

(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.

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§ 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 re-

ceived 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 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 imme-

diately 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