC derived from the sale of the export property (as defined in section 993 (c)) and (ii) 10 percent of the export promotion expenses (as defined in paragraph (f) of this section) of the DISC attributable to such qualified export receipts.

(3) *The "50-50" combined taxable income method.* Under the combined taxable income method of pricing, the transfer price for a sale by the related supplier to the DISC is the price as a result of which the taxable income derived by the DISC from the sale will not exceed the sum of (i) 50 percent of the combined taxable income (as defined in subparagraph (6) of this paragraph) of the DISC and its related supplier attributable to the qualified export receipts from such sale and (ii) 10 percent of the export promotion expenses (as defined in paragraph (f) of this section) of the DISC attributable to such qualified export receipts.

(4) *Section 482 method.* If the rules of subparagraphs (2) and (3) of this paragraph are inapplicable to a sale or a taxpayer does not choose to use them, the transfer price for a sale by the related supplier to the DISC is to be determined on the basis of the sale price actually charged but subject to the rules provided by section 482 and the regulations thereunder.

(5) *Incomplete transactions.* (i) For purposes of the gross receipts and combined taxable income methods, where property (encompassed within a trans-

action or group chosen under subparagraph (7) of this paragraph) is transferred by a related supplier to a DISC during a taxable year of either the DISC or related supplier, but some or all of such property is not sold by the DISC during such year—

(a) The transfer price of such property sold by the DISC during such year shall be computed separately from the transfer price of the property not sold by the DISC during such year.

(b) With respect to such property not sold by the DISC during such year, the transfer price paid by the DISC for such year shall be the related supplier's cost of goods sold (see subparagraph (6) (ii) of this paragraph) with respect to the property, except that, with respect to such taxable years ending on or before August 15, 1975, the transfer price paid by the DISC shall be at least (but need not exceed) the related supplier's cost of goods sold with respect to the property.

(c) For the subsequent taxable year during which such property is resold by the DISC, an additional amount shall be paid by the DISC (to be treated as income for such year by the related supplier) equal to the excess of the amount which would have been the transfer price under this section had the transfer to the DISC by the related supplier and the resale by the DISC taken place during the taxable year of the DISC during which it resold the property over the amount already paid under (b) of this subdivision.

(d) The time and manner of payment of transfer prices required by (b) and (c) of this subdivision shall be determined under paragraph (e) (3), (4), and (5) of this section.

(ii) For purposes of this paragraph, a DISC may determine the year in which it receives property from a related supplier and the year in which it sells property in accordance with the method of identifying goods in its inventory properly used under section 471 or 472 (relating respectively to general rule for inventories and to LIFO inventories). Transportation expense of the related supplier in connection with a transaction to which this subparagraph applies shall be treated as an item of cost of goods sold with respect to the property if the related supplier includes the cost of intracompany transportation between its branches, divisions, plants, or other units in its cost of goods sold (see subparagraph (6) (ii) of this paragraph).

(6) *Combined taxable income.* For purposes of this section, the combined taxable income of a DISC and its related supplier from a sale of export property is the excess of the gross receipts (as defined in section 993(f)) of the DISC from such sale over the total costs of the DISC and related supplier which relate to such gross receipts. Gross receipts from a sale do not include interest with respect to the sale. Combined taxable income under this paragraph shall be determined after taking into account under paragraph (e) (2) of this section all adjustments required by section 482 with respect to transactions to which such sec-

tion is applicable. In determining the gross receipts of the DISC and the total costs of the DISC and related supplier which relate to such gross receipts, the following rules shall be applied:

(i) Subject to subdivisions (ii) through (v) of this subparagraph, the taxpayer's method of accounting used in computing taxable income will be accepted for purposes of determining amounts and the taxable year for which items of income and expense (including depreciation) are taken into account. See § 1.991-1(b)(2) with respect to the method of accounting which may be used by a DISC.

(ii) Cost of goods sold shall be determined in accordance with the provisions of § 1.61-3. See sections 471 and 472 and the regulations thereunder with respect to inventories. With respect to property to which an election under section 631 applies (relating to cutting of timber considered as a sale or exchange), cost of goods sold shall be determined by applying § 1.631-1 (d) (3) and (e) (relating to fair market value as of the beginning of the taxable year of the standing timber cut during the year considered as its cost).

(iii) Costs (other than cost of goods sold) which shall be treated as relating to gross receipts from sales of export property are (a) the expenses, losses, and other deductions definitely related, and therefore allocated and apportioned, thereto, and (b) a ratable part of any other expenses, losses, or other deductions which are not definitely related to a class of gross income, determined in a manner consistent with the rules set forth in § 1.861-8.

(iv) The taxpayer's choice in accordance with subparagraph (7) of this paragraph as to the grouping of transactions shall be controlling, and costs deductible in a taxable year shall be allocated and apportioned to the items or classes of gross income of such taxable year resulting from such grouping.

(v) [Reserved]

(7) *Grouping transactions.* (i) Generally, the determinations under this section are to be made on a transaction-by-transaction basis. However, at the annual choice of the taxpayer some or all of these determinations may be made on the basis of groups consisting of products or product lines.

(ii) A determination by a taxpayer as to a product or a product line will be accepted by a district director if such determination conforms to any one of the following standards: (a) A recognized industry or trade usage, or (b) the 2-digit major groups (or any inferior classifications or combinations thereof, within a major group) of the Standard Industrial Classification as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President.

(iii) A choice by the taxpayer to group transactions for a taxable year on a product or product line basis shall apply to all transactions with respect to that product or product line consummated during the taxable year. However, the choice of a product or product line

grouping applies only to transactions covered by the grouping and, as to transactions not encompassed by the grouping, the determinations are made on a transaction-by-transaction basis. For example, the taxpayer may choose a product grouping with respect to one product and use the transaction-by-transaction method for another product within the same taxable year.

(iv) For rules as to grouping certain related and subsidiary services, see paragraph (d) (3) (ii) of this section.

(d) *Rules under section 994(a) (1) and (2) for transactions other than sales.* The following rules are prescribed for purposes of applying the gross receipts method or combined taxable income method to transactions other than sales:

(i) *Leases.* In the case of a lease of export property by a related supplier to a DISC for sublease by the DISC to produce gross receipts, for any taxable year the amount of rent the DISC must pay to the related supplier shall be determined under the DISC's lease with its related supplier but must be computed in a manner consistent with the rules in paragraph (c) of this section for computing the transfer price in the case of sales and resales of export property under the gross receipts method or combined taxable income method. For purposes of applying this subparagraph, transactions may not be so grouped on a product or product line basis under the rules of paragraph (c) (7) of this section as to combine in any one group of transactions both lease transactions and sale transactions involving the same product or product line.

(2) *Commissions.* If any transaction to which section 994 applies is handled on a commission basis for a related supplier by a DISC and such commissions give rise to qualified export receipts under section 993(a) —

(i) The amount of the income that may be earned by the DISC in any year is the amount, computed in a manner consistent with paragraph (c) of this section, which the DISC would have been permitted to earn under the gross receipts method, the combined taxable income method, or section 482 method if the related supplier had sold (or leased) the property or service to the DISC and the DISC in turn sold (or subleased) to a third party, whether or not a related party, and

(ii) The maximum commission the DISC may charge the related supplier is the sum of the amount of income determined under subdivision (i) of this subparagraph plus the DISC's total costs for the transaction as determined under paragraph (c) (6) of this section.

(3) *Receipts from services.* (i) *Related and subsidiary services attributable to the year of the export transaction.* The gross receipts for related and subsidiary services described in paragraph (b) (3) of this section shall be treated as part of the receipts from the export transaction to which such services are related and subsidiary, but only if, under the arrangement between the DISC and its related supplier and the accounting

method otherwise employed by the DISC, the income from such services is includible for the same taxable year as income from such export transaction.

(ii) *Other services.* In the case of related and subsidiary services to which subdivision (i) of this subparagraph does not apply and other services described in paragraph (b) (4) or (5) of this section performed by a related supplier (relating respectively to engineering and architectural services and certain managerial services), the amount of taxable income which the DISC may derive for any taxable year shall be determined under the arrangement between the DISC and its related supplier and shall be computed in a manner consistent with the rules in paragraph (c) of this section for computing the transfer price in the case of sales for resale of export property under the gross receipts method or combined taxable income method. Related and subsidiary services to which subdivision (i) of this subparagraph does not apply may be grouped, under the rules for grouping of transactions in paragraph (c) (7) of this section, with the products or product lines to which they are related and subsidiary, so long as the grouping of services chosen is consistent with the grouping of products or product lines chosen for the taxable year in which either the products or product lines were sold or in which payment for such services is received or accrued. The rules for grouping of transactions in paragraph (c) (7) of this section shall not apply with respect to the determination of taxable income which the DISC may derive from other services described in paragraph (b) (4) or (5) of this section performed by a related supplier or commissions on such services, and such determination shall be made only on a transaction-by-transaction basis.

