

statement attached to the shareholder's return for the year in which the rights are received. This election, once made, shall be irrevocable with respect to the rights for which the election was made. Any shareholder making such an election shall retain a copy of the election and of the tax return with which it was filed, in order to substantiate the use of an allocated basis upon a subsequent disposition of the stock acquired by exercise.

EFFECTS ON CORPORATION

§ 1.312-1 Adjustment to earnings and profits reflecting distributions by corporations.

(a) In general, on the distribution of property by a corporation with respect to its stock, its earnings, and profits (to the extent thereof) shall be decreased by—

- (1) The amount of money,
- (2) The principal amount of the obligations of such corporation issued in such distribution, and
- (3) The adjusted basis of other property.

For special rule with respect to distributions to which section 312(e) applies, see § 1.312-5.

(b) The adjustment provided in section 312(a)(3) and paragraph (a)(3) of this section with respect to a distribution of property (other than money or its own obligations) shall be made notwithstanding the fact that such property has appreciated or depreciated in value since acquisition.

(c) The application of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example 1. Corporation A distributes to its sole shareholder property with a value of \$10,000 and a basis of \$5,000. It has \$12,500 in earnings and profits. The reduction in earnings and profits by reason of such distribution is \$5,000. Such is the reduction even though the amount of \$10,000 is includible in the income of the shareholder (other than a corporation) as a dividend.

Example 2. The facts are the same as in *Example (1)* above except that the property has a basis of \$15,000 and the earnings and profits of the corporation are \$20,000. The reduction in earnings and profits is \$15,000. Such is the reduction even though only the amount of \$10,000 is includible in the income of the shareholder as a dividend.

(d) In the case of a distribution of stock or rights to acquire stock a portion of which is includible in income by reason of section 305(b), the earnings and profits shall be reduced by the fair market value of such portion. No reduction shall be made if a distribution of stock or rights to acquire stock is not includible in income under the provisions of section 305.

(e) No adjustment shall be made in the amount of the earnings and profits of the issuing corporation upon a disposition of section 306 stock unless such disposition is a redemption.

§ 1.312-2 Distribution of inventory assets.

Section 312(b) provides for the increase and the decrease of the earnings and profits of a corporation which distributes, with respect to its stock, inventory assets as defined in section 312(b)(2), where the fair market value of such assets exceeds their adjusted basis. The rules provided in section 312(b) (relating to distributions of certain inventory assets) shall be applicable without regard to the method used in computing inventories for the purpose of the computation of taxable income. Section 312(b) does not apply to distributions described in section 312(e).

§ 1.312-3 Liabilities.

The amount of any reductions in earnings and profits described in section 312 (a) or (b) shall be (a) reduced by the amount of any liability to which the property distributed was subject and by the amount of any other liability of the corporation assumed by the shareholder in connection with such distribution, and (b) increased by the amount of gain recognized to the corporation under section 311 (b), (c), or (d), or under section 341(f), 617(d), 1245(a), 1250(a), 1251(c), 1252(a), or 1254(a).

[T.D. 7209, 37 FR 20804, Oct. 5, 1972, as amended by T.D. 8586, 60 FR 2500, Jan. 10, 1995]

§ 1.312-4 Examples of adjustments provided in section 312(c).

The adjustments provided in section 312(c) may be illustrated by the following examples:

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Example 1. On December 2, 1954, Corporation X distributed to its sole shareholder, A, an individual, as a dividend in kind a vacant lot which was not an inventory asset. On that date, the lot had a fair market value of \$5,000 and was subject to a mortgage of \$2,000. The adjusted basis of the lot was \$3,100. The amount of the earnings and profits was \$10,000. The amount of the dividend received by A is \$3,000 (\$5,000, the fair market value, less \$2,000, the amount of the mortgage) and the reduction in the earnings and profits of Corporation X is \$1,100 (\$3,100, the basis, less \$2,000, the amount of mortgage).

Example 2. The facts are the same as in *Example (1)* above with the exception that the amount of the mortgage to which the property was subject was \$4,000. The amount of the dividend received by A is \$1,000, and there is no reduction in the earnings and profits of the corporation as a result of the distribution (disregarding such reduction as may result from an increase in tax to Corporation X because, of gain resulting from the distribution). There is a gain of \$900 recognized to Corporation X, the difference between the basis of the property (\$3,100) and the amount of the mortgage (\$4,000), under section 311(c) and an increase in earnings and profits of \$900.

