

(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 immediately 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 corporation, they shall remain unchanged.

(c) In no case shall any part of a deficit of a distributing corporation within the meaning of section 355 be allocated to a controlled corporation.

§ 1.312-11 Effect on earnings and profits of certain other tax-free exchanges, tax-free distributions, and tax-free transfers from one corporation to another.

(a) If property is transferred by one corporation to another, and, under the law applicable to the year in which the transfer was made, no gain or loss was recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings and profits of the transferor shall be made as between the transferor and the transferee. Transfers to which the preceding sentence applies include contributions to capital, transfers under section 351, transfers in connection with reorganizations under section 368, transfers in liquidations under section 332 and intercompany transfers during a period of affiliation. However, if, for example, property is transferred from one corporation to another in a transaction under section 351 or as a contribution to capital and the transfer is not followed or preceded by a reorganization, a transaction under section 302(a) involving a substantial part of the transferor's stock, or a total or partial liquidation, then ordinarily no allocation of the earnings and profits of the transferor shall be made. For specific rules as to allocation of earnings and profits in certain reorganizations under section 368 and in certain liquidations under section 332 see section 381 and the regulations thereunder. For allocation of earnings and profits in certain corporate separations see section 312(i) and § 1.312-10.

(b) The general rule provided in section 316 that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, or in a transaction subject to section 355, to its shareholders—

(i) Of stock or securities in such corporation or in another corporation a party to the reorganization in any taxable year beginning before January 1,