

**Internal Revenue Service, Treasury § 1.338–0
(4-1-16 Edition)**

§ 1.338–0 Outline of topics.

This section lists the captions contained in the regulations under section 338 as follows:

§ 1.338–1 General principles; status of old target and new target.

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- (a) through (c) [Reserved]
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 - (2) Exceptions.
 - (3) Amount of additional premium.
 - (i) In general.
 - (ii) Increases in unpaid loss reserves.
 - (iii) Increases in other reserves.
 - (4) Limitation on additional premium.
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(e) Effect of section 338 election on section 846(e) election.

(1) In general.

(2) Revocation of existing section 846(e) election.

(f) through (h) [Reserved]

§ 1.338(h)(10)–1 Deemed asset sale and liquidation.

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(2) Selling consolidated group.

(3) Selling affiliate; affiliated target.

(4) S corporation target.

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(ii) Time and manner of making the election for new target.

(3) Old target election for retroactive election.

(i) Availability of election.

(ii) Time and manner of making the election for old target.

[T.D. 8940, 66 FR 9929, Feb. 13, 2001, as amended

by T.D. 9158, 70 FR 55741, Sept. 16, 2004;

T.D. 9257, 71 FR 17999, Apr. 10, 2006; T.D. 9264,

71 FR 30595, May 30, 2006; T.D. 9358, 72 FR 51705, Sept. 11, 2007; T.D. 9377, 73 FR 3871,

Jan. 23, 2008; T.D. 9619, 78 FR 28489, May 15, 2013]

§ 1.338–1 General principles; status of old target and new target.

(a) In general—(1) Deemed transaction. Elections are available under section 338 when a purchasing corporation acquires the stock of another corporation (the target) in a qualified stock purchase. One type of election, under section 338(g), is available to the purchasing corporation. Another type of election, under section 338(h)(10), is, in more limited circumstances, available jointly to the purchasing corporation and the sellers of the stock. (Rules concerning eligibility for these elections are contained in §§ 1.338–2, 1.338–3, and 1.338(h)(10)–1.) However, if, as a result of the deemed purchase of old target’s assets pursuant to a section 336(e) election, there would be both a qualified stock purchase and a qualified stock disposition (as defined in § 1.336–1(b)(6)) of the stock of a subsidiary of target, neither a section 338(g) election nor a section 338(h)(10) election may be made with respect to the qualified stock purchase of the subsidiary. Instead, a section 336(e) election may be made with respect to such purchase. See § 1.336–1(b)(6)(ii). Although target is a single corporation under corporate law, if a section 338 election is made, then two separate corporations, old target and new target, generally are considered to exist for purposes of subtitle A of the Internal Revenue Code. Old target is treated as transferring all of its assets to an unrelated person in exchange for consideration that includes the discharge of its liabilities (see § 1.1001–2(a)), and new target is treated as acquiring all of its assets from an unrelated person in exchange for consideration that includes the assumption of those liabilities. (Such transaction is, without regard to its characterization

for Federal income tax purposes, referred to as the deemed asset sale and the income tax consequences thereof as the deemed sale tax consequences.) If a section 338(h)(10) election is made, old target is deemed to liquidate following the deemed asset sale.

(2) Application of other rules of law. Other rules of law apply to determine the tax consequences to the parties as if they had actually engaged in the transactions deemed to occur under section 338 and the regulations thereunder except to the extent otherwise provided in those regulations. See also § 1.338–6(c)(2). Other rules of law may characterize the transaction as something other than or in addition to a sale and purchase of assets; however, the transaction between old and new target must be a taxable transaction. For example, if the target is an insurance company for which a section 338 election is made, the deemed asset sale results in an assumption reinsurance transaction for the insurance contracts deemed transferred from old target to new target. See, generally, § 1.817–4(d), and for special rules regarding the acquisition of insurance company targets, § 1.338–11. See also § 1.367(a)–8(k)(13) for a rule applicable to gain recognition agreements (filed under §§ 1.367(a)–3(b)(1)(ii) and 1.367(a)–8) and deemed asset sales as a result of an election under section 338(g).

(3) Overview. Definitions and special nomenclature and rules for making the section 338 election are provided in § 1.338–2. Qualification for the section 338 election is addressed in § 1.338–3. The amount for which old target is treated as selling all of its assets (the aggregate deemed sale price, or ADSP) is addressed in § 1.338–4. The amount for which new target is deemed to have

purchased all its assets (the adjusted grossed-up basis, or AGUB) is addressed in § 1.338–5. Section 1.338–6 addresses allocation both of ADSP among the assets old target is deemed to have sold and of AGUB among the assets new target is deemed to have purchased. Section 1.338–7 addresses allocation of ADSP or AGUB when those amounts subsequently change. Asset and stock consistency are addressed in § 1.338–8. International aspects of section 338 are covered in § 1.338–9. Rules for the filing of returns are provided in § 1.338–10. Section 1.338–11 provides special rules for insurance company targets. Eligibility for and treatment of section 338(h)(10) elections is addressed in § 1.338(h)(10)–1.