Example 3. Corporation A, having accumulated earnings and profits of \$100,000, distributed in kind to its shareholders, not in liquidation, inventory assets which had a basis to it on the "Lifo" method (section 472) of \$46,000 and on the basis of cost or market (section 471) of \$50,000. The inventory had a fair market value of \$55,000 and was subject to a liability of \$35,000. This distribution results in a net decrease in earnings and profits of Corporation A of \$11,000, (without regard to any tax on Corporation A) computed as follows:

"Fifo" basis of inventory	\$50,000	
Less: "Lifo" basis of inventory	46,000	
Gain recognized—addition to earnings and profits (section 311(b))		\$4,000
Adjustment to earnings and profits required by section 312(b)(1)(A):		
Fair market value of inventory	\$55,000	
Less: "Lifo" basis plus adjustment under section 311(b)	50,000	5,000
Total increase in earnings and profits		9,000
Decrease in earnings and profits—under section 312(b)(1)(B)(i)	\$55,000	
Less: Liability assumed	35,000	
Net amount of distribution (decrease in earnings)		20,000
Net decrease in earnings and profits		11,000

§ 1.312-5 Special rule for partial liquidations and certain redemptions.

The part of the distribution properly chargeable to capital account within the provisions of section 312(e) shall

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not be considered a distribution of earnings and profits within the meaning of section 301 for the purpose of determining taxability of subsequent distributions by the corporation.

§ 1.312-6 Earnings and profits.

(a) In determining the amount of earnings and profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated before March 1, 1913) due consideration must be given to the facts, and, while mere bookkeeping entries increasing or decreasing surplus will not be conclusive, the amount of the earnings and profits in any case will be dependent upon the method of accounting properly employed in computing taxable income (or net income, as the case may be). For instance, a corporation keeping its books and filing its income tax returns under subchapter E, chapter 1 of the Code, on the cash receipts and disbursements basis may not use the accrual basis in determining earnings and profits; a corporation computing income on the installment basis as provided in section 453 shall, with respect to the installment transactions, compute earnings and profits on such basis; and an insurance company subject to taxation under section 831 shall exclude from earnings and profits that portion of any premium which is unearned under the provisions of section 832(b)(4) and which is segregated accordingly in the unearned premium reserve.

(b) Among the items entering into the computation of corporate earnings and profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 61 or corresponding provisions of prior revenue acts. Gains and losses within the purview of section 1002 or corresponding provisions of prior revenue acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section. Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends

when distributed to shareholders in the form of dividends.

(c)(1) In the case of a corporation in which depletion or depreciation is a factor in the determination of income, the only depletion or depreciation deductions to be considered in the computation of the total earnings and profits are those based on cost or other basis without regard to March 1, 1913, value. In computing the earnings and profits for any period beginning after February 28, 1913, the only depletion or depreciation deductions to be considered are those based on (i) cost or other basis, if the depletable or depreciable asset was acquired subsequent to February 28, 1913, or (ii) adjusted cost or March 1, 1913, value, whichever is higher, if acquired before March 1, 1913. Thus, discovery or percentage depletion under all revenue acts for mines and oil and gas wells is not to be taken into consideration in computing the earnings and profits of a corporation. Similarly, where the basis of property in the hands of a corporation is a substituted basis, such basis, and not the fair market value of the property at the time of the acquisition by the corporation, is the basis for computing depletion and depreciation for the purpose of determining earnings and profits of the corporation.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. Oil producing property which A had acquired in 1949 at a cost of \$28,000 was transferred to Corporation Y in December 1951, in exchange for all of its capital stock. The fair market value of the stock and of the property as of the date of the transfer was \$247,000. Corporation Y, after four years' operation, effected in 1955 a cash distribution to A in the amount of \$165,000. In determining the extent to which the earnings and profits of Corporation Y available for dividend distributions have been increased as the result of production and sale of oil, the depletion to be taken into account is to be computed upon the basis of \$28,000 established in the nontaxable exchange in 1951 regardless of the fair market value of the property or of the stock issued in exchange therefor.

(d) A loss sustained for a year before the taxable year does not affect the earnings and profits of the taxable year. However, in determining the

earnings and profits accumulated since February 28, 1913, the excess of a loss sustained for a year subsequent to February 28, 1913, over the undistributed earnings and profits accumulated since February 28, 1913, and before the year for which the loss was sustained, reduces surplus as of March 1, 1913, to the extent of such excess. If the surplus as of March 1, 1913, was sufficient to absorb such excess, distributions to shareholders after the year of the loss are out of earnings and profits accumulated since the year of the loss to the extent of such earnings.

(e) With respect to the effect on the earnings and profits accumulated since February 28, 1913, of distributions made on or after January 1, 1916, and before August 6, 1917, out of earnings or profits accumulated before March 1, 1913, which distributions were specifically declared to be out of earnings and profits accumulated before March 1, 1913, see section 31(b) of the Revenue Act of 1916, as added by section 1211 of the Revenue Act of 1917 (40 Stat. 336).

§ 1.312-7 Effect on earnings and profits of gain or loss realized after February 28, 1913.