(e) *Methods of applying paragraphs (c) and (d) of this section.* (1) *Limitation on DISC income ("no loss" rule).*—

(i) *In general.* Except as otherwise provided in this subparagraph, neither the gross receipts method nor the combined taxable income method may be applied to cause in any taxable year a loss to the related supplier, but either method may be applied to the extent it does not cause a loss. A loss to a related supplier would result if the taxable income of the DISC would exceed the combined taxable income of the related supplier and the DISC. If, however, there is no combined taxable income of the DISC and the related supplier (because, for example, a combined loss is incurred), a transfer price (or commission) will not be deemed to cause a loss to the related supplier if it allows the DISC to recover an amount not in excess of its costs (if any).

(ii) *Special rule for applying "4 percent" gross receipts method to sales.* A transfer price or commission, determined under the "4 percent" gross receipts method (determined without regard to subdivision (i) of this subparagraph), for a sale of export property referred to in paragraph (b) (1) of this section, will not be considered to cause a loss for the related supplier if for the

DISC's taxable year, the ratio that (a) the taxable income of the DISC derived from such sale by using such price or commission bears to (b) the DISC's gross receipts from such sale is not greater than the ratio that (c) all of the taxable income of the related supplier and the DISC from all sales of the same product or product line (domestic and foreign) to third parties whether or not related parties bears to (d) the total gross receipts of the related supplier and the DISC from such sales. For purposes of the preceding sentence, sales between the DISC and its related suppliers shall not be taken into account under (c) or (d) of this subdivision. For example, assume that for a taxable year of a DISC the total costs of the related supplier and the DISC with respect to all sales (\$150 for domestic and \$44 for foreign) of a product line are \$194 and the total gross receipts of the related supplier and the DISC with respect to such sales are \$200 so that the total taxable income of the related supplier and the DISC with respect to such sales is \$6. The parties would thus be entitled to compute a transfer price determined under the gross receipts method on any given sale of product A of such product line by the related supplier to the DISC which would allocate to the DISC taxable income equal to not more than 3 percent (i.e., \$6/\$200) of its gross receipts derived from its resale of such product. If the DISC were to resell an item of product A for \$10, the transfer price paid by the DISC to the related supplier determined under the gross receipts method could be as low as \$9.70.

(iii) *Grouping transactions.* For purposes of subdivision (i) of this subparagraph, the basis for grouping transactions chosen by the taxpayer under paragraph (c) (7) of this section for the taxable year shall be applied. For purposes of making the computations of subdivision (ii) (c) and (d) of this subparagraph, however, the taxpayer may choose any basis for grouping transactions permissible under paragraph (c) (7) of this section, even though it may not be the same basis as that already chosen under paragraph (c) (7) of this section for computing transfer prices or commissions to a DISC. If, for example, the taxpayer has chosen to group transactions on a product basis for computing transfer prices or commissions to a DISC for a taxable year, the taxpayer may still group transactions on a product line basis for purposes of computing taxable income and total gross receipts under subdivision (ii) (c) and (d) of this subparagraph. For a further example, if the taxpayer computes taxable income for one group of transactions under the gross receipts method and computes taxable income for a second group of transactions under the combined taxable income method, the taxpayer may aggregate these transactions for purposes of computing taxable income and total gross receipts under subdivision (ii) (c) and (d) of this subparagraph.

(2) *Relationship to section 482.* In applying the rules under section 994, it may be necessary to first take into account the price of a transfer (or other transaction) between the DISC (or related supplier) and a related party which is subject to the arm's length standard of section 482. Thus, for example, where a related supplier sells export property to a DISC which the related supplier purchased from related parties, the costs taken into account in computing the combined taxable income of the DISC and the related supplier are determined after any necessary adjustment under section 482 of the price paid by the related supplier to the related parties. In applying section 482 to a transfer by a DISC, however, the DISC and its related supplier are treated as if they were a single entity carrying on all the functions performed by the DISC and the related supplier with respect to the transaction and the DISC shall be allowed to receive under the section 482 standard the amount the related supplier would have received had there been no DISC.

(3) [Reserved]

(4) *Subsequent determination of transfer price or commission.* The DISC and its related supplier would ordinarily determine under section 994 and this section the transfer price payable by the DISC (or the commission payable to the DISC) for a transaction before the DISC files its return for the taxable year of the transaction. After the DISC has filed its return, a redetermination of the transfer price (or commission) may only be made if permitted by the Code and the regulations thereunder. Such a redetermination would include a redetermination by reason of an adjustment under section 482 which affects the amounts which entered into the determination of the transfer price or commission.

(5) [Reserved]

(6) [Reserved]

(f) *Export promotion expenses.*—(1) *Purpose of expense.* (i) In order for an expense or cost of a type described in subparagraph (2) of this paragraph to be an export promotion expense, the expense or cost must be incurred or treated as incurred by the DISC (under subparagraph (7) of this paragraph) to advance the sale, lease, or other distribution of export property for use, consumption, or distribution outside the United States. Costs of services in performing installation (but not assembly) on the site and for meeting warranty commitments if such services are related and subsidiary (within the meaning of § 1.993-1(d)) to any qualified sale, lease, or other distribution of export property by the DISC (or with respect to which the DISC received a commission) will be considered to advance the sale, lease, or other distribution of export property. General and administrative expenses attributable to billing customers, other clerical functions of the DISC, or generally operating the DISC, will also be considered to advance the sale, lease, or other distribution of export property.

(ii) Where an expense or cost incurred

or treated as incurred by the DISC qualifies only in part as an export promotion expense, such expense or cost must be allocated between the qualified portion and such other portion on a reasonable basis. See § 1.994-2(b) (2) for the option of the related supplier not to claim expenses as export promotion expenses.

(2) *Types of expenses.* The only expenses or costs which may be export promotion expenses are those expenses or costs meeting the test of subparagraph (1) of this paragraph which constitute—

(i) Ordinary and necessary expenses of the DISC paid or incurred during the DISC's taxable year in carrying on any trade or business, allowable as deductions under section 162, such as expenses for market studies, advertising, salaries and wages (including contributions or compensations deductible under section 404) of sales, clerical, and other personnel, rentals on property, sales commissions, warehousing, and other selling expenses;

(ii) A reasonable allowance under section 167 for exhaustion, wear and tear, or obsolescence of the property of the DISC;

(iii) Costs of freight (subject to the limitations of subparagraph (4) of this paragraph);

(iv) Costs of packaging for export (as defined in subparagraph (5) of this paragraph); or

(v) Costs of designing and labeling packages exclusively for export markets (under subparagraph (6) of this paragraph).

(3) *Ineligible expenses.* Items ineligible to be export promotion expenses include, for example, interest expenses, bad debt expenses, freight insurance, State and local income and franchise taxes, the cost of manufacture or assembly operations, and items of cost of goods sold (except as otherwise provided in this paragraph in the case of certain freight, packaging, and designing and labeling expenses). Income or similar taxes eligible for a foreign tax credit under sections 901 and 903 are also not eligible to be export promotion expenses.

(4) *Freight expenses.*—(i) *In general.* Export promotion expenses include one-half of the freight expense (not including insurance) for shipping export property aboard a U.S.-flag carrier in those cases where law or regulation of the United States or of any State or political subdivision thereof or of any agency or instrumentality of any of these does not require that the export property be shipped aboard a U.S.-flag carrier. For purposes of this paragraph, the term "freight expense" includes charges paid for c.o.d. service, miscellaneous ground charges, such as charges incurred for services normally performed by U.S.-flag carriers, charges for services of loading aboard U.S.-flag carriers normally performed by such carriers, freight forwarders, or independent contractors engaged in loading property, and charges attributable to a freight consolidation function normally performed by freight forwarders. In order for one-half of

freight expenses paid to the owner (or the agent of the owner) of a U.S.-flag carrier to be claimed as an export promotion expense, the DISC must obtain a written statement (such as, for example, a bill of lading) from the owner (or the agent) disclosing that the export property was shipped aboard the owner's U.S.-flag carrier or another U.S.-flag carrier, and the DISC must have no reasonable basis for disbelieving such statement of the owner (or the agent). For the requirement of a written statement from a freight forwarder, see subdivision (iv) of this subparagraph.

(ii) *U.S.-flag carrier defined.* For purposes of this paragraph, the term "U.S.-flag carrier" is an airplane owned and operated by a U.S. person or persons (as defined in section 7701(a)(30)) or a ship documented under the laws of the United States. Shipment initiated by delivery to the U.S. Postal Service shall be considered shipment aboard a U.S.-flag carrier, but not if shipped to a place to which mail shipments from the United States are ordinarily accomplished by land transportation, such as to Canada or Mexico, unless airmail is specified.

(iii) *Shipment pursuant to law or regulation.* Shipment pursuant to law or regulation includes instances where a U.S.-flag carrier must be used in order to obtain permission from the Government to make the export. If the law or regulation requires a fixed portion of the export property to be shipped aboard a U.S.-flag carrier, the freight expense on that portion of such export property that was so shipped in order to satisfy such requirement cannot qualify as an export promotion expense.

(iv) *Freight forwarders.* A payment to a freight forwarder shall be considered freight expense within the meaning of this paragraph to the extent the forwarder utilizes a U.S.-flag carrier. For purposes of this paragraph, the term "freight forwarder" includes air freight consolidators and carriers owned and operated by U.S. persons utilizing U.S.-flag carriers such as non-vessel-owning common carriers. In order for one-half of freight expenses paid to a freight forwarder to be claimed as export promotion expenses, the DISC must obtain a written statement (such as, for example, a bill of lading) from the freight forwarder disclosing that the export property was shipped aboard a U.S.-flag carrier, and the DISC must have no reasonable basis for disbelieving such statement of the freight forwarder.