(b) Treatment of target under other provisions of the Internal Revenue Code—(1) General rule for subtitle A. Except as provided in this section, new target is treated as a new corporation that is unrelated to old target for purposes of subtitle A of the Internal Revenue Code. Thus—

(i) New target is not considered related to old target for purposes of section 168 and may make new elections under section 168 without taking into account the elections made by old target; and

(ii) New target may adopt, without obtaining prior approval from the Commissioner, any taxable year that meets the requirements of section 441 and any method of accounting that meets the requirements of section 446. Notwithstanding § 1.441–1T(b)(2), a new target may adopt a taxable year on or before the last day for making the election under section 338 by filing its first return for the desired taxable year on or

before that date.

(2) Exceptions for subtitle A. New target and old target are treated as the same corporation for purposes of—

(i) The rules applicable to employee benefit plans (including those plans described in sections 79, 104, 105, 106, 125, 127, 129, 132, 137, and 220), qualified pension, profit-sharing, stock bonus and annuity plans (sections 401(a) and 403(a)), simplified employee pensions (section 408(k)), tax qualified stock option plans (sections 422 and 423), welfare benefit funds (sections 419, 419A, 512(a)(3), and 4976), and voluntary employee benefit associations (section 501(c)(9) and the regulations thereunder);

(ii) Sections 1311 through 1314 (relating to the mitigation of the effect of limitations), if a section 338(h)(10) election is not made for target;

(iii) Section 108(e)(5) (relating to the reduction of purchase money debt);

(iv) Section 45A (relating to the Indian Employment Credit), section 51 (relating to the Work Opportunity Credit), section 51A (relating to the Welfare to Work Credit), and section 1396 (relating to the Empowerment Zone Act);

(v) Sections 401(h) and 420 (relating to medical benefits for retirees);

(vi) Section 414 (relating to definitions and special rules); and

(vii) Section 846(e) (relating to an election to use an insurance company's historical loss payment pattern).

(viii) Any other provision designated in the Internal Revenue Bulletin by the Internal Revenue Service. See

§ 601.601(d)(2)(ii) of this chapter. See, for example, § 1.1001-3(e)(4)(i)(F) providing that an election under section 338 does not result in the substitution of a new obligor on target's debt. See also, for example, § 1.1502-77(c)(8), providing that an election under section 338 does not result in a deemed termination of target's existence for purposes of the rules applicable to the agent for a consolidated group.

(3) General rule for other provisions of the Internal Revenue Code. Except as provided in the regulations under section 338 or in the Internal Revenue Bulletin by the Internal Revenue Service (see § 601.601(d)(2)(ii) of this chapter), new target is treated as a continuation of old target for purposes other than subtitle A of the Internal Revenue Code. For example—

(i) New target is liable for old target's Federal income tax liabilities, including the tax liability for the deemed sale tax consequences and those tax liabilities of the other members of any consolidated group that included old target that are attributable to taxable years in which those corporations and old target joined in the same consolidated return (see § 1.1502-6(a));

(ii) Wages earned by the employees of old target are considered wages earned by such employees from new target for purposes of sections 3101 and 3111 (Federal Insurance Contributions Act) and section 3301 (Federal Unemployment Tax Act); and

(iii) Old target and new target must use the same employer identification number.

(c) Anti-abuse rule—(1) In general. The rules of this paragraph (c) apply for

purposes of applying the regulations under sections 336(e), 338, and 1060. The Commissioner is authorized to treat any property (including cash) transferred by old target in connection with the transactions resulting in the application of the residual method (and not held by target at the close of the acquisition date) as, nonetheless, property of target at the close of the acquisition date if the property so transferred is, within 24 months after the deemed asset sale, owned by new target, or is owned, directly or indirectly, by a member of the affiliated group of which new target is a member and continues after the acquisition date to be held or used primarily in connection with one or more of the activities of new target. In addition, the Commissioner is authorized to treat any property (including cash) transferred to old target in connection with the transactions resulting in the application of the residual method (and held by target at the close of the acquisition date) as, nonetheless, not being property of target at the close of the acquisition date if the property so transferred is, within 24 months after the deemed asset sale, not owned by new target but owned, directly or indirectly, by a member of the affiliated group of which new target is a member, or owned by new target but held or used primarily in connection with an activity conducted, directly or indirectly, by another member of the affiliated group of which new target is a member in combination with other property retained by or acquired, directly or indirectly, from the transferor of the property (or a member of the same affiliated group) to old target. For purposes of this paragraph (c)(1), an interest in an entity is considered held or used in connection with an activity if property of the entity is so held or used. The authority

of the Commissioner under this paragraph (c)(1) includes the making of any appropriate correlative adjustments (avoiding, to the extent possible, the duplication or omission of any item of income, gain, loss, deduction, or basis).