(a) In order to determine the effect on earnings and profits of gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation, section 312(f)(1) prescribed certain rules for—

(1) The computation of the total earnings and profits of the corporation of most frequent application in determining invested capital; and

(2) The computation of earnings and profits of the corporation for any period beginning after February 28, 1913, of most frequent application in determining the source of dividend distributions.

Such rules are applicable whenever under any provision of subtitle A of the Code it is necessary to compute either the total earnings and profits of the corporation or the earnings and profits for any period beginning after February 28, 1913. For example, since the earnings and profits accumulated after February 28, 1913, or the earnings and profits of the taxable year, are earnings and profits for a period beginning

after February 28, 1913, the determination of either must be in accordance with the regulations prescribed by this section for the ascertainment of earnings and profits for any period beginning after February 28, 1913. Under subparagraph (1) of this paragraph, such gain or loss is determined by using the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, but disregarding value as of March 1, 1913. Under subparagraph (2) of this paragraph, there is used such adjusted basis for determining gain, giving effect to the value as of March 1, 1913, whenever applicable. In both cases the rules are the same as those governing depreciation and depletion in computing earnings and profits (see § 1.312-6). Under both subparagraphs (1) and (2) of this paragraph, the adjusted basis is subject to the limitations of the third sentence of section 312(f)(1) requiring the use of adjustments proper in determining earnings and profits. The proper adjustments may differ under section 312(f)(1)(A) and (B) depending upon the basis to which the adjustments are to be made. If the application of section 312(f)(1)(B) results in a loss and if the application of section 312(f)(1)(A) to the same transaction reaches a different result, then the loss under section 312(f)(1)(B) will be subject to the adjustment thereto required by section 312(g)(2). (See § 1.312-9.)

(b)(1) The gain or loss so realized increases or decreases the earnings and profits to, but not beyond, the extent to which such gain or loss was recognized in computing taxable income (or net income, as the case may be) under the law applicable to the year in which such sale or disposition was made. As used in this paragraph, the term "recognized" has reference to that kind of realized gain or loss which is recognized for income tax purposes by the statute applicable to the year in which the gain or loss was realized. For example, see section 356. A loss (other than a wash sale loss with respect to which a deduction is disallowed under the provisions of section 1091 or corresponding provisions of prior revenue laws) may be recognized though not allowed as a deduction (by reason, for example, of the operation of sections 267

and 1211 and corresponding provisions of prior revenue laws) but the mere fact that it is not allowed does not prevent decrease in earnings and profits by the amount of such disallowed loss. Wash sale losses, however, disallowed under section 1091 and corresponding provisions of prior revenue laws, are deemed nonrecognized losses and do not reduce earnings or profits. The *recognized* gain or loss for the purpose of computing earnings and profits is determined by applying the recognition provisions to the realized gain or loss computed under the provisions of section 312(f)(1) as distinguished from the realized gain or loss used in computing taxable income (or net income, as the case may be).

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. Corporation X on January 1, 1952, owned stock in Corporation Y which it had acquired from Corporation Y in December 1951, in an exchange transaction in which no gain or loss was recognized. The adjusted basis to Corporation X of the property exchanged by it for the stock in Corporation Y was \$30,000. The fair market value of the stock in Corporation Y when received by Corporation X was \$930,000. On April 9, 1955, Corporation X made a cash distribution of \$900,000 and, except for the possible effect of the transaction in 1951, had no earnings or profits accumulated after February 28, 1913, and had no earnings or profits for the taxable year. The amount of \$900,000 representing the excess of the fair market value of the stock of Corporation Y over the adjusted basis of the property exchanged therefor was not recognized gain to Corporation X under the provisions of section 112 of the Internal Revenue Code of 1939. Accordingly, the earnings and profits of Corporation X are not increased by \$900,000, the amount of the gain realized but not recognized in the exchange, and the distribution was not a taxable dividend. The basis in the hands of Corporation Y of the property acquired by it from Corporation X is \$30,000. If such property is thereafter sold by Corporation Y, gain or loss will be computed on such basis of \$30,000, and earnings and profits will be increased or decreased accordingly.

Example 2. On January 2, 1910, Corporation M acquired nondepreciable property at a cost of \$1,000. On March 1, 1913, the fair market value of such property in the hands of Corporation M was \$2,200. On December 31, 1952, Corporation M transfers such property to Corporation N in exchange for \$1,900 in cash and all Corporation N's stock, which has a

fair market value of \$1,100. For the purpose of computing the total earnings and profits of Corporation M, the gain on such transaction is \$2,000 (the sum of \$1,900 in cash and stock worth \$1,100 minus \$1,000, the adjusted basis for computing gain, determined without regard to March 1, 1913, value), \$1,900 of which is recognized under section 356, since this was the amount of money received, although for the purpose of computing net income the gain is only \$800 (the sum of \$1,900 in cash and stock worth \$1,100, minus \$2,200, the adjusted basis for computing gain determined by giving effect to March 1, 1913, value). Such earnings and profits will therefore be increased by only \$800 as a result of the earnings and profits of Corporation M for any period beginning after February 28, 1913, however, the gain arising from the transaction, like the taxable gain, is only \$800, all of which is recognized under section 112(c) of the Internal Revenue Code of 1939, the money received being in excess of such amount. Such earnings and profits will therefore be increased by only \$800 as a result of the transaction. For increase 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, see § 1.312-9.

