

that is, \$15,000 minus \$6,250 (\$10,000 less depletion of \$3,750), of which only \$7,250 is recognized because the recognized gain cannot exceed the sum of money received in the transaction. See section 1031(b) and the corresponding provisions of prior revenue laws. If, however, the cash received was only \$2,250 and the value of the property received was \$12,750, then the increase in earnings and profits would be \$2,250, that amount being the gain recognized under section 1031.

Example 3. On January 1, 1973, corporation X purchased for \$10,000 a depreciable asset with an estimated useful life of 20 years and no salvage value. In computing depreciation on the asset, corporation X used the declining balance method with a rate twice the straight line rate. On December 31, 1976, the asset was sold for \$9,000. Under section 1016(a)(2), the basis of the asset is adjusted for depreciation allowed for the years 1973 through 1976, or a total of \$3,439. Thus, X realizes a gain of \$2,439 (the excess of the amount realized, \$9,000, over the adjusted basis, \$6,561). However, the proper adjustment to basis for the purpose of determining earnings and profits is only \$2,000, i.e., the total amount which, under § 1.312-15, was applied in the computation of earnings and profits for the years 1973-76. Hence, upon sale of the asset, earnings and profits are increased by only \$1,000, i.e., the excess of the amount realized, \$9,000, over the adjusted basis for earnings and profits purposes, \$8,000.

(d) For adjustment and allocation of the earnings and profits of the transferor as between the transferor and the transferee in cases where the transfer of property by one corporation to another corporation results in the non-recognition in whole or in part of gain or loss, see § 1.312-10; and see section 381 for earnings and profits of successor corporations in certain transactions.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 7221, 37 FR 24746, Nov. 21, 1972]

§ 1.312-8 Effect on earnings and profits of receipt of tax-free distributions requiring adjustment or allocation of basis of stock.

(a) In order to determine the effect on earnings and profits, where a corporation receives (after February 28, 1913) from a second corporation a distribution which (under the law applicable to the year in which the distribution was made) was not a taxable dividend to the shareholders of the second corporation, section 312(f) prescribes certain rules. It provides that the

amount of such distribution shall not increase the earnings and profits of the first or receiving corporation in the following cases: (1) No such increase shall be made in respect of the part of such distribution which (under the law applicable to the year in which the distribution was made) is directly applied in reduction of the basis of the stock in respect of which the distribution was made and (2) no such increase shall be made if (under the law applicable to the year in which the distribution was made) the distribution causes the basis of the stock in respect of which the distribution was made to be allocated between such stock and the property received (or such basis would but for section 307(b) be so allocated). Where, therefore, the law (applicable to the year in which the distribution was made, as, for example, a distribution in 1934 from earnings and profits accumulated before March 1, 1913) requires that the amount of such distribution shall be applied against and reduce the basis of the stock with respect to which the distribution was made, there is no increase in the earnings and profits by reason of the receipt of such distribution. Similarly, where there is received by a corporation a distribution from another corporation in the form of a stock dividend and the law applicable to the year in which such distribution was made requires the allocation, as between the old stock and the stock received as a dividend, of the basis of the old stock (or such basis would but for section 307(b) be so allocated), then there is no increase in the earnings and profits by reason of the receipt of such stock dividend even though such stock dividend constitutes income within the meaning of the sixteenth amendment to the Constitution.

(b) The principles set forth in paragraph (a) of this section may be illustrated by the following examples:

Example 1. Corporation X in 1955 distributed to Corporation Y, one of its shareholders, \$10,000 which was out of earnings or profits accumulated before March 1, 1913, and did not exceed the adjusted basis of the stock in respect of which the distribution was made. This amount of \$10,000 was, therefore, a tax-free distribution and under the provisions of section 301(c)(2) must be applied against and reduce the adjusted basis of the stock in respect of which the distribution

was made. The earnings and profits of Corporation Y are not increased by reason of the receipt of this distribution.