(2) Examples. The following examples illustrate this paragraph (c):

Example 1. Prior to a qualified stock purchase under section 338, target transfers one of its assets to a related party. The purchasing corporation then purchases the target stock and also purchases the transferred asset from the related party. After its purchase of target, the purchasing corporation and target are members of the same affiliated group. A section 338 election is made. Under an arrangement with the purchaser, the separately transferred asset is used primarily in connection with target's activities. Applying the anti-abuse rule of this paragraph (c), the Commissioner may consider target to own the transferred asset for purposes of applying the residual method under section 338.

Example 2. T owns all the stock of T1. T1 leases intellectual property to T, which T uses in connection with its own activities. P, a purchasing corporation, wishes to buy the T-T1 chain of corporations. P, in connection with its planned purchase of the T stock, contracts to consummate a purchase of all the stock of T1 on March 1 and of all the stock of T on March 2. Section 338 elections are thereafter made for both T and T1. Immediately after the purchases, P, T and T1 are members of the same affiliated group. T continues to lease the intellectual property from T1 and that is the primary use of the intellectual property. Thus, an asset of T, the T1 stock, was removed from T's own assets prior to the qualified stock purchase of the T stock, T1's own assets are used after the deemed asset sale in connection with T's

own activities, and the T1 stock is after the deemed asset sale owned by P, a member of the same affiliated group of which T is a member. Applying the anti-abuse rule of this paragraph (c), the Commissioner may, for purposes of application of the residual method under section 338 both to T and to T1, consider P to have bought only the stock of T, with T at the time of the qualified stock purchases of both T and T1 (the qualified stock purchase of T1 being triggered by the deemed sale under section 338 of T's assets) owning T1. The Commissioner accordingly would allocate consideration to T's assets as though the T1 stock were one of those assets, and then allocate consideration within T1 based on the amount allocated to the T1 stock at the T level.

(d) Next day rule for post-closing transactions. If a target corporation for which an election under section 338 is made engages in a transaction outside the ordinary course of business on the acquisition date after the event resulting in the qualified stock purchase of the target or a higher tier corporation, the target and all persons related thereto (either before or after the qualified stock purchase) under section 267(b) or section 707 must treat the transaction for all Federal income tax purposes as occurring at the beginning of the day following the transaction and after the deemed purchase by new target.

(e) Effective/applicability date. Paragraphs (a)(1) and (c)(1) of this section are applicable to any qualified stock disposition for which the disposition date (as defined in § 1.336-1(b)(8)) is on or after May 15, 2013. [T.D. 8940, 66 FR 9929, Feb. 13, 2001, as amended by T.D. 9002, 67 FR 43540, June 28, 2002; T.D. 9257, 71 FR 18000, Apr. 10, 2006; T.D. 9377,

73 FR 3871, Jan. 23, 2008; T.D. 9446, 74 FR 6957, Feb. 11, 2009; T.D. 9619, 78 FR 28489, May 15, 2013; T.D. 9715, 80 FR 17317, Apr. 1, 2015]

§ 1.338–2 Nomenclature and definitions; mechanics of the section 338 election.

(a) Scope. This section prescribes rules relating to elections under section 338.

(b) Nomenclature. For purposes of the regulations under section 338 (except as otherwise provided):

(1) T is a domestic target corporation that has only one class of stock outstanding. Old T refers to T for periods ending on or before the close of T's acquisition date; new T refers to T for subsequent periods.

(2) P is the purchasing corporation.

(3) The P group is an affiliated group of which P is a member.

(4) P1, P2, etc., are domestic corporations that are members of the P group.

(5) T1, T2, etc., are domestic corporations that are target affiliates of T. These corporations (T1, T2, etc.) have only one class of stock outstanding and may also be targets.

(6) S is a domestic corporation (unrelated to P and B) that owns T prior to the purchase of T by P. (S is referred to in cases in which it is appropriate to consider the effects of having all of the outstanding stock of T owned by a domestic corporation.)

(7) A, a U.S. citizen or resident, is an individual (unrelated to P and B) who

owns T prior to the purchase of T by P. (A is referred to in cases in which it is appropriate to consider the effects of having all of the outstanding stock of T owned by an individual who is a U.S. citizen or resident. Ownership of T by A and ownership of T by S are mutually exclusive circumstances.)

(8) B, a U.S. citizen or resident, is an individual (unrelated to T, S, and A) who owns the stock of P.

(9) F, used as a prefix with the other terms in this paragraph (b), connotes foreign, rather than domestic, status. For example, FT is a foreign corporation (as defined in section 7701(a)(5)) and FA is an individual other than a U.S. citizen or resident.

(10) CFC, used as a prefix with the other terms in this paragraph (b) referring to a corporation, connotes a controlled foreign corporation (as defined in section 957, taking into account section 953(c)). A corporation identified with the prefix F may be a controlled foreign corporation. (The prefix CFC is used when the corporation's status as a controlled foreign corporation is significant.)

(c) Definitions. For purposes of the regulations under section 338 (except as otherwise provided):

(1) Acquisition date. The term acquisition date has the same meaning as in section 338(h)(2).