Example 3. On July 31, 1955, Corporation R owned oil-producing property acquired after February 28, 1913, at a cost of \$200,000, but having an adjusted basis (by reason of taking percentage depletion) of \$100,000 for determining gain. However, the adjusted basis of such property to be used in computing gain or loss for the purpose of earnings and profits is, because of the provisions of the third sentence of section 312(f)(1), \$150,000. On such day Corporation R transferred such property to Corporation S in exchange for \$25,000 in cash and all of the stock of Corporation S, which had a fair market value of \$100,000. For the purpose of computing taxable income, Corporation R has realized a gain of \$25,000 as a result of this transaction, all of which is recognized under section 356. For the purpose of computing earnings and profits, however, Corporation R has realized a loss of \$25,000, none of which is recognized owing to the provisions of section 356(c). The earnings and profits of Corporation R are therefore neither increased nor decreased as a result of the transaction. The adjusted basis of the Corporation S stock in the hands of Corporation R for purposes of computing earnings and profits, however, will be \$125,000 (though only \$100,000 for the purpose of computing taxable income), computed as follows:

Basis of property transferred	\$200,000
Less money received on exchange	25,000
Plus gain or minus loss recognized on exchange	None
<hr/>	
Basis of stock	175,000
Less adjustments (same as those used in determining adjusted basis of property transferred) ..	50,000
<hr/>	
Adjusted basis of stock	125,000

If, therefore, Corporation R should subsequently sell the Corporation S stock for \$100,000, a loss of \$25,000 will again be realized for the purpose of computing earnings and profits, all of which will be recognized and will be applied to decrease the earnings and profits of Corporation R.

(c)(1) The third sentence of section 312(f)(1) provides for cases in which the adjustments, prescribed in section 1016, to the basis indicated in section 312(f)(1)(A) or (B), as the case may be, differ from the adjustments to such basis proper for the purpose of determining earnings or profits. The adjustments provided by such third sentence reflect the treatment provided by §§ 1.312-6 and 1.312-15 relative to cases where the deductions for depletion and depreciation in computing taxable income (or net income, as the case may be) differ from the deductions proper for the purpose of computing earnings and profits.

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

Example 1. Corporation X purchased on January 2, 1931, an oil lease at a cost of \$10,000. The lease was operated only for the years 1931 and 1932. The deduction for depletion in each of the years 1931 and 1932 amounted to \$2,750, of which amount \$1,750 represented percentage depletion in excess of depletion based on cost. The lease was sold in 1955 for \$15,000. Under section 1016(a)(2), in determining the gain or loss from the sale of the property, the basis must be adjusted for cost depletion of \$1,000 in 1931 and percentage depletion of \$2,750 in 1932. However, the adjustment of such basis, proper for the determination of earnings and profits, is \$1,000 for each year, or \$2,000. Hence, the cost is to be adjusted only to the extent of \$2,000, leaving an adjusted basis of \$8,000 and the earnings and profits will be increased by \$7,000, and not by \$8,750. The difference of \$1,750 is equal to the amount by which the percentage depletion for the year 1932 (\$2,750) exceeds the depletion on cost for that year (\$1,000) and has already been applied in the computation of earnings and profits for the year 1932 by taking into account only \$1,000 instead of \$2,750 for depletion in the computation of such earnings and profits. (See § 1.316-1.)

Example 2. If, in *Example (1)*, above, the property, instead of being sold, is exchanged in a transaction described in section 1031 for like property having a fair market value of \$7,750 and cash of \$7,250, then the increase in earnings and profits amounts to \$7,000, that is, \$15,000 (\$7,750 plus \$7,250) minus the basis

of \$8,000. However, in computing taxable income of Corporation X, the gain is \$8,750, 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

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312(g)(1), the amount of such loss so to be applied shall be reduced by the amount, if any, by which the adjusted basis of the property used in determining the loss, exceeds the adjusted basis computed without regard to the fair market value of the property on March 1, 1913. If the amount so applied in reduction of the loss exceeds such loss, the excess over such loss shall increase 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 application of section 312(g)(2) may be illustrated by the following examples:

