

§ 1.312-5

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

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