(2) Acquisition date assets. Acquisition date assets are the assets of the target held at the beginning of the day after the acquisition date (but see § 1.338–1(d) (regarding certain transactions on the acquisition date)).

(3) Affiliated group. The term affiliated

group has the same meaning as in section 338(h)(5). Corporations are affiliated on any day they are members of the same affiliated group.

(4) Common parent. The term common parent has the same meaning as in section 1504.

(5) Consistency period. The consistency period is the period described in section 338(h)(4)(A) unless extended pursuant to § 1.338–8(j)(1).

(6) Deemed asset sale. The deemed asset sale is the transaction described in § 1.338–1(a)(1) that is deemed to occur for purposes of subtitle A of the Internal Revenue Code if a section 338 election is made.

(7) Deemed sale tax consequences. Deemed sale tax consequences refers to, in the aggregate, the Federal income tax consequences (generally, the income, gain, deduction, and loss) of the deemed asset sale. Deemed sale tax consequences also refers to the Federal income tax consequences of the transfer of a particular asset in the deemed asset sale.

(8) Deemed sale return. The deemed sale return is the return on which target's deemed sale tax consequences are reported that does not include any other items of target. Target files a deemed sale return when a section 338 election (but not a section 338(h)(10) election) is filed for target and target is a member of a selling group (defined in paragraph (c)(16) of this section) that files a consolidated return for the period that includes the acquisition date. See § 1.338–10. If target is an S corporation for the period that ends on the day before the acquisition date and a section 338 election (but not a section 338(h)(10) election)

is filed for target, see § 1.338–10(a)(3).

(9) Domestic corporation. A domestic corporation is a corporation—

(i) That is domestic within the meaning of section 7701(a)(4) or that is treated as domestic for purposes of subtitle A of the Internal Revenue Code (e.g., to which an election under section 953(d) or 1504(d) applies); and

(ii) That is not a DISC, a corporation described in section 1248(e), or a corporation to which an election under section 936 applies.

(10) Old target's final return. Old target's final return is the income tax return of old target for the taxable year ending at the close of the acquisition date that includes the deemed sale tax consequences. However, if a deemed sale return is filed for old target, the deemed sale return is considered old target's final return.

(11) Purchasing corporation. The term purchasing corporation has the same meaning as in section 338(d)(1). The purchasing corporation may also be referred to as purchaser. Unless otherwise provided, any reference to the purchasing corporation is a reference to all members of the affiliated group of which the purchasing corporation is a member. See sections 338(h)(5) and (8). Also, unless otherwise provided, any reference to the purchasing corporation is, with respect to a deemed purchase of stock under section 338(a)(2), a reference to new target with respect to its own deemed purchase of stock in another target.

(12) Qualified stock purchase. The term qualified stock purchase has the same

meaning as in section 338(d)(3).

(13) Related persons. Two persons are related if stock in a corporation owned by one of the persons would be attributed under section 318(a) (other than section 318(a)(4)) to the other.

(14) Section 338 election. A section 338 election is an election to apply section 338(a) to target. A section 338 election is made by filing a statement of section 338 election pursuant to paragraph (d) of this section. The form on which this statement is filed is referred to in the regulations under section 338 as the Form 8023, "Elections Under Section 338 For Corporations Making Qualified Stock Purchases."

(15) Section 338(h)(10) election. A section 338(h)(10) election is an election to apply section 338(h)(10) to target. A section 338(h)(10) election is made by making a joint election for target under § 1.338(h)(10)–1 on Form 8023.

(16) Selling group. The selling group is the affiliated group (as defined in section 1504) eligible to file a consolidated return that includes target for the taxable period in which the acquisition date occurs. However, a selling group is not an affiliated group of which target is the common parent on the acquisition date.

(17) Target; old target; new target. Target is the target corporation as defined in section 338(d)(2). Old target refers to target for periods ending on or before the close of target's acquisition date. New target refers to target for subsequent periods.

(18) Target affiliate. The term target affiliate has the same meaning as in section 338(h)(6) (applied without section 338(h)(6)(B)(i)). Thus, a corporation

described in section 338(h)(6)(B)(i) is considered a target affiliate for all purposes of section 338. If a target affiliate is acquired in a qualified stock purchase, it is also a target.

(19) 12-month acquisition period. The 12-month acquisition period is the period described in section 338(h)(1), unless extended pursuant to § 1.338–8(j)(2).

(d) Time and manner of making election. The purchasing corporation makes a section 338 election for target by filing a statement of section 338 election on Form 8023 in accordance with the instructions to the form. The section 338 election must be made not later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs. A section 338 election is irrevocable. See § 1.338(h)(10)–1(c)(2) for section 338(h)(10) elections.

(e) Special rules for foreign corporations or DISCs—(1) Elections by certain foreign purchasing corporations—(i) General rule. A qualifying foreign purchasing corporation is not required to file a statement of section 338 election for a qualifying foreign target before the earlier of 3 years after the acquisition date and the 180th day after the close of the purchasing corporation's taxable year within which a triggering event occurs.