Example 1. Corporation Y acquired non-depreciable property before March 1, 1913, at a cost of \$8,000. Its fair market value as of March 1, 1913, was \$13,000, and it was sold in 1955 for \$10,000. Under section 312(f)(1)(B) the adjusted basis would be \$13,000 and there would be a loss of \$3,000. The application of section 312(f)(1)(B) would result in a loss from the sale in 1955 to be applied in decrease of earnings and profits for that year. Section 312(g)(2), however, applies and the loss of \$3,000 is reduced by the amount by which the adjusted basis of \$13,000 exceeds the cost of \$8,000 (the adjusted basis computed without regard to the value on March 1, 1913), namely \$5,000. The amount of the loss is, accordingly, reduced from \$3,000 to zero and there is no decrease in earnings and profits of Corporation Y for the year 1955 as a result of the sale. The amount applied in reduction of the decrease, namely, \$5,000, exceeds \$3,000. Accordingly, as a result of the sale the excess of \$2,000 increases that part of the earnings and profits of Corporation Y consisting of increase in value of property accrued before, but realized on or after March 1, 1913.

Example 2. Corporation Z 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 \$8,000. Under section 312(f)(1)(B) the adjusted basis would be \$12,000 and there would be a loss of \$4,000. The application of section 312(f)(1)(B) would result in a loss from the sale in 1955 to be applied in decrease of earnings and profits for that year. Section 312(g)(2), however, applies and the loss of \$4,000 is reduced by the amount by which the adjusted basis of \$12,000 exceeds the cost of \$10,000 (the adjusted basis computed without regard to the value on March 1, 1913), namely, \$2,000. The amount of the loss is, accordingly, reduced from \$4,000 to \$2,000 and the decrease in earnings and profits of Corporation Z for the year 1955 as a result of the sale is \$2,000 instead of \$4,000. The amount applied in reduction of the decrease, namely, \$2,000,

does not exceed \$4,000. Accordingly, as a result of the sale there is no increase in that part of the earnings and profits of Corporation Z consisting of increase in value of property accrued before, but realized on or after, March 1, 1913.

§ 1.312-10 Allocation of earnings in certain corporate separations.

(a) If one corporation transfers part of its assets constituting an active trade or business to another corporation in a transaction to which section 368(a)(1)(4) applies and immediately thereafter the stock and securities of the controlled corporation are distributed in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies, the earnings and profits of the distributing corporation immediately before the transaction shall be allocated between the distributing corporation and the controlled corporation. In the case of a newly created controlled corporation, such allocation generally shall be made in proportion to the fair market value of the business or businesses (and interests in any other properties) retained by the distributing corporation and the business or businesses (and interests in any other properties) of the controlled corporation immediately after the transaction. In a proper case, allocation shall be made between the distributing corporation and the controlled corporation in proportion to the net basis of the assets transferred and of the assets retained or by such other method as may be appropriate under the facts and circumstances of the case. The term *net basis* means the basis of the assets less liabilities assumed or liabilities to which such assets are subject. The part of the earnings and profits of the taxable year of the distributing corporation in which the transaction occurs allocable to the controlled corporation shall be included in the computation of the earnings and profits of the first taxable year of the controlled corporation ending after the date of the transaction.

(b) If a distribution or exchange to which section 355 applies (or so much of section 356 as relates to section 355) is not in pursuance of a plan meeting the

requirements of a reorganization as defined in section 368(a)(1)(D), the earnings and profits of the distributing corporation shall be decreased by the lesser of the following amounts:

(1) The amount by which the earnings and profits of the distributing corporation would have been decreased if it had transferred the stock of the controlled corporation to a new corporation in a reorganization to which section 368(a)(1)(D) applied and immediately thereafter distributed the stock of such new corporation or,

(2) The net worth of the controlled corporation. (For this purpose the term *net worth* means the sum of the basis of all of the properties plus cash minus all liabilities.)

If the earnings and profits of the controlled corporation immediately before the transaction are less than the amount of the decrease in earnings and profits of the distributing corporation (including a case in which the controlled corporation has a deficit) the earnings and profits of the controlled corporation, after the transaction, shall be equal to the amount of such decrease. If the earnings and profits of the controlled corporation immediately before the transaction are more than the amount of the decrease in the earnings and profits of the distributing corporation, they shall remain unchanged.

(c) In no case shall any part of a deficit of a distributing corporation within the meaning of section 355 be allocated to a controlled corporation.

§ 1.312-11 Effect on earnings and profits of certain other tax-free exchanges, tax-free distributions, and tax-free transfers from one corporation to another.

(a) If property is transferred by one corporation to another, and, under the law applicable to the year in which the transfer was made, no gain or loss was recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings and profits of the transferor shall be made as between the transferor and the transferee. Transfers to which the preceding

sentence applies include contributions to capital, transfers under section 351, transfers in connection with reorganizations under section 368, transfers in liquidations under section 332 and intercompany transfers during a period of affiliation. However, if, for example, property is transferred from one corporation to another in a transaction under section 351 or as a contribution to capital and the transfer is not followed or preceded by a reorganization, a transaction under section 302(a) involving a substantial part of the transferor's stock, or a total or partial liquidation, then ordinarily no allocation of the earnings and profits of the transferor shall be made. For specific rules as to allocation of earnings and profits in certain reorganizations under section 368 and in certain liquidations under section 332 see section 381 and the regulations thereunder. For allocation of earnings and profits in certain corporate separations see section 312(i) and § 1.312-10.