(v) *Freight within the United States.* A DISC may not claim as export promotion expense any amount that is attributable to carriage of export property between points within the United States. If, however, export property is carried from the United States to a foreign country on a through shipment pursuant to a single bill of lading or similar document aboard one or more U.S.-flag carriers, the freight expense of such carriage shall not be apportioned between the domestic and foreign portions of such carriage, even though a carrier may stop en route within the United States or the

export property may be shifted from one carrier to another, and one-half of such freight expense may be claimed as an export promotion expense. Freight expense does not include the cost of transporting the export property to the depot of the U.S.-flag carrier or freight forwarder for shipment abroad. The expense of shipment of export property initiated by delivery to the U.S. Postal Service for ultimate delivery outside the United States shall be considered as attributable entirely to carriage of such property outside the United States.

(5) *Packaging for export.* (i) Export promotion expenses include the direct and indirect cost of packaging export property (including the cost of the package) for export whether or not the packaging is the same as domestic packaging. Such packaging costs do not include costs of manufacturing (as defined in the regulations under section 993) and assembly. Thus, if a DISC buys and packages export property for resale, its costs of packaging the export property are export promotion expenses. If, however, the process of such packaging by the DISC is physically integrated with the process of manufacturing the export property by the related supplier, the costs of such packaging are not export promotion expenses.

(ii) The cost of containers leased from a shipping company to which the DISC also pays freight for the property packaged is not a cost of packaging. However, in such circumstances, one-half of the rental charge may be allowable as a freight expense if permitted under subparagraph (4) of this paragraph.

(6) *Designing and labeling packages.* Export promotion expenses include the direct and indirect costs of designing and labeling packages, including bottles, cans, jars, boxes, cartons, or containers, to the extent incurred for export markets. Thus, for example, to the extent incurred for supplying export markets, the cost of designing labels in a foreign language and the cost of printing such labels are export promotion expenses.

(7) *DISC must incur export promotion expenses—(i) In general.* In order for an expense to be an export promotion expense it must be incurred or treated as incurred under this subparagraph by the DISC. For example, an expense is incurred by a DISC if the expense results from (a) the DISC incurring an obligation to pay compensation to its employees, (b) depreciation of property owned by the DISC and used by its employees, (c) the DISC incurring an obligation to pay for office supplies used by its employees, (d) the DISC incurring an obligation to pay space costs for use by its employees, or (e) the DISC incurring an obligation to pay other costs supporting efforts by its employees.

(ii) *Payments to independent contractors.* A payment to an independent contractor, directly or indirectly, is treated as incurred by the DISC if the cost of performing the function performed by the independent contractor would be considered an export promotion expense described in subparagraphs

(1) and (2) of this paragraph if performed by the DISC, and if, in a case where the services of the independent contractor were engaged by a party related to the DISC, such related party and such DISC agreed in writing before the contract was entered into that a specified portion or all of the contract was for the benefit of the DISC and that all of the expenses of the contract (eligible to be considered as export promotion expenses) with respect to such portion would be borne by the DISC.

(iii) *Expenses incurred by related parties.* Reimbursements or other payments by a DISC to a related party are export promotion expenses only if the expenses of the related party for which reimbursement is made are for space in a building actually used by employees of the DISC or for export property owned by the DISC. Except as otherwise provided in the preceding sentence, expenses incurred by a foreign international sales corporation (FISC) or a real property holding company (as defined in section 993(e)(1) and (2), respectively) shall not be treated as export promotion expenses of its DISC.

(iv) *Selling commissions paid by a DISC.* A commission paid by a DISC to a person other than a related person, with respect to a transaction which gives rise to qualified export receipts of the DISC, is an export promotion expense of the DISC. A commission paid by a DISC to a related person is not an export promotion expense.

(v) *Sales of promotional material.* If a DISC sells promotional material to a buyer of export property from the DISC at a price which is greater than the costs of the DISC for such material, such costs are not export promotion expenses. If, however, the DISC sells promotional material at a price which is less than its costs for such material, the excess of such costs over such price is an export promotion expense. For rules relating to the status of promotional material as qualified export assets and export property, see § 1.993-2 and § 1.993-3, respectively.

(vi) An expense may be incurred by the DISC under subdivisions (i) through (v) of this subparagraph even if the accounting for and payment of such expense is handled by a related party and the DISC reimburses the related party for such expenses.

(8) *Incomplete transactions.* Expenses eligible to be treated as export promotion expenses which are attributable to the sale, lease, or other distribution of export property and which are incurred prior to the taxable year of sale, lease, or other distribution by the DISC are not treated as export promotion expenses until the taxable year of sale, lease, or other distribution or until the taxable year in which it is first determined that no transaction is reasonably expected to result from the expense incurred (whether or not a transaction subsequently results). Thus, for example, if a DISC incurs a packaging cost which is otherwise eligible to be treated as an export promotion expense, the DISC may not include such charge as an export promo-

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tion expense until the year in which the export property with respect to which the packaging cost was incurred is actually sold by the DISC. If no transaction is reasonably expected to result from the packaging cost, such cost should be al-

located as an export promotion expense to the group of transactions to which such cost is most closely related.

(g) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). J and K are calendar year taxpayers. J, a domestic manufacturing company, owns all the stock of K, a DISC for the taxable year. During 1972, J manufactures only 100 units of a product (which is eligible to be export property as defined in section 993(c)). J enters into a written agreement with K whereby K is granted a sales franchise with respect to exporting such property and K will receive commissions with respect to such exports equal to the maximum amount permitted to be received under the intercompany pricing rules of section 994. Thereafter, the 100 units are sold for \$1,000. J's cost of goods sold attributable to the 100 units is \$650. J's direct selling expenses so attributable are \$100. Although J has other deductible expenses, for purposes of this example assume that J has no other deductible expenses. K pays \$230 to independent contractors which qualify as export promotion expenses under paragraph (f) (7) (ii) of this section. K does not perform functions substantial enough to entitle it to an allocation of income which meets the arm's length standard of section 482. The income which K may earn under section 994 under the franchise is \$20, computed as follows:

(1) Combined taxable income:	
(a) K's sales price	\$1,000
(b) Less deductions:	
J's cost of goods sold	\$650
J's direct selling expenses	100
K's export promotion expenses	230
Total deductions	980
(c) Combined taxable income	20
(2) K's profit under combined taxable income method (before application of loss limitation):	
(a) 50 percent of combined taxable income	10
(b) Plus: 10 percent of K's export promotion expenses (10% of \$230)	23
(c) K's profit	33
(3) K's profit under gross receipts method (before application of loss limitation):	
(a) 4 percent of K's sales price (4% of \$1,000)	40
(b) Plus: 10 percent of K's export promotion expenses (10% of \$230)	23
(c) K's profit	63

Since combined taxable income (\$20) is lower than both K's profit under the combined taxable income method (\$33) and under the gross receipts method (\$63), the maximum income K may earn is \$20. Accordingly, the commissions K may receive from J are \$20, i.e., K's expenses (\$230) plus K's profit (\$20).

Example (2). M and N are calendar year taxpayers. M, a domestic manufacturing company, owns all the stock of N, a DISC for the taxable year. During 1972, M produces and sells a particular product line of export property to N for \$75, a price which can be justified as satisfying the standard of arm's length price of section 482. N performs substantial functions with respect to the transaction and resells the export property for \$100. M's cost of goods sold attributable to the export property is \$60. M's direct selling expenses so attributable (relating to advertising of the product line in foreign markets) are \$12. Although M has other deductible expenses, for purposes of this example, assume that M has no other deductible expenses. N's expenses attributable to resale of the export property are \$22 of which \$20 are export promotion expenses. The maximum profit which N may earn with respect to the product line is \$6, computed as follows:

(1) Combined taxable income:	
(a) N's sales price	\$100
(b) Less deductions:	
M's cost of goods sold	\$60
M's direct selling expenses	12
N's expenses	22
Total deductions	94
(c) Combined taxable income	6
(2) N's profit under combined taxable income method (before application of loss limitation):	
(a) 50 percent of combined taxable income	3
(b) Plus: 10 percent of N's export promotion expenses (10% of \$20)	2
(c) N's profit	5
(3) N's profit under gross receipts method (before application of loss limitation):	
(a) 4 percent of N's sales price (4% of \$100)	4
(b) Plus: 10 percent of N's export promotion expenses (10% of \$20)	2
(c) N's profit	6

(4) N's profit under section 482 method:

(a) N's sales price.....	100
(b) Less deductions:	
N's cost of goods sold (price paid by N to M).....	75
N's expenses.....	22
Total deductions.....	97
(c) N's profit.....	3

Since the gross receipts method results in greater profit to N (\$6) than does the combined taxable income method (\$5) or section 482 method (\$3), and does not exceed combined taxable income (\$6), N may earn a maximum profit of \$6. Accordingly, the transfer price from M to N may be readjusted as long as the transfer price is not readjusted below \$72, computed as follows:

(5) Transfer price from M to N:

(a) N's sales price.....	\$100
(b) Less:	
N's expenses.....	22
N's profit.....	6
Total subtractions.....	28
(c) Transfer price.....	72