(ii) Qualifying foreign purchasing corporation. A purchasing corporation is a qualifying foreign purchasing corporation only if, during the acquisition period of a qualifying foreign target, all the corporations in the purchasing corporation's affiliated group are foreign corporations that are not subject to United States tax.

(iii) Qualifying foreign target. A target

is a qualifying foreign target only if target and its target affiliates are foreign corporations that, during target's acquisition period, are not subject to United States tax (and will not become subject to United States tax during such period because of a section 338 election). A target affiliate is taken into account for purposes of the preceding sentence only if, during target's 12-month acquisition period, it is or becomes a member of the affiliated group that includes the purchasing corporation.

(iv) Triggering event. A triggering event occurs in the taxable year of the qualifying foreign purchasing corporation in which either that corporation or any corporation in its affiliated group becomes subject to United States tax.

(v) Subject to United States tax. For purposes of this paragraph (e)(1), a foreign corporation is considered subject to United States tax—

(A) For the taxable year for which that corporation is required under § 1.6012-2(g) (other than § 1.6012-2(g)(2)(i)(B)(2)) to file a United States income tax return; or

(B) For the period during which that corporation is a controlled foreign corporation, a passive foreign investment company for which an election under section 1295 is in effect, a foreign investment company, or a foreign corporation the stock ownership of which is described in section 552(a)(2).

(2) Acquisition period. For purposes of this paragraph (e), the term acquisition period means the period beginning on the first day of the 12-month acquisition period and ending on the acquisition date.

(3) Statement of section 338 election may be filed by United States shareholders in certain cases. The United States shareholders (as defined in section 951(b)) of a foreign purchasing corporation that is a controlled foreign corporation (as defined in section 957 (taking into account section 953(c))) may file a statement of section 338 election on behalf of the purchasing corporation if the purchasing corporation is not required under § 1.6012-2(g) (other than § 1.6012-2(g)(2)(i)(B)(2)) to file a United States income tax return for its taxable year that includes the acquisition date. Form 8023 must be filed as described in the form and its instructions and also must be attached to the Form 5471, "Information Returns of U.S. Persons With Respect to Certain Foreign Corporations," filed with respect to the purchasing corporation by each United States shareholder for the purchasing corporation's taxable year that includes the acquisition date (or, if paragraph

(e)(1)(i) of this section applies to the election, for the purchasing corporation's taxable year within which it becomes a controlled foreign corporation). The provisions of § 1.964-1(c) (including § 1.964-1(c)(7)) do not apply to an election made by the United States shareholders.

(4) Notice requirement for U.S. persons holding stock in foreign target—(i) General rule. If a target subject to a section 338 election was a controlled foreign corporation, a passive foreign investment company, or a foreign personal holding company at any time during the portion of its taxable year that ends on its acquisition date, the purchasing corporation must deliver written notice of the election (and a copy of Form 8023, its attachments and instructions) to—

(A) Each U.S. person (other than a member of the affiliated group of which the purchasing corporation is a member (the purchasing group member)) that, on the acquisition date of the foreign target, holds stock in the foreign target; and

(B) Each U.S. person (other than a purchasing group member) that sells stock in the foreign target to a purchasing group member during the foreign target's 12-month acquisition period.

(ii) Limitation. The notice requirement of this paragraph (e)(4) applies only where the section 338 election for the foreign target affects income, gain, loss, deduction, or credit of the U.S. person described in paragraph (e)(4)(i) of this section under section 551, 951, 1248, or 1293.

(iii) Form of notice. The notice to U.S. persons must be identified prominently as a notice of section 338 election and must—

(A) Contain the name, address, and employer identification number (if any) of, and the country (and, if relevant, the lesser political subdivision) under the laws of which are organized the purchasing corporation and the relevant target (i.e., the target the stock of which the particular U.S. person held or sold under the circumstances described in paragraph (e)(4)(i) of this section);

(B) Identify those corporations as the purchasing corporation and the foreign target, respectively; and

(C) Contain the following declaration (or a substantially similar declaration):
THIS DOCUMENT SERVES AS NOTICE
OF AN ELECTION UNDER SECTION 338

FOR THE ABOVE CITED FOREIGN TARGET THE STOCK OF WHICH YOU EITHER HELD OR SOLD UNDER THE CIRCUMSTANCES DESCRIBED IN TREASURY REGULATIONS SECTION 1.338–2(e)(4). FOR POSSIBLE UNITED STATES FEDERAL INCOME TAX CONSEQUENCES UNDER SECTION 551, 951, 1248, OR 1293 OF THE INTERNAL REVENUE CODE OF 1986 THAT MAY APPLY TO YOU, SEE TREASURY REGULATIONS SECTION 1.338–9(b). YOU MAY BE REQUIRED TO ATTACH THE INFORMATION ATTACHED TO THIS NOTICE TO CERTAIN RETURNS.