(b) The general rule provided in section 316 that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, or in a transaction subject to section 355, to its shareholders—

(i) Of stock or securities in such corporation or in another corporation a party to the reorganization in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see section 112(g) of the Revenue Act of 1932 (47 Stat. 197)); or

(ii) Of stock (other than preferred stock) in another corporation which is a party to the reorganization without the surrender by the distributees of stock in the distributing corporation if the distribution occurs after October 20, 1951, and is subject to section 112(b)(11) of the Internal Revenue Code of 1939; or

(iii) Of stock or securities in such corporation or in another corporation a party to the reorganization in any taxable year beginning before January 1,

1939, or on or after such date, in exchange for its stock or securities in a transaction to which section 112(b)(3) of the Internal Revenue Code of 1939 was applicable; or

(iv) Of stock or securities in such corporation or in another corporation in exchange for its stock or securities in a transaction subject to section 354 or 355,

if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(2) The distribution in any taxable year (beginning before January 1, 1939, or on or after such date) of stock or securities, or other property or money, to a corporation in complete liquidation of another corporation, under the circumstances described in section 112(b)(6) of the Revenue Act of 1936 (49 Stat. 1679), the Revenue Act of 1938 (52 Stat. 485), of the Internal Revenue Code of 1939, or section 332 of the Internal Revenue Code of 1954.

(3) The distribution in any taxable year (beginning after December 31, 1938), of stock or securities, or other property or money, in the case of an exchange or distribution described in section 371 of the Internal Revenue Code of 1939 or in section 1081 of the Internal Revenue Code of 1954 (relating to exchanges and distributions in obedience to orders of the Securities and Exchange Commission), if no gain to the distributee from the receipt of such stock, securities, or other property or money was recognized by law.

(4) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115(f) of the Revenue Act of 1934 (48 Stat. 712) or a corresponding provision of a prior Revenue Act, or section 305 of the Code.

(5) The distribution, in a taxable year of the distributee beginning after December 31, 1931, by or on behalf of an insolvent corporation, in connection with a section 112(b)(10) reorganization under the Internal Revenue Code of 1939, or in a transaction subject to section 371 of the Internal Revenue Code of 1954, of stock or securities in a corporation organized or made use of to

effectuate the plan of reorganization, if under section 112(e) of the Internal Revenue Code of 1939 or section 371 of the Internal Revenue Code of 1954 no gain to the distributee from the receipt of such stock or securities was recognized by law.

(c) A distribution described in paragraph (b) of this section does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. In the case, however, of amounts distributed in liquidation (other than a taxfree liquidation or reorganization described in paragraph (b)(1), (2), (3), or (5) of this section) the earnings or profits of the corporation making the distribution are diminished by the portion of such distribution properly chargeable to earnings or profits accumulated after February 28, 1913, after first deducting from the amount of such distribution the portion thereof allocable to capital account.

(d) For the purposes of this section, the terms *reorganization* and *party to the reorganization* shall, for any taxable year beginning before January 1, 1934, have the meanings assigned to such terms in section 112 of the Revenue Act of 1932 (47 Stat. 196); for any taxable year beginning after December 31, 1933, and before January 1, 1936, have the meanings assigned to such terms in section 112 of the Revenue Act of 1934 (48 Stat. 704); for any taxable year beginning after December 31, 1935, and before January 1, 1938, have the meanings assigned to such terms in section 112 of the Revenue Act of 1936 (49 Stat. 1678); for any taxable year beginning after December 31, 1937, and before January 1, 1939, have the meanings assigned to such terms in section 112 of the Revenue Act of 1938 (52 Stat. 485); and for any taxable year beginning after December 31, 1938, and ending before June 22, 1954, providing no election is made under section 393(b)(2) of the Internal Revenue Code of 1954, have the meanings assigned to such terms in section

112(g)(1) of the Internal Revenue Code of 1939.

§ 1.312-12 Distributions of proceeds of loans guaranteed by the United States.

(a) The provisions of section 312(j) are applicable with respect to a loan, any portion of which is guaranteed by an agency of the United States Government without regard to the percentage of such loan subject to such guarantee.