Example (3). Q and R are calendar year taxpayers. Q, a domestic manufacturing company, owns all the stock of R, a DISC for the taxable year. During 1972, Q produces and sells a product line of export property to R for \$170, a price which can be justified as satisfying the standards of arm's length price of section 482, and R resells the export property for \$200. Q's cost of goods sold attributable to the export property is \$115 so that the combined gross income from the sale of the export property is \$85 (i.e., \$200 minus \$115). Q's expenses incurred in connection with the property sold are \$35. Q's deductible overhead and other supportive expenses allocable to all gross income are \$6. Apportionment of these supportive expenses on the basis of gross income does not result in a material distortion of income and is a reasonable method of apportionment. Q's gross income from sources other than the transaction is \$170 making total gross income of Q and R (excluding the transfer price paid by R) \$255 (i.e., \$85 plus \$170). R's expenses attributable to resale of the export property are \$20, all of which are export promotion expenses. The maximum profit which R may earn with respect to the product line is \$16, computed as follows:

(1) Combined taxable income:

(a) R's sales price.....	\$200
(b) Less deductions:	
(i) Q's cost of goods sold.....	115
(ii) Q's expenses incurred in connection with the property sold.....	35
(iii) Apportionment of Q's supportive expenses:	
Q's supportive expenses.....	\$6
Combined gross income from sale of export property.....	85
Total gross income of Q and R.....	255
Apportionment $\frac{6 \times 85}{255}$	2
(iv) R's expenses.....	20
Total deductions.....	172

(c) Combined taxable income..... 28

(2) R's profit under combined taxable income method (before application of loss limitation):

(a) 50 percent of combined taxable income.....	14
(b) Plus: 10 percent of R's export promotion expenses (10% of \$20).....	2
(c) R's profit.....	16

(3) R's profit under gross receipts method (before application of loss limitation):

(a) 4 percent of R's sales price (4% of \$200).....	8
(b) Plus: 10 percent of R's export promotion expenses (10% of \$20).....	2
(c) R's profit.....	10

(4) R's profit under section 482 method:

(a) R's sales price.....	200
(b) Less deductions:	
R's cost of goods sold (price paid by R to Q).....	170
R's expenses.....	20
Total deductions.....	190
(c) R's profit.....	10

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Since the combined taxable income method results in greater profit to R (\$16) than does the gross receipts method (\$10) or section 482 method (\$10), and does not exceed combined taxable income (\$28), R may earn a maximum profit of \$16. Accordingly, the transfer price from Q to R may be readjusted as long as the transfer price is not readjusted below \$164 computed as follows:

(5) Transfer price from Q to R:

(a) R's sales price.....	\$200
(b) Less:	
R's expenses.....	\$20
R's profit.....	16
Total.....	36
(c) Transfer price.....	164

Example (4). S and T are calendar year taxpayers. S, a domestic manufacturing company, owns all the stock of T, a DISC for the taxable year. During 1972, S produces and sells 100 units of a particular product to T under a written agreement which provides that the transfer price between S and T shall be that price which allocates to T the maximum permitted to be received under the intercompany pricing rules of section 994. Thereafter, the 100 units are sold by T for \$950. S's cost of goods sold attributable to the 100 units is \$650. S's other deductible expenses so attributable are \$300. Although S has other deductible expenses, for purposes of this example, assume that S has no deductible expenses not definitely allocable to any item of gross income. T's expenses attributable to the resale of the 100 units are \$50. S chooses not to apply the section 482 method. T may not earn any income under the gross receipts or combined taxable income method with respect to resale of the 100 units because combined taxable income is a negative figure, computed as follows:

(1) Combined taxable income:

(a) T's sales price.....	\$950
(b) Less deductions:	
S's cost of goods sold.....	650
S's expenses.....	300
T's expenses.....	50
Total deductions.....	1,000
(c) Combined taxable income (loss).....	(\$50)

Under paragraph (e)(1)(i) of this section, T is permitted to recover its expenses attributable to the 100 units (\$50) even though such recovery results in a loss or increased loss to the related supplier. Accordingly, the transfer price from S to T may be readjusted as long as the transfer price is not readjusted below \$900, computed as follows:

(2) Transfer price from S to T:

(a) T's sales price.....	\$950
(b) Less: T's expenses.....	50
(c) Transfer price.....	900

Example (5). Assume the same facts as in example (4) except that S chooses to apply the section 482 method and that under arm's length dealings T would have derived \$10 of income. Accordingly, the transfer price from S to T may be set at an amount not less than \$890, computed as follows:

(1) Transfer price from S to T:

(a) T's sales price.....	\$950
(b) Less:	
T's expenses.....	50
T's profit.....	10
Total deductions.....	60
(c) Transfer price.....	890

Example (6). X and Y are calendar year taxpayers. X, a domestic manufacturing company, owns all the stock of Y, a DISC for the taxable year. During March 1972, X manufactures a particular product of export property which it leases on April 1, 1972, to Y for a term of 1 year at a monthly rental of \$1,000, a rent which satisfies the standard of arm's length rental under section 482. Y subleases the product on April 1, 1972, for a term of 1 year at a monthly rental of \$1,200. X's cost for the product leased is \$40,000. X's other deductible expenses attributable to the product are \$900, all of which are incurred in 1972. Although X has other deductible expenses, for purposes of this example, assume that X has no other deductible expenses. Y's expenses attributable to sublease of the export property are \$450, all of which are incurred in 1972 and are export promotion expenses. X depreciates the property on a straight line basis without the use of an averaging convention, assuming a useful life of 8 years and no salvage value. The profit which Y may earn with respect to the transaction is \$3,895 for 1972 and \$1,175 for 1973, computed as follows:

COMPUTATION FOR 1972

(1) Combined taxable income:	
(a) Y's sublease rental receipts for year ($\$1,200 \times 9$ months)	\$10,800
(b) Less deductions:	
X's depreciation ($\$40,000 \times \frac{1}{2} \times \frac{1}{12}$)	3,750
X's other expenses	900
Y's expenses	450
Total deductions	5,100
(c) Combined taxable income	5,700
(2) Y's profit under combined taxable income method (before application of loss limitation):	
(a) 50 percent of combined taxable income	2,850
(b) Plus: 10 percent of Y's export promotion expenses (10% of \$450)	45
(c) Y's profit	2,895
(3) Y's profit under gross receipts method (before application of loss limitation):	
(a) 4 percent of Y's sublease rental receipts for year (4% of \$10,800)	432
(b) Plus: 10 percent of Y's export promotion expenses (10% of \$450)	45
(c) Y's profit	477
(4) Y's profit under section 482 method:	
(a) Y's sublease rental receipts for year	\$10,800
(b) Less deductions:	
Y's lease rental payments for year	9,000
Y's expenses	450
Total deductions	9,450
(c) Y's profit	1,350

Since the combined taxable income method results in greater profit to Y (\$2,895) than does the gross receipts method (\$477) or section 482 method (\$1,350), Y may earn a profit of \$2,895 for 1972. Accordingly, the monthly rental payable by Y to X for 1972 may be readjusted as long as the monthly rental payable is not readjusted below \$828.33, computed as follows:

(5) Monthly rental payable by Y to X for 1972:	
(a) Y's sublease rental receipts for year	\$10,800.00
(b) Less:	
Y's expenses	450.00
Y's profit	2,895.00
Total	3,345.00
(c) Rental payable for 1972	7,455.00
(d) Rental payable each month ($\$7,455 \div 9$ months)	828.33

COMPUTATION FOR 1973

(1) Combined taxable income:	
(a) Y's sublease rental receipts for year ($\$1,200 \times 3$ months)	\$3,600
(b) Less: X's depreciation ($\$40,000 \times \frac{1}{2} \times \frac{1}{12}$)	1,250
(c) Combined taxable income	2,350
(2) Y's profit under combined taxable income method (before application of loss limitation):	
(a) 50 percent of combined taxable income	\$1,175
(b) Y's profit	1,175
(3) Y's profit under gross receipts method (before application of loss limitation):	
(a) 4 percent of Y's sublease rental receipts for year (4% of \$3,600)	144
(b) Y's profit	144
(4) Y's profit under section 482 method:	
(a) Y's sublease rental receipts for year	3,600
(b) Less: Y's lease rental payments for year	3,000
(c) Y's profit	600

Since the combined taxable income method results in greater profit to Y (\$1,175) than does the gross receipts method (\$144) or section 482 method (\$600), Y may earn a profit of \$1,175 for 1973. Accordingly, the monthly rental payable by Y to X for 1973 may be readjusted as long as the monthly rental payable is not readjusted below \$808.33, computed as follows:

(5) Monthly rental payable by Y to X for 1973:	
(a) Y's sublease rental receipts for year	\$3,600.00
(b) Less: Y's profit	1,175.00
(c) Rental payable for 1973	2,425.00
(d) Rental payable for each month (\$2,425 ÷ 3 months)	808.33

§ 1.994-2 Marginal costing rules.