(iv) Timing of notice. The notice required by this paragraph (e)(4) must be delivered to the U.S. person on or before the later of the 120th day after the acquisition date of the particular target or the day on which Form 8023 is filed. The notice is considered delivered on the date it is mailed to the proper address (or an address similar enough to complete delivery), unless the date it is mailed cannot be reasonably determined. The date of mailing will be determined under the rules of section 7502. For example, the date of mailing is the date of U.S. postmark or the applicable date recorded or marked by a designated delivery service.

(v) Consequence of failure to comply. A statement of section 338 election is not valid if timely notice is not given to one or more U.S. persons described in this paragraph (e)(4). If the form of notice fails to comply with all requirements of this paragraph (e)(4), the section 338 election is valid, but the waiver rule of § 1.338–10(b)(1) does not apply.

(vi) Good faith effort to comply. The purchasing corporation will be considered to have complied with this paragraph (e)(4), even though it failed to provide notice or provide timely notice

to each person described in this paragraph (e)(4), if the Commissioner determines that the purchasing corporation made a good faith effort to identify and provide timely notice to those U.S. persons. [T.D. 8940, 66 FR 9929, Feb. 13, 2001]

§ 1.338–3 Qualification for the section 338 election.

(a) Scope. This section provides rules on whether certain acquisitions of stock are qualified stock purchases and on other miscellaneous issues under section 338.

(b) Rules relating to qualified stock purchases—

(1) Purchasing corporation requirement.

An individual cannot make a qualified stock purchase of target. Section 338(d)(3) requires, as a condition of a qualified stock purchase, that a corporation purchase the stock of target.

If an individual forms a corporation (new P) to acquire target stock, new P can make a qualified stock purchase of target if new P is considered for tax purposes to purchase the target stock. Facts that may indicate that new P does not purchase the target stock include new P's merging downstream into target, liquidating, or otherwise disposing of the target stock following the purported qualified stock purchase.

(2) Purchase. The term purchase has the same meaning as in section 338(h)(3). Stock in a target (or target affiliate) may be considered purchased if, under general principles of tax law, the purchasing corporation is considered to own stock of the target (or target affiliate) meeting the requirements of section 1504(a)(2), notwithstanding that no amount may be paid for (or allocated to) the stock.

(3) Acquisitions of stock from related

corporations—(i) In general. Stock acquired by a purchasing corporation from a related corporation (R) is generally not considered acquired by purchase. See section 338(h)(3)(A)(iii).

(ii) Time for testing relationship. For purposes of section 338(h)(3)(A)(iii), a purchasing corporation is treated as related to another person if the relationship specified in section 338(h)(3)(A)(iii) exists—

(A) In the case of a single transaction, immediately after the purchase of target stock;

(B) In the case of a series of acquisitions otherwise constituting a qualified stock purchase within the meaning of section 338(d)(3), immediately after the last acquisition in such series; and

(C) In the case of a series of transactions effected pursuant to an integrated plan to dispose of target stock, immediately after the last transaction in such series.

(iii) Cases where section 338(h)(3)(C) applies—acquisitions treated as purchases. If section 338(h)(3)(C) applies and the purchasing corporation is treated as acquiring stock by purchase from R, solely for purposes of determining when the stock is considered acquired, target stock acquired from R is considered to have been acquired by the purchasing corporation on the day on which the purchasing corporation is first considered to own that stock under section 318(a) (other than section 318(a)(4)).

(iv) Examples. The following examples illustrate this paragraph (b)(3):

Example 1. (i) S is the parent of a group of

corporations that are engaged in various businesses. Prior to January 1, Year 1, S decided to discontinue its involvement in one line of business. To accomplish this, S forms a new corporation, Newco, with a nominal amount of cash. Shortly thereafter, on January 1, Year 1, S transfers all the stock of the subsidiary conducting the unwanted business (T) to Newco in exchange for 100 shares of Newco common stock and a Newco promissory note. Prior to January 1, Year 1, S and Underwriter (U) had entered into a binding agreement pursuant to which U would purchase 60 shares of Newco common stock from S and then sell those shares in an Initial Public Offering (IPO). On January 6, Year 1, the IPO closes.

(ii) Newco's acquisition of T stock is one of a series of transactions undertaken pursuant to one integrated plan. The series of transactions ends with the closing of the IPO and the transfer of all the shares of stock in accordance with the agreements. Immediately after the last transaction effected pursuant to the plan, S owns 40 percent of Newco, which does not give rise to a relationship described in section 338(h)(3)(A)(iii). See § 1.338-3(b)(3)(ii)(C). Accordingly, S and Newco are not related for purposes of section 338(h)(3)(A)(iii).

(iii) Further, because Newco's basis in the T stock is not determined by reference to S's basis in the T stock and because the transaction is not an exchange to which section 351, 354, 355, or 356 applies, Newco's acquisition of the T stock is a purchase within the meaning of section 338(h)(3).

Example 2. (i) On January 1 of Year 1, P purchases 75 percent in value of the R stock. On that date, R owns 4 of the 100 shares of T stock. On June 1 of Year 1, R acquires an additional 16 shares of T stock. On December 1 of Year 1, P purchases 70 shares of T stock from an unrelated person and 12 of the 20 shares of T stock held by R.