(b) The application of section 312(j) is illustrated by the following example:

Example. Corporation A borrowed \$1,000,000 for the purpose of construction of an apartment house, the cost and adjusted basis of which was \$900,000. This loan was guaranteed by an agency of the United States Government. One year after such loan was made and after the completion of construction of the building (but before such corporation had received any income) it distributed \$100,000 cash to its shareholders. The earnings and profits of the taxable year of such corporation are increased (pursuant to section 312(j)) by \$100,000 immediately prior to such distribution and are decreased by \$100,000 immediately after such distribution. Such decrease, however, does not reduce the earnings and profits below zero. Two years later, it has no accumulated earnings and has earnings of the taxable year of \$100,000. Before it has made any payments on the loan, it distributes \$200,000 to its shareholders. The earnings and profits of the taxable year of the corporation (\$100,000) are increased by \$100,000, the excess of the amount of the guaranteed loan over the adjusted basis of the apartment house (calculated without adjustment for depreciation). The entire amount of each distribution is treated as a distribution out of earnings and profits and, accordingly, as a taxable dividend.

§ 1.312-15 Effect of depreciation on earnings and profits.

(a) *Depreciation for taxable years beginning after June 30, 1972—(1) In general.* Except as provided in subparagraph (2) of this paragraph and paragraph (c) of this section, for purposes of computing the earnings and profits of a corporation (including a real estate investment trust as defined in section 856) for any taxable year beginning after June 30, 1972, the allowance for depreciation (and amortization, if any) shall be deemed to be the amount which would be allowable for such year if the straight line method of depreciation had been used for all property for

which depreciation is allowable for each taxable year beginning after June 30, 1972. Thus, for taxable years beginning after June 30, 1972, in determining the earnings and profits of a corporation, depreciation must be computed under the straight line method, notwithstanding that in determining taxable income the corporation uses an accelerated method of depreciation described in subparagraph (A), (B), or (C) of section 312(m)(2) or elects to amortize the basis of property under section 169, 184, 187, or 188, or any similar provision. See § 1.168(k)-1(f)(7) with respect to the treatment of the additional first year depreciation deduction allowable under section 168(k) for qualified property or 50-percent bonus depreciation property, and § 1.1400L(b)-1(f)(7) with respect to the treatment of the additional first year depreciation deduction allowable under section 1400L(b) for qualified New York Liberty Zone property, for purposes of computing the earnings and profits of a corporation.

(2) *Exception.* (i) If, for any taxable year beginning after June 30, 1972, a method of depreciation is used by a corporation in computing taxable income which the Secretary or his delegate has determined results in a reasonable allowance under section 167(a) and which is not a declining balance method of depreciation (described in § 1.167(b)-2), the sum of the years-digits method (described in § 1.167(b)-3), or any other method allowed solely by reason of the application of subsection (b)(4) or (j)(1)(C) of section 167, then the adjustment to earnings and profits for depreciation for such year shall be determined under the method so used (in lieu of the straight line method).

(ii) The Commissioner has determined that the “unit of production” (see § 1.167(b)-0(b)), and the “machine hour” methods of depreciation, when properly used under appropriate circumstances, meet the requirements of subdivision (i) of this subparagraph. Thus, the adjustment to earnings and profits for depreciation (for the taxable year for which either of such methods is properly used under appropriate circumstances) shall be determined under whichever of such methods is used to compute taxable income.

(3) *Determinations under straight line method.* (i) In the case of property with respect to which an allowance for depreciation is claimed in computing taxable income, the determination of the amount which would be allowable under the straight line method shall be based on the manner in which the corporation computes depreciation in determining taxable income. Thus, if an election under § 1.167(a)-11 is in effect with respect to the property, the amount of depreciation which would be allowable under the straight line method shall be determined under § 1.167(a)-11(g)(3). On the other hand, if property is not depreciated under the provisions of § 1.167(a)-11, the amount of depreciation which would be allowable under the straight line method shall be determined under § 1.167(b)-1. Any election made under section 167(f), with respect to reducing the amount of salvage value taken into account in computing the depreciation allowance for certain property, or any convention adopted under § 1.167(a)-10(b) or § 1.167(a)-11(c)(2), with respect to additions and retirements from multiple asset accounts, which is used in computing depreciation for taxable income shall be used in computing depreciation for earnings and profits purposes.

(ii) In the case of property with respect to which an election to amortize is in effect under section 169, 184, 187, or 188, or any similar provision, the amount which would be allowable under the straight line method of depreciation shall be determined under the provisions of § 1.167(b)-1. Thus, the cost or other basis of the property, less its estimated salvage value, is to be deducted in equal annual amounts over the period of the estimated useful life of the property. In computing the amount of depreciation for earnings and profits purposes, a taxpayer may utilize the provisions of section 167(f) (relating to the reduction in the amount of salvage value taken into account in computing the depreciation allowance for certain property) and any convention which could have been adopted for such property under § 1.167(a)-10(b) (relating to additions and retirements from multiple asset accounts).

