

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 pre-

vent 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
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Basis of stock	175,000
Less adjustments (same as those used in determining adjusted basis of property transferred) ..	50,000
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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 real-

ized 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.

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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 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