(ii) Of the 12 shares of T stock purchased by P from R on December 1 of Year 1, 3 of those shares are deemed to have been acquired by P on January 1 of Year 1, the date on which 3 of the 4 shares of T stock held by R on that date were first considered owned by P under section 318(a)(2)(C) (i.e., $4 \times .75$). The remaining 9 shares of T stock purchased by P from R on December 1 of Year 1 are deemed to have been acquired by P on June 1 of Year 1, the date on which an additional 12 of the 20 shares of T stock owned by R on that date were first considered owned by P under section 318(a)(2)(C) (i.e., $(20 \times .75) - 3$). Because stock acquisitions by P sufficient for a qualified stock purchase of T occur within a 12-month period (i.e., 3 shares constructively on January 1 of Year 1, 9 shares constructively on June 1 of Year 1, and 70 shares actually on December 1 of Year 1), a qualified stock purchase is made on December 1 of Year 1.

Example 3. (i) On February 1 of Year 1, P acquires 25 percent in value of the R stock from B (the sole shareholder of P). That R stock is not acquired by purchase. See section 338(h)(3)(A)(iii). On that date, R owns 4 of the 100 shares of T stock. On June 1 of Year 1, P purchases an additional 25 percent in value of the R stock, and on January 1 of Year 2, P purchases another 25 percent in value of the R stock. On June 1 of Year 2, R acquires an additional 16 shares of the T stock. On December 1 of Year 2, P purchases 68 shares of the T stock from an unrelated person and 12 of the 20 shares of the T stock held by R.

(ii) Of the 12 shares of the T stock purchased by P from R on December 1 of Year 2, 2 of those shares are deemed to have been acquired by P on June 1 of Year 1, the date on which 2 of the 4 shares of the T stock held by R on that date were first considered owned by P under section 318(a)(2)(C) (i.e., $4 \times .5$). For purposes of this attribution, the R stock need not be acquired by P by purchase. See

section 338(h)(1). (By contrast, the acquisition of the T stock by P from R does not qualify as a purchase unless P has acquired at least 50 percent in value of the R stock by purchase. Section 338(h)(3)(C)(i).) Of the remaining 10 shares of the T stock purchased by P from R on December 1 of Year 2, 1 of those shares is deemed to have been acquired by P on January 1 of Year 2, the date on which an additional 1 share of the 4 shares of the T stock held by R on that date was first considered owned by P under section 318(a)(2)(C) (i.e., $(4 \times .75) - 2$). The remaining 9 shares of the T stock purchased by P from R on December 1 of Year 2, are deemed to have been acquired by P on June 1 of Year 2, the date on which an additional 12 shares of the T stock held by R on that date were first considered owned by P under section 318(a)(2)(C) (i.e., $(20 \times .75) - 3$). Because a qualified stock purchase of T by P is made on December 1 of Year 2 only if all 12 shares of the T stock purchased by P from R on that date are considered acquired during a 12-month period ending on that date (so that, in conjunction with the 68 shares of the T stock P purchased on that date from the unrelated person, 80 of T's 100 shares are acquired by P during a 12-month period) and because 2 of those 12 shares are considered to have been acquired by P more than 12 months before December 1 of Year 2 (i.e., on June 1 of Year 1), a qualified stock purchase is not made. (Under § 1.338-8(j)(2), for purposes of applying the consistency rules, P is treated as making a qualified stock purchase of T if, pursuant to an arrangement, P purchases T stock satisfying the requirements of section 1504(a)(2) over a period of more than 12 months.)

Example 4. Assume the same facts as in Example 3, except that on February 1 of Year 1, P acquires 25 percent in value of the R stock by purchase. The result is the same as in Example 3.

(4) Acquisition date for tiered targets—

(i) Stock sold in deemed asset sale. If an election under section 338 is made for target, old target is deemed to sell target's assets and new target is deemed to acquire those assets. Under section 338(h)(3)(B), new target's deemed purchase of stock of another corporation is a purchase for purposes of section 338(d)(3) on the acquisition date of target. If new target's deemed purchase causes a qualified stock purchase of the other corporation and if a section 338 election is made for the other corporation, the acquisition date for the other corporation is the same as the acquisition date of target. However, the deemed sale and purchase of the other corporation's assets is considered to take place after the deemed sale and purchase of target's assets.

(ii) Example. The following example illustrates this paragraph (b)(4):

Example. A owns all of the T stock. T owns 50 of the 100 shares of X stock. The other 50 shares of X stock are owned by corporation Y, which is unrelated to A, T, or P. On January 1 of Year 1, P makes a qualified stock purchase of T from A and makes a section 338 election for T. On December 1 of Year 1, P purchases the 50 shares of X stock held by Y. A qualified stock purchase of X is made on December 1 of Year 1, because the deemed purchase of 50 shares of X stock by new T because of the section 338 election for T and the actual purchase of 50 shares of X stock by P are treated as purchases made by one corporation. Section 338(h)(8). For purposes of determining whether those purchases occur within a 12-month acquisition period as required by section 338(d)(3), T is deemed to purchase its X stock on T's acquisition date, i.e., January 1 of Year 1.