Example 2. Corporation Z in 1955 had outstanding common and preferred stock of which Corporation Y held 100 shares of the common and no preferred. The stock had a cost basis to Corporation Y of \$100 per share, or a total cost of \$10,000. In December of that year it received a dividend of 100 shares of the preferred stock of Corporation Z. Such distribution is a stock dividend which, under section 305, was not taxable and was accordingly not included in the gross income of Corporation Y. The original cost of \$10,000 is allocated to the 200 shares of Corporation Z none of which has been sold or otherwise disposed of by Corporation Y. See section 307 and § 1.307-1. The earnings and profits of Corporation Y are not increased by reason of the receipt of such stock dividend.

§ 1.312-9 Adjustments to earnings and profits reflecting increase in value accrued before March 1, 1913.

(a) In order to determine, for the purpose of ascertaining the source of dividend distributions, that part of the earnings and profits which is represented by increase in value of property accrued before, but realized on or after, March 1, 1913, section 312(g) prescribes certain rules.

(b)(1) Section 312(g)(1) sets forth the general rule with respect to computing the increase to be made in that part of the earnings and profits consisting of increase in value of property accrued before, but realized on or after, March 1, 1913.

(2) The effect of section 312(g)(1) may be illustrated by the following examples:

Example 1. Corporation X acquired non-depreciable property before March 1, 1913, at a cost of \$10,000. Its fair market value as of March 1, 1913, was \$12,000 and it was sold in 1955 for \$15,000. The increase in earnings and profits based on the value as of March 1, 1913, representing earnings and profits accumulated since February 28, 1913, is \$3,000. If the basis is determined without regard to the value as of March 1, 1913, there would be an increase in earnings and profits of \$5,000. The difference of \$2,000 (\$5,000 minus \$3,000) represents the increase to be made in that part of the earnings and profits of Corporation X consisting of the increase in value of property accrued before, but realized on or after, March 1, 1913.

Example 2. Corporation Y acquired depreciable property in 1908 at a cost of \$100,000. Assuming no additions or betterments, and

that the depreciation sustained before March 1, 1913, was \$10,000, the adjusted cost as of that date was \$90,000. Its fair market value as of March 1, 1913, was \$94,000 and on February 28, 1955, it was sold for \$25,000. For the purpose of determining gain from the sale, the basis of the property is the fair market value of \$94,000 as of March 1, 1913, adjusted for depreciation for the period subsequent to February 28, 1913, computed on such fair market value. If the amount of the depreciation deduction allowed after February 28, 1913, and properly allowable for each of such years to the date of the sale in 1955 is the aggregate sum of \$81,467, the adjusted basis for determining gain in 1955 (\$94,000 less \$81,467) is \$12,533 and the gain would be \$12,467 (\$25,000 less \$12,533). The increase in earnings and profits accumulated since February 28, 1913, by reason of the sale, based on the value as of March 1, 1913, adjusted for depreciation is \$12,467. If the depreciation since February 28, 1913, had been based on the adjusted cost of \$90,000 (\$100,000 less \$10,000) instead of the March 1, 1913, value of \$94,000, the depreciation sustained from that date to the date of sale would have been \$78,000 instead of \$81,467 and the actual gain on the sale based on the cost of \$100,000 adjusted by depreciation on such cost to \$12,000 (\$100,000 reduced by the sum of \$10,000 and \$78,000) would be \$13,000 (\$25,000 less \$12,000). If the adjusted basis of the property was determined without regard to the value as of March 1, 1913, there would be an increase in earnings and profits of \$13,000. The difference of \$533 (\$13,000 minus \$12,467) represents the increase to be made in that part of the earnings and profits of Corporation Y consisting of the increase in value of property accrued before, but realized on or after, March 1, 1913 (assuming that the proper increase in such surplus had been made each year for the difference between depreciation based on cost and the depreciation based on March 1, 1913, value). Thus, the total increase in that part of earnings and profits consisting of the increase in value of property accrued before, but realized on or after, March 1, 1913, is \$4,000 (\$94,000 less \$90,000).

(c)(1) Section 312(g)(2) is an exception to the general rule in section 312(g)(1) and also operates as a limitation on the application of section 312(f). It provides that, if the application of section 312(f)(1)(B) to a sale or other disposition after February 28, 1913, results in a loss which is to be applied in decrease of earnings and profits for any period beginning after February 28, 1913, then, notwithstanding section 312(f) and in lieu of the rule provided in section 312(g)(1), the amount of such loss so to be applied shall be reduced by the