(a) *In general.* This section prescribes the marginal costing rules authorized by section 994(b)(2). If under paragraph (c)(1) of this section a DISC is treated for its taxable year as seeking to establish or maintain a foreign market for sales of an item, product, or product line of export property (as defined in § 1.993-3) from which qualified export receipts are derived, the marginal costing rules prescribed in paragraph (b) of this section may be applied to allocate costs between gross receipts derived from such sales and other gross receipts for purposes of computing, under the "50-50" combined taxable income method of § 1.994-1(c)(3), the combined taxable income of the DISC and related supplier derived from such sales. Such marginal costing rules may be applied whether or not the related supplier manufactures, produces, grows, or extracts (within the meaning of § 1.993-3(c)) the extent property sold. Such marginal costing rules do not apply to sales of export property which in the hands of a purchaser related under section 954(d)(3) to the seller give rise to foreign base company sales income as described in section 954(d) unless, for the purchaser's year in which it resells the export property, section 954(b)(3)(A) is applicable or such income is under the exceptions in section 954(b)(4). Such marginal costing rules do not apply to leases of property or the performance of any services whether or not related and subsidiary services (as defined in § 1.994-1(b)(3)).

(b) *Marginal costing rules for allocations of costs.* (1) *In general.* Marginal costing is a method under which only marginal or variable costs of producing and selling a particular item, product, or product line are taken into account for purposes of section 994. Where this section is applicable, costs attributable to deriving qualified export receipts for the DISC's taxable year from sales of an item, product, or product line may be determined in any manner the related supplier (as defined in § 1.994-1(a)(3)) chooses, provided that the requirements of both subparagraphs (2) and (3) of this paragraph are met.

(2) *Variable costs taken into account.* There are taken into account in computing the combined taxable income of the DISC and its related supplier from sales of an item, product, or product line the following costs: (i) Direct production costs (as defined in § 1.471-11(b)(2)(i)) and (ii) costs which are export promotion expenses, but only if they are

claimed as export promotion expenses in determining taxable income derived by the DISC under the combined taxable income method of § 1.994-1(c)(3). At the taxpayer's option, all, a part, or none of the costs which qualify as export promotion expenses may be so claimed as export promotion expenses.

(3) *Overall profit percentage limitation.* As a result of such determination of costs attributable to such qualified export receipts for the DISC's taxable year, the combined taxable income of the DISC and its related supplier from sales of such item, product, or product line for the DISC's taxable year does not exceed gross receipts (determined under § 1.993-6) of the DISC derived from such sales, multiplied by the overall profit percentage (determined under paragraph (c)(2) of this section).

(c) *Definitions.* (1) *Establishing or maintaining a foreign market.* A DISC shall be treated for its taxable year as seeking to establish or maintain a foreign market with respect to sales of an item, product, or product line of export property from which qualified export receipts are derived if the combined taxable income computed under paragraph (b) of this section is greater than the combined taxable income computed under § 1.994-1(c)(6).

(2) *Overall profit percentage.* (i) For purposes of this section, the overall profit percentage for a taxable year of the DISC for a product or product line is the percentage which—

(a) The combined taxable income of the DISC and its related supplier plus all other taxable income of its related supplier from all sales (domestic and foreign) of such product or product line during the DISC's taxable year, computed under the full costing method, is of

(b) The total gross receipts (determined under § 1.993-6) from all such sales.

(ii) At the annual option of the related supplier, the overall profit percentage for the DISC's taxable year for all products and product lines may be determined by aggregating the amounts described in subdivision (i) (a) and (b) of this subparagraph of the DISC, and all domestic members of the controlled group (as defined in § 1.993-1(k)) of which the DISC is a member, for the DISC's taxable year and for taxable years of such members ending with or within the DISC's taxable year.

(iii) For purposes of determining the amounts in subdivisions (i) (b) and (ii) of this subparagraph, a sale of property between a DISC and its related supplier

or between domestic members of the controlled group shall be taken into account only during the DISC's taxable year (or taxable year of the member ending within the DISC's taxable year) during which the property is ultimately sold to a person which is neither the DISC nor such a domestic member.

(3) *Grouping of transactions.* (i) In general, for purposes of this section, an item, product, or product line is the item or group consisting of the product or product line pursuant to § 1.994-1(c)(7) used by the taxpayer for purposes of applying the intercompany pricing rules of § 1.994-1.

(ii) However, for purposes of determining the overall profit percentage under subparagraph (2) of this paragraph, any product or product line grouping permissible under § 1.994-1(c)(7) may be used at the annual choice of the taxpayer, even though it may not be the same item or grouping referred to in subdivision (i) of this subparagraph, as long as the grouping chosen for determining the overall profit percentage is at least as broad as the grouping referred to in such subdivision (i).

(4) *Full costing method.* For purposes of this section, the term "full costing method" is the method for determining combined taxable income set forth in § 1.994-1(c)(6).

(d) *Application of limitation on DISC income ("no loss" rule).* If the marginal costing rules of this section are applied, the combined taxable income method of § 1.994-1(c)(3) may not be applied to cause in any taxable year a loss to the related supplier, but such method may be applied to the extent it does not cause a loss. For purposes of the preceding sentence, a loss to a related supplier would result if the taxable income of the DISC would exceed the combined taxable income of the related supplier and the DISC determined in accordance with paragraph (b) of this section. If, however, there is no combined taxable income (so determined), see the last sentence of § 1.994-1(e)(1)(i).

(e) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). X and Y are calendar year taxpayers. X, a domestic manufacturing company, owns all the stock of Y, a DISC for the taxable year. During 1973, X manufactures a product line which is eligible to be export property (as defined in § 1.993-3). X enters into a written agreement with Y whereby Y is granted a sales franchise with respect to exporting such product line from which qualified export receipts will be derived and Y will receive commissions with respect to such exports equal to the maximum amount permitted to be received under the intercompany pricing rules of section 994. Commissions are computed using the combined taxable income method under § 1.994-1(c)(3). For purposes of applying the combined taxable income method, X and Y compute their combined taxable income attributable to the product line of export property under the marginal costing rules in accordance with the additional facts assumed in the table below:

(1) Maximum combined taxable income (determined under paragraph (b)(2) of this section):	
(a) Y's gross receipts from export sales.....	\$95.00
(b) Less:	
(i) Direct materials.....	40.00
(ii) Direct labor.....	20.00
(iii) Y's export promotion expenses claimed in determining Y's DISC taxable income.....	5.00
(iv) Total deductions.....	65.00
(c) Maximum combined taxable income.....	30.00
(2) Overall profit percentage limitation (determined under paragraph (b)(3) of this section):	
(a) Gross receipts of X and Y from all domestic and foreign sales.....	400.00
(b) Less deductions:	
(i) Direct materials.....	160.00
(ii) Direct labor.....	80.00
(iii) Other costs (of which \$8 are costs of the DISC including \$5 of export promotion expenses claimed in determining Y's taxable income).....	40.00
(c) Total deductions.....	280.00
(d) Total taxable income from all sales computed on a full costing method.....	120.00
(e) Overall profit percentage (line (d) (\$120) divided by line (a) (\$400)) (percent).....	30%
(f) Multiply by gross receipts from Y's export sales (line (1)(a)).....	\$95.00
(g) Overall profit percentage limitations.....	28.50

Since the overall profit percentage limitation under line (2)(g) (\$28.50) is less than maximum combined taxable income under line (1)(c) (\$30), combined taxable income under marginal costing is limited to \$28.50. 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 \$28.50. Accordingly, the costs attributable to export sales (other than for direct material, direct labor, and export promotion expenses) are \$1.50, i.e., line (1)(c) (\$30) minus line (2)(g) (\$28.50). Under the combined taxable income method of § 1.994-1(c)(3), Y will have taxable income attributable to the sales of \$14.75, i.e., the sum of 1/2

of combined taxable income (1/2 of \$28.50) 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 \$22.75, i.e., Y's costs (\$8, see line (2)(b)(iii)) plus Y's profit (\$14.75).

Example (2). (1) Assume the same facts as in example (1), except that gross receipts from export sales are only \$85 and gross receipts from all sales remain at \$400. 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.....	5.00
(iv) Total deductions.....	65.00
(c) Maximum combined taxable income.....	20.00
(2) Overall profit percentage limitation (determined under paragraph (b)(3) of this section):	
(a) Gross receipts from Y's export sales (line (1)(a)).....	85.00
(b) Multiply by overall profit percentage (as determined in example (1)) (percent).....	30%
(c) Overall profit percentage limitation.....	25.50

Since maximum combined taxable income under line (1)(c) (\$20) is less than the overall profit percentage limitation under line (2)(c) (\$25.50), combined taxable income under marginal costing is limited to \$20. 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 \$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 1/2 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,

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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., $\frac{1}{2}$ of combined taxable income ($\frac{1}{2}$ 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 \$10, 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)).....	
(4) Overall profit percentage limitation (as determined in example (2)).....	35.50

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).

[FR Doc. 75-16997 Filed 7-15-75; 8:45 am]

[T.D. 7369]

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Treatment of Letters, Memorandums, and Similar Property and of Gains and Losses From Involuntary Conversions

By a notice of proposed rule making appearing in the *FEDERAL REGISTER* for December 15, 1970 (35 FR 18973), amendments to the Income Tax Regulations (26 CFR Part 1) were proposed in order to conform those regulations to the amendments of the Internal Revenue Code of 1954 made by section 514, relating to letters, memorandums, and similar property, and section 516(b), relating to certain casualty losses, of the Tax Reform Act of 1969 (Pub. L. 91-172, 83 Stat. 643, 646). After consideration of all such relevant matter as was presented by interested persons regarding the rules proposed, the amendment of the regulations as proposed are adopted by this document, subject to the changes indicated below.