(5) Effect of redemptions—(i) General rule. Except as provided in this paragraph (b)(5), a qualified stock purchase is made on the first day on which the

percentage ownership requirements of section 338(d)(3) are satisfied by reference to target stock that is both—

(A) Held on that day by the purchasing corporation; and

(B) Purchased by the purchasing corporation during the 12-month period ending on that day.

(ii) Redemptions from persons unrelated to the purchasing corporation. Target stock redemptions from persons unrelated to the purchasing corporation that occur during the 12-month acquisition period are taken into account as reductions in target's outstanding stock for purposes of determining whether target stock purchased by the purchasing corporation in the 12-month acquisition period satisfies the percentage ownership requirements of section 338(d)(3).

(iii) Redemptions from the purchasing corporation or related persons during 12-month acquisition period—(A) General rule. For purposes of the percentage ownership requirements of section 338(d)(3), a redemption of target stock during the 12-month acquisition period from the purchasing corporation or from any person related to the purchasing corporation is not taken into account as a reduction in target's outstanding stock.

(B) Exception for certain redemptions from related corporations. A redemption of target stock during the 12-month acquisition period from a corporation related to the purchasing corporation is taken into account as a reduction in target's outstanding stock to the extent that the redeemed stock would have been considered purchased by the purchasing corporation (because of section

338(h)(3)(C)) during the 12-month acquisition period if the redeemed stock had been acquired by the purchasing corporation from the related corporation on the day of the redemption. See paragraph (b)(3) of this section.

(iv) Examples. The following examples illustrate this paragraph (b)(5):

Example 1. QSP on stock purchase date; redemption from unrelated person during 12-month period. A owns all 100 shares of T stock. On January 1 of Year 1, P purchases 40 shares of the T stock from A. On July 1 of Year 1, T redeems 25 shares from A. On December 1 of Year 1, P purchases 20 shares of the T stock from A. P makes a qualified stock purchase of T on December 1 of Year 1, because the 60 shares of T stock purchased by P within the 12-month period ending on that date satisfy the 80-percent ownership requirements of section 338(d)(3) (i.e., 60/75 shares), determined by taking into account the redemption of 25 shares.

Example 2. QSP on stock redemption date; redemption from unrelated person during 12-month period. The facts are the same as in Example 1, except that P purchases 60 shares of T stock on January 1 of Year 1 and none on December 1 of Year 1. P makes a qualified stock purchase of T on July 1 of Year 1, because that is the first day on which the T stock purchased by P within the preceding 12-month period satisfies the 80-percent ownership requirements of section 338(d)(3) (i.e., 60/75 shares), determined by taking into account the redemption of 25 shares.

Example 3. Redemption from purchasing corporation not taken into account. On December 15 of Year 1, T redeems 30 percent of its stock from P. The redeemed stock was held by P for several years and constituted P's total interest in T. On December 1 of Year 2, P purchases the remaining T stock from A. P does not make a qualified stock purchase of T on December 1 of Year 2. For purposes of

the 80-percent ownership requirements of section 338(d)(3), the redemption of P's T stock on December 15 of Year 1 is not taken into account as a reduction in T's outstanding stock.

Example 4. Redemption from related person taken into account. On January 1 of Year 1, P purchases 60 of the 100 shares of X stock. On that date, X owns 40 of the 100 shares of T stock. On April 1 of Year 1, T redeems X's T stock and P purchases the remaining 60 shares of T stock from an unrelated person. For purposes of the 80-percent ownership requirements of section 338(d)(3), the redemption of the T stock from X (a person related to P) is taken into account as a reduction in T's outstanding stock. If P had purchased the 40 redeemed shares from X on April 1 of Year 1, all 40 of the shares would have been considered purchased (because of section 338(h)(3)(C)(i)) during the 12-month period ending on April 1 of Year 1 (24 of the 40 shares would have been considered purchased by P on January 1 of Year 1 and the remaining 16 shares would have been considered purchased by P on April 1 of Year 1). See paragraph (b)(3) of this section. Accordingly, P makes a qualified stock purchase of T on April 1 of Year 1, because the 60 shares of T stock purchased by P on that date satisfy the 80-percent ownership requirements of section 338(d)(3) (i.e., 60/60 shares), determined by taking into account the redemption of 40 shares.

(c) Effect of post-acquisition events on eligibility for section 338 election—(1) Post-acquisition elimination of target. (i) The purchasing corporation may make an election under section 338 for target even though target is liquidated on or after the acquisition date. If target liquidates on the acquisition date, the liquidation is considered to occur on the following day and immediately after new target's deemed purchase of assets. The purchasing corporation

may also make an election under section 338 for target even though target is merged into another corporation, or otherwise disposed of by the purchasing corporation provided that, under the facts and circumstances, the purchasing corporation is considered for tax purposes as the purchaser of the target stock. