

**§ 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	
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