Proposed § 1.341-6(b) (2) (iv), relating to categories of subsection (e) assets, has been revised by the addition of a rule to make clear that letters, memorandums, or similar property prepared by personnel who are under the administrative control of an individual, such as a corporate executive, will be deemed to have been prepared or produced for him whether or not such letters, memorandums, or similar property are reviewed by him. The purpose of this change was to forestall the possibility that such letters, memorandums, or similar property might be excluded on the ground that they were neither created by the personal efforts of the individual or prepared or produced for him.

Several changes have been made in proposed § 1.1221-1(c). The term "person" in the first sentence of subparagraph (1) of paragraph (c) has been replaced by the term "taxpayer." References to an "individual" in subparagraph (2) have been replaced by references to a "person" in order to make clear that the references include corporations also. The definition of "similar property" in subparagraph (2) has been revised to make clear that the phrase includes an oral recording of any type, a transcript of an oral recording, and a transcript of an oral interview or of dictation. This latter change is in keeping with the announcement made by the Assistant Secretary of the Treasury for Tax Policy on May 20, 1974, that the regulations under section 1221(3) of the 1954 Code would treat Presidential tapes as "similar property" for purposes of that section. A new provision has been added to subparagraph (2) to provide that the rule on letters, memorandums, or similar property does not apply to property, such as a corporate archive, office correspondence, or a financial record, sold or disposed of as part of a going business if such property

has no significant value separate and apart from its relation to and use in such business. Subparagraph (2) has also been revised to make clear that it does not apply to any property to which subparagraph (1) (relating to copyrights or literary, musical, or artistic compositions) applies, priority thus being given to the application of subparagraph (1) in any situation where there is a possibility of overlap between subparagraphs (1) and (2).

A new subparagraph (3) has been added to proposed § 1.1221-1(c) in order to coordinate the provisions of § 1.341-6(b) (2) (iv) and § 1.1221-1(c), which are *pari materia*.

Several changes have been made in the proposed amendment of § 1.1231-1. Paragraph (a) (1) of such section has been revised to make clear that the reference to letters and memorandums applies also to property similar to letters and memorandums. A minor technical change has been made in the material following paragraph (c) (5). The proposed amendment to example (1) in § 1.1231-1(g) has been revised to reinstate language which was deleted by the proposed amendment. This change has been made to eliminate the possibility that the deletion may be found misleading; however, it has been made clear that the rule applies for taxable years beginning after December 31, 1957, and before January 1, 1970. In the process of making the change the existing reference to taxable years ending after December 31, 1957, has been changed to read as taxable years beginning after December 31, 1957.

In view of the foregoing, the amendments of the regulations as proposed are hereby adopted, subject to the changes set forth below:

PARAGRAPH 1. The amendment of § 1.341, as set forth in paragraph 1 of the notice of proposed rule making, is changed to read as set forth below.

PAR. 2. The amendment of § 1.341-6(b) (2) (iv), as set forth in paragraph 2 of the notice of proposed rule making, is changed to read as set forth below.

PAR. 3. The amendment of § 1.1221-1(c), as set forth in paragraph 5 of the notice of proposed rule making, is changed to read as set forth below.

PAR. 4. The amendment to § 1.1231-1, as set forth in paragraph 7 of the notice of proposed rule making, is changed by revising paragraph (a), so much of paragraph (c) as follows subparagraph (5), and so much of example (1) in paragraph (g) as follows the tabulation therein to read as set forth below.

(Section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805))

[SEAL] DONALD C. ALEXANDER,
Commissioner of Internal Revenue.

Approved: July 10, 1975.

FREDERIC W. HICKMAN,
Assistant Secretary of Treasury.

PARAGRAPH 1. Section 1.341 is amended as follows:

§ 1.341 Statutory provisions; collapsible corporations.

Sec. 341. Collapsible corporations—(a) Treatment of gain to shareholders. Gain from—

(1) The sale or exchange of stock of a collapsible corporation.

(2) A distribution in partial or complete liquidation of a collapsible corporation, which distribution is treated under this part as in part or full payment in exchange for stock, and

(3) A distribution made by a collapsible corporation which, under section 301(c) (3) (A), is treated, to the extent it exceeds the basis of the stock, in the same manner as a gain from the sale or exchange of property.

to the extent that it would be considered (but for the provisions of this section) as gain from the sale or exchange of a capital asset held for more than 6 months shall, except as otherwise provided in this section, be considered as gain from the sale or exchange of property which is not a capital asset.

(e) Exceptions to application of section.

(5) Subsection (e) asset defined. (A) ***

(iv) Property (unless included under clause (i), (ii), or (iii), which consists of a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, or any interest in any such property, if the property was created in whole or in part by the personal efforts of, or (in the case of a letter, memorandum, or similar property) was prepared, or produced in whole or in part for, any individual who owns more than 5 percent in value of the stock of the corporation.

(12) Nonapplication of section 1245(a). For purposes of this subsection, the determination of whether gain from the sale or exchange of property would under any provision of this chapter be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b) shall be made without regard to the application of sections 617(d) (1), 1245(a), 1250(a), 1251(c), and 1252(a).

(f) Certain sales of stock of consenting corporations—(1) In general. Subsection (a) (1) shall not apply to a sale of stock of a corporation (other than a sale to the issuing corporation) if such corporation (hereinafter in this subsection referred to as "consenting corporation") consents (at such time and in such manner as the Secretary or his delegate may by regulations prescribe) to have the provisions of paragraph (2) apply. Such consent shall apply with respect to each sale of stock of such corporation made within the 6-month period beginning with the date on which such consent is filed.

(2) Recognition of gain. Except as provided in paragraph (3), if a subsection (f) asset (as defined in paragraph (4)) is disposed of at any time by a consenting corporation (or, if paragraph (3) applies, by a transferee corporation), then the amount by which—

(A) In the case of a sale, exchange, or involuntary conversion, the amount realized or

(B) In the case of any other disposition, the fair market value of such asset,

exceeds the adjusted basis of such asset shall be treated as gain from the sale or exchange of such asset. Such gain shall be recognized notwithstanding any other provision of this subtitle, but only to the extent such gain is not recognized under any other provision of this subtitle.

(3) *Exception for certain tax-free transactions.* If the basis of a subsection (f) asset in the hands of a transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section 332, 351, 361, 371(a), or 374(a), then the amount of gain taken into account by the transferor under paragraph (2) shall not exceed the amount of gain recognized to the transferor on the transfer of such asset (determined without regard to this subsection). This paragraph shall apply only if the transferee—

(A) Is not an organization which is exempt from tax imposed by this chapter, and

(B) Agrees (at such time and in such manner as the Secretary or his delegate may by regulations prescribe) to have the provisions of paragraph (2) apply to any disposition by it of such subsection (f) asset.

(4) *Subsection (f) asset defined.* For purposes of this subsection—

(A) *In general.* The term "subsection (f) asset" means any property which, as of the date of any sale of stock referred to in paragraph (1), is not a capital asset and is property owned by, or subject to an option to acquire held by, the consenting corporation. For purposes of this subparagraph, land or any interest in real property (other than a security interest), and unrealized receivables or fees (as defined in subsection (b)(4)), shall be treated as property which is not a capital asset.

(B) *Property under construction.* If manufacture, construction, or production with respect to any property described in subparagraph (A) has commenced before any date of sale described therein, the term "subsection (f) asset" includes the property resulting from such manufacture, construction, or production.

(C) *Special rule for land.* In the case of land or any interest in real property (other than a security interest) described in subparagraph (A), the term "subsection (f) asset" includes any improvements resulting from construction with respect to such property if such construction is commenced (by the consenting corporation or by a transferee corporation which has agreed to the application of paragraph (2)) within 2 years after the date of any sale described in subparagraph (A).

(5) *5-year limitation as to shareholder.* Paragraph (1) shall not apply to the sale of stock of a corporation by a shareholder if, during the 5-year period ending on the date of such sale, such shareholder (or any related person within the meaning of subsection (e)(8)(A)) sold any stock of another consenting corporation within any 6-month period beginning on a date on which a consent was filed under paragraph (1) by such other corporation.

(6) *Special rule for stock ownership in other corporations.* If a corporation (hereinafter in this paragraph referred to as "owning corporation") owns 5 percent or more in value of the outstanding stock of another corporation on the date of any sale of stock of the owning corporation during a 6-month period with respect to which a consent under paragraph (1) was filed by the owning corporation, such consent shall not be valid with respect to such sale unless such other corporation has (within the 6-month period ending on the date of such sale) filed a valid consent under paragraph (1) with respect to sales of its stock. For purposes of applying paragraph (4) to such other corporation, a sale of stock of the owning corporation to which paragraph (1) applies shall be treated as a sale of stock of such other corporation. In the case of a chain of corporations connected by the 5-percent ownership requirements of this paragraph, rules similar to the rules of the two preceding sentences shall be applied.

(7) *Adjustments to basis.* The Secretary or his delegate shall prescribe such regulations as he may deem necessary to provide for adjustments to the basis of property to reflect gain recognized under paragraph (2).

