

The election shall be made by a shareholder with respect to all the rights received by him in a particular distribution in respect of all the stock of the same class owned by him in the issuing corporation at the time of such distribution. Such election to allocate basis to rights shall be in the form of a 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),

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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:

*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   |         |
|   |          | \$4,000 |
| 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   |
|   |          | 9,000   |
| Total increase in earnings and profits .....                            |          | 9,000   |

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|--|----------|--------|
| Decrease in earnings and profits—under section 312(b)(1)(B)(i) ..... | \$55,000 |        |
| Less: Liability assumed .....  | 35,000   |        |
|  |          | 20,000 |
| 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 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