(b) *Transitional rules—(1) Depreciation.* If, for the taxable year which includes June 30, 1972, (i) the allowance for depreciation of any property is computed under a method other than the straight line method or a method described in paragraph (a)(2) of this section, and (ii) paragraph (a)(1) of this section applies to such property for the first taxable year beginning after June 30, 1972, then adjustments to earnings and profits for depreciation of such property for taxable years beginning after June 30, 1972, shall be determined as if the corporation changed to the straight line method with respect to such property as of the first day of the first taxable year beginning after June 30, 1972. Thus, if an election under § 1.167(a)-11 is in effect with respect to the property, the change shall be made under the provisions of § 1.167(a)-11(c)(1)(iii), except that no statement setting forth the vintage accounts for which the change is made shall be furnished with the income tax return of the year of change if the change is only for purposes of computing earnings and profits. In all other cases, the unrecovered cost or other basis of the property (less a reasonable estimate for salvage) as of such first day shall be recovered through equal annual allowances over the estimated remaining useful life determined in accordance with the circumstances existing at that time. See paragraph (a)(3)(i) of this section for rules relating to the applicability of section 167(f) in determining salvage value.

(2) *Amortization.* If, for the taxable year which includes June 30, 1972, the basis of any property is amortized under section 169, 184, 187, or 188, or any similar provision, then adjustments to earnings and profits for depreciation or amortization of such property for taxable years beginning after June 30, 1972, shall be determined as if the unrecovered cost or other basis of the property (less a reasonable estimate for salvage) as of the first day of the first taxable year beginning after June 30, 1972, were recovered through equal annual allowances over the estimated remaining useful life of the property determined in accordance with the circumstances existing at that time. See paragraph (a)(3)(ii) of this section for

rules relating to the applicability of section 167(f).

(c) *Certain foreign corporations.* Paragraphs (a) and (b) of this section shall not apply in computing the earnings and profits of a foreign corporation for any taxable year for which less than 20 percent of the gross income from all sources of such corporation is derived from sources within the United States.

(d) *Books and records.* Wherever different methods of depreciation are used for taxable income and earnings and profits purposes, records shall be maintained which show the depreciation taken for earnings and profits purposes each year and which will allow computation of the adjusted basis of the property in each account using the depreciation taken for earnings and profits purposes.

[T.D. 7221, 37 FR 24746, Nov. 21, 1972, as amended by T.D. 9283, 71 FR 51746, Aug. 31, 2006]

DEFINITIONS; CONSTRUCTIVE OWNERSHIP
OF STOCK

§ 1.316-1 Dividends.

(a)(1) The term *dividend* for the purpose of subtitle A of the Code (except when used in subchapter L, chapter 1 of the Code, in any case where the reference is to dividends and similar distributions of insurance companies paid to policyholders as such) comprises any distribution of property as defined in section 317 in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of either—

(i) Earnings and profits accumulated since February 28, 1913, or

(ii) Earnings and profits of the taxable year computed without regard to the amount of the earnings and profits (whether of such year or accumulated since February 28, 1913) at the time the distribution was made.

The earnings and profits of the taxable year shall be computed as of the close of such year, without diminution by reason of any distributions made during the taxable year. For the purpose of determining whether a distribution constitutes a dividend, it is unnecessary to ascertain the amount of the earnings and profits accumulated since

February 28, 1913, if the earnings and profits of the taxable year are equal to or in excess of the total amount of the distributions made within such year.

(2) Where a corporation distributes property to its shareholders on or after June 22, 1954, the amount of the distribution which is a dividend to them may not exceed the earnings and profits of the distributing corporation.

(3) The rule of (2) above may be illustrated by the following example:

Example. X and Y, individuals, each own one-half of the stock of Corporation A which has earnings and profits of \$10,000. Corporation A distributes property having a basis of \$6,000 and a fair market value of \$16,000 to its shareholders, each shareholder receiving property with a basis of \$3,000 and with a fair market value of \$8,000 in a distribution to which section 301 applies. The amount taxable to each shareholder as a dividend under section 301(c) is \$5,000.

(b)(1) In the case of a corporation which, under the law applicable to the taxable year in which a distribution is made, is a personal holding company or which, for the taxable year in respect of which a distribution is made under section 563 (relating to dividends paid within 2 1/2 months after the close of the taxable year), or section 547 (relating to deficiency dividends), or corresponding provisions of a prior income tax law, was under the applicable law a personal holding company, the term *dividend*, in addition to the meaning set forth in the first sentence of section 316, also means a distribution to its shareholders as follows: A distribution within a taxable year of the corporation, or of a shareholder, is a dividend to the extent of the corporation's undistributed personal holding company income (determined under section 545 without regard to distributions under section 316(b)(2)) for the taxable year in which, or, in the case of a distribution under section 563 or section 547, the taxable year in respect of which, the distribution was made. This subparagraph does not apply to distributions in partial or complete liquidation of a personal holding company. In the case of certain complete liquidations of a personal holding company see subparagraph (2) of this paragraph.

(2) In the case of a corporation which, under the law applicable to the taxable