[Sec. 341 as amended by sec. 20, Technical Amendments Act 1958 (72 Stat. 1615); sec. 13(f)(4), Rev. Act 1962 (78 Stat. 1035); sec. 231(b)(4), Rev. Act 1964 (78 Stat. 105); sec. 1(a), Act of Aug. 22, 1964 (Pub. Law 88-484, 78 Stat. 596); sec. 1(b)(4), Act of Sept. 12, 1966 (Pub. Law 89-570, 80 Stat. 762); sec. 211(b)(4) and 514(b)(1), Tax Reform Act 1969 (83 Stat. 570, 643)]

PAR. 2. Section 1.341-6 is amended by revising (b)(2)(iv) as follows:

§ 1.341-6 Exceptions to application of section.

(b) *Subsection (e) asset defined.* * * *
(2) *Categories of subsection (e) assets.* * * *

(iv) The fourth category of subsection (e) assets is property (unless included under subdivision (i), (ii), or (iii) of this subparagraph) which consists of a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, or any interest in any such property, if the property was created in whole or in part by the personal efforts of, or, in the case of a letter, memorandum, or property similar to a letter or memorandum, was prepared, or produced in whole or in part, for, any individual actual or constructive shareholder who is considered to own more than 5 percent in value of the outstanding stock of the corporation. For items included in the phrase "similar property" see paragraph (c) of § 1.1221-1. In general, property is created in whole or in part by the personal efforts of an individual if such individual performs literary, theatrical, musical, artistic, or other creative or productive work which affirmatively contributes to the creation of the property, or if such individual directs and guides others in the performance of such work. An individual, such as a corporate executive, who merely has administrative control of writers, actors, artists, or personnel and who does not substantially engage in the direction and guidance of such persons in the performance of their work, does not create property by his personal efforts. However, a letter or memorandum, or property similar to a letter or memorandum, which is prepared by personnel who are under the administrative control of an individual, such as a corporate executive, shall be deemed to have been prepared or produced for him whether or not such letter, memorandum, or similar property is reviewed by him. In addition, a letter, memorandum, or property similar to a letter or memorandum, addressed to an individual shall be considered as prepared or produced for him. In the case of a letter, memorandum, or property similar to a letter or memorandum, this subdivision applies only to sales and other dispositions occurring after July 25, 1969.

PAR. 3. Section 1.817-2 is amended by revising (b)(1)(i)(c) as follows:

§ 1.817-2 Treatment of capital gains and losses.

(b) *Modification of sections 1221 and 1231.* (1) * * *

(i) * * *
(c) A copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property held by a taxpayer described in section 1221(3). In the case of a letter, memorandum, or property similar to a letter or memorandum, this subdivision (c) applies only to sales and other dispositions occurring after July 25, 1969.

PAR. 4. Section 1.1221 is amended by revising paragraph (3) of section 1221 and the historical note to read as follows:

§ 1.1221 Statutory provisions; capital asset defined.

Sec. 1221. *Capital asset defined.* * * *
(3) A copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by—

(A) A taxpayer whose personal efforts created such property.

(B) In the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or

(C) A taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange in whole or in part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);

[Sec. 1221 as amended by sec. 514(a), Tax Reform Act 1969 (83 Stat. 643)]

PAR. 5. Section 1.1221-1 is amended by revising paragraph (c) as follows:

§ 1.1221-1 Meaning of terms.

(c) (1) A copyright, a literary, musical, or artistic composition, and similar property are excluded from the term "capital assets" if held by a taxpayer whose personal efforts created such property, or if held by a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of a taxpayer whose personal efforts created such property. For purposes of this subparagraph, the phrase "similar property" includes for example, such property as a theatrical production, a radio program, a newspaper cartoon strip, or any other property eligible for copyright protection (whether under statute or common law), but does not include a patent or an invention, or a design which may be protected only under the patent law and not under the copyright law.

(2) In the case of sales and other dispositions occurring after July 25, 1969, a letter, a memorandum, or similar property is excluded from the term "capital asset" if held by (i) a taxpayer whose personal efforts created such property, (ii) a taxpayer for whom such property was prepared or produced, or (iii) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference

to the basis of such property in the hands of a taxpayer described in subdivision (i) or (ii) of this subparagraph. In the case of a collection of letters, memorandums, or similar property held by a person who is a taxpayer described in subdivision (i), (ii), or (iii) of this subparagraph as to some of such letters, memorandums, or similar property but not as to others, this subparagraph shall apply only to those letters, memorandums, or similar property as to which such person is a taxpayer described in such subdivision. For purposes of this subparagraph, the phrase "similar property" includes, for example, such property as a draft of a speech, a manuscript, a research paper, an oral recording of any type, a transcript of an oral recording, a transcript of an oral interview or of dictation, a personal or business diary, a log or journal, a corporate archive, including a corporate charter, office correspondence, a financial record, a drawing, a photograph, or a dispatch. A letter, memorandum, or property similar to a letter or memorandum, addressed to a taxpayer shall be considered as prepared or produced for him. This subparagraph does not apply to property, such as a corporate archive, office correspondence, or a financial record, sold or disposed of as part of a going business if such property has no significant value separate and apart from its relation to and use in such business; it also does not apply to any property to which subparagraph (1) of this paragraph applies (i.e., property to which section 1221(3) applied before its amendment by section 514(a) of the Tax Reform Act of 1969 (83 Stat. 643)).

(3) For purposes of this paragraph, in general property is created in whole or in part by the personal efforts of a taxpayer if such taxpayer performs literary, theatrical, musical, artistic, or other creative or productive work which affirmatively contributes to the creation of the property, or if such taxpayer directs and guides others in the performance of such work. A taxpayer, such as corporate executive, who merely has administrative control of writers, actors, artists, or personnel and who does not substantially engage in the direction and guidance of such persons in the performance of their work, does not create property by his personal efforts. However, for purposes of subparagraph (2) of this paragraph, a letter or memorandum, or property similar to a letter or memorandum, which is prepared by personnel who are under the administrative control of a taxpayer, such as a corporate executive, shall be deemed to have been prepared or produced for him whether or not such letter, memorandum, or similar property is reviewed by him.

(4) For the application to section 1231 to the sale or exchange of property to which this paragraph applies, see § 1.1231-1. For the application of section 170 to the charitable contribution of property to which this paragraph applies, see section 170(e) and the regulations thereunder.

PAR. 6. Section 1.1231 is amended by revising so much of section 1231(a) as follows paragraph (1), by revising section 1231(b)(1)(C), by revising section 1231(b)(3), and by revising the historical note as follows:

§ 1.1231 Statutory provisions; property used in the trade or business and involuntary conversions.

Sec. 1231. *Property used in the trade or business and involuntary conversions—(a) General rule.* * * *

(2) Losses (including losses not compensated for by insurance or otherwise) upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of (A) property used in the trade or business or (B) capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

In the case of any involuntary conversion (subject to the provisions of this subsection but for this sentence) arising from fire, storm, shipwreck, or other casualty, or from theft, of any property used in the trade or business or of any capital asset held for more than 6 months, this subsection shall not apply to such conversion (whether resulting in gain or loss) if during the taxable year the recognized losses from such conversions exceed the recognized gains from such conversions.

(b) *Definition of property used in the trade or business.* * * *

(1) *General rule.* * * *
(C) A copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by a taxpayer described in paragraph (3) of section 1221.

(3) *Livestock.* Such term includes—

(A) Cattle and horses, regardless of age, held by the taxpayer for draft, breeding, dairy, or sporting purposes, and held by him for 24 months or more from the date of acquisition, and

(B) Other livestock, regardless of age, held by the taxpayer for draft, breeding, dairy, or sporting purposes, and held by him for 12 months or more from the date of acquisition.

Such term does not include poultry.

[Sec. 1231 as amended by sec. 49, Technical Amendments Act 1958 (72 Stat. 1642); sec. 227, Rev. Act 1964 (78 Stat. 97); secs. 212(b)(1), 514(b)(2), and 516(b), Tax Reform Act 1969 (83 Stat. 571, 643, 646)]

PAR. 7. Section 1.1231-1 is amended by revising paragraphs (a), (c)(1)(ii), so much of paragraph (c) as follows subparagraph (5), and (e), by revising so much of example (1) in paragraph (g) as follows the tabulation therein, and adding examples (4) through (8) to paragraph (g) as follows:

§ 1.1231-1 Gains and losses from the sale or exchange of certain property used in the trade or business.

(a) *In general.* Section 1231 provides that, subject to the provisions of paragraph (e) of this section, a taxpayer's gains and losses from the disposition (including involuntary conversion) of assets described in that section as "property used in the trade or business" and from the involuntary conversion of capital assets held for more than 6 months shall be treated as long-term capital gains and

losses if the total gains exceed the total losses. If the total gains do not exceed the total losses, all such gains and losses are treated as ordinary gains and losses. Therefore, if the taxpayer has no gains subject to section 1231, a recognized loss from the condemnation (or from a sale or exchange under threat of condemnation) of even a capital asset held for more than 6 months is an ordinary loss. Capital assets subject to section 1231 treatment include only capital assets involuntarily converted. The noncapital assets subject to section 1231 treatment are (1) depreciable business property and business real property held for more than 6 months, other than stock in trade and certain copyrights and artistic property and, in the case of sales and other dispositions occurring after July 25, 1969, other than a letter, memorandum, or property similar to a letter or memorandum; (2) timber, coal, and iron ore, but only to the extent that section 631 applies thereto; and (3) certain livestock and unharvested crops. See paragraph (c) of this section.

(c) Transactions to which section applies. * * *

(1) * * *
(ii) A copyright, a literary, musical, or artistic composition, or similar property, or (in the case of sales and other dispositions occurring after July 25, 1969) a letter, memorandum, or property similar to a letter or memorandum, held by a taxpayer described in section 1221(3); or

For purposes of section 1231, the phrase "property used in the trade or business" means property described in this paragraph (other than property described in subparagraph (2) of this paragraph). Notwithstanding any of the provisions of this paragraph, section 1231(a) does not apply to gains and losses under the circumstances described in paragraph (e) (2) or (3) of this section.

(e) *Involuntary conversion—(1) General rule.* For purposes of section 1231, the terms "compulsory or involuntary conversion" and "involuntary conversion" of property mean the conversion of property into money or other property as a result of complete or partial destruction, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof. Losses upon the complete or partial destruction, theft, seizure, requisition, or condemnation of property are treated as losses upon an involuntary conversion whether or not there is a conversion of the property into other property or money and whether or not the property is uninsured, partially insured, or totally insured. For example, if a capital asset held for more than 6 months, with an adjusted basis of \$400, but not held for the production of income, is stolen, and the loss which is sustained in the taxable year 1956 is not compensated for by insurance or otherwise, section 1231 applies to the \$400 loss. For certain exceptions to this subparagraph, see subparagraphs (2) and (3) of this paragraph.

(2) *Certain uninsured losses.* Notwithstanding the provisions of subparagraph (1) of this paragraph, losses sustained during a taxable year beginning after December 31, 1957, and before January 1, 1970, with respect to both property used in the trade or business and any capital asset held for more than 6 months and held for the production of income, which losses arise from fire, storm, shipwreck, or other casualty, or from theft, and which are not compensated for by insurance in any amount, are not losses to which section 1231(a) applies. Such losses shall not be taken into account in applying the provisions of this section.

(3) *Exclusion of gains and losses from certain involuntary conversions.* Notwithstanding the provisions of subparagraph (1) of this paragraph, if for any taxable year beginning after December 31, 1969, the recognized losses from the involuntary conversion as a result of fire, storm, shipwreck, or other casualty, or from theft, of any property used in the trade or business or of any capital asset held for more than 6 months exceed the recognized gains from the involuntary conversion of any such property as a result of fire, storm, shipwreck, or other casualty, or from theft, such gains and losses are not gains and losses to which section 1231 applies and shall not be taken into account in applying the provisions of this section. The net loss, in effect, will be treated as an ordinary loss. This subparagraph shall apply whether such property is uninsured, partially insured, or totally insured and, in the case of a capital asset held for more than 6 months, whether the property is property used in the trade or business, property held for the production of income, or a personal asset.

(g) Examples.

Example (1).

Since the aggregate of the recognized gains (\$12,500) exceeds the aggregate of the recognized losses (\$9,000), such gains and losses are treated under section 1231 as gains and losses from the sale or exchange of capital assets held for more than 6 months. For any taxable year beginning after December 31, 1957, and before January 1, 1970, the \$5,000 loss upon theft of bonds (item 6) would not be taken into account under section 1231. See paragraph (c)(2) of this section.

Example (4). A, an individual, makes his income tax return on a calendar year basis. During 1970 trees on A's residential property which were planted in 1950 after the purchase of such property were destroyed by fire. The loss, which was in the amount of \$2,000 after applying section 165(c)(3), was not compensated for by insurance or otherwise. During the same year A also recognized a \$1,500 gain from insurance proceeds compensating him for the theft sustained in 1970 of a diamond brooch purchased in 1960 for personal use. A has no other gains or losses for 1970 from the involuntary conversion of property. Since the recognized losses exceed the recognized gains from the involuntary conversion for 1970 as a result of fire, storm, shipwreck, or other casualty, or from theft, of any property used

in the trade or business or of any capital asset held for more than 6 months, neither the gain nor the loss is included in making the computations under section 1231.

Example (5). The facts are the same as in example (4), except that A also recognized a gain of \$1,000 from insurance proceeds compensating him for the total destruction by fire of a truck, held for more than 6 months, used in A's business and subject to an allowance for depreciation. A has no other gains or losses for 1970 from the involuntary conversion of property. Since the recognized losses (\$2,000) do not exceed the recognized gains (\$2,500) from the involuntary conversion for 1970 as a result of fire, storm, shipwreck, or other casualty, or from theft, of any property used in the trade or business or of any capital asset held for more than 6 months, such gains and losses are included in making the computations under section 1231. Thus, if A has no other gains or losses for 1970 to which section 1231 applies, the gains and losses from these involuntary conversions are treated under section 1231 as gains and losses from the sale or exchange of capital assets held for more than 6 months.

Example (6). The facts are the same as in example (5) except that A also has the following recognized gains and losses for 1970 to which section 1231 applies:

	Gains	Losses
Gain on sale of machinery, used in the business and subject to an allowance for depreciation, held for more than 6 months.....	\$4,000	
Gain reported in 1970 (under sec. 453) on installment sale in 1969 of factory premises used in the business (including building and land, each held for more than 6 months).....		6,000
Gain reported in 1970 (under sec. 453) on installment sale in 1970 of land held for more than 6 months, used in the business as a storage lot for trucks.....		2,000
Loss upon the sale in 1970 of warehouse, used in the business and subject to an allowance for depreciation, held for more than 6 months.....		\$5,000
Total gains.....	12,000	
Total losses.....		5,000

Since the aggregate of the recognized gains (\$14,500) exceeds the aggregate of the recognized losses (\$7,000), such gains and losses are treated under section 1231 as gains and losses from the sale or exchange of capital assets held for more than 6 months.

Example (7). B, an individual, makes his income tax return on the calendar year basis. During 1970 furniture used in his business and held for more than 6 months was destroyed by fire. The recognized loss, after compensation by insurance, was \$2,000. During the same year B recognized a \$1,000 gain upon the sale of a parcel of real estate used in his business and held for more than 6 months, and a \$6,000 loss upon the sale of stock held for more than 6 months. B has no other gains or losses for 1970 from the involuntary conversion, or the sale or exchange of, property. The \$6,000 loss upon the sale of stock is not a loss to which section 1231 applies since the stock is not property used in the trade or business, as defined in section 1231(b). The \$2,000 loss upon the destruction of the furniture is not a loss to which section 1231 applies since

the recognized losses (\$2,000) exceed the recognized gains (\$0) from the involuntary conversion for 1970 as a result of fire, storm, shipwreck, or other casualty, or from theft, of any property used in the trade or business or of any capital asset held for more than 6 months. Accordingly, the \$1,000 gain upon the sale of real estate is considered to be gain from the sale or exchange of a capital asset held for more than 6 months since the gains (\$1,000) to which section 1231 applies exceed the losses (\$0) to which such section applies.

Example (8). The facts are the same as in example (7) except that B also recognized a gain of \$4,000 from insurance proceeds compensating him for the total destruction by fire of a freighter, held for more than 6 months, used in B's business and subject to an allowance for depreciation. Since the recognized losses (\$2,000) do not exceed the recognized gains (\$4,000) from the involuntary conversion for 1970 as a result of fire, storm, shipwreck, or other casualty, or from theft, of any property used in the trade or business or of any capital asset held for more than 6 months, such gains and losses are included in making the computations under section 1231. Since the aggregate of the recognized gains to which section 1231 applies (\$5,000) exceeds the aggregate of the recognized losses to which such section applies (\$2,000), such gains and losses are treated under section 1231 as gains and losses from the sale or exchange of capital assets held for more than 6 months. The \$6,000 loss upon the sale of stock is not taken into account in making such computation since it is not a loss to which section 1231 applies.

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[T.D. 7368]

PART 53—FOUNDATION EXCISE TAXES

Administration of Private Foundation Excise Taxes

On June 17, 1974, notice of proposed rule making with respect to the amendment of the Foundation Excise Tax Regulations (26 CFR Part 53) relating to the administration of the private foundation excise taxes, which taxes were added by the Tax Reform Act of 1969 (83 Stat. 524), was published in the FEDERAL REGISTER (39 FR 20975).

The amendments to the regulations provide rules for the filing of returns for the excise taxes imposed by chapter 42. In general, returns must be filed by all persons liable for tax at the time and place the private foundation files its annual information or tax return. A taxpayer may, by signing the foundation's annual return designate it as his return. Rules providing for the extension of time to file returns and to pay the tax due are also provided.

Adoption of amendments to the regulations. After consideration of all such relevant matter as was presented by interested persons regarding the rules proposed, the amendment of the Foundation Excise Tax Regulations (26 CFR Part 53) is hereby adopted, subject to the changes set forth below:

PARAGRAPH 1. Section 53.6011-1 as set forth in the appendix to the notice of proposed rule making is changed to read as set forth below.

PAR. 2. Section 53.6071-1 as set forth in the appendix to the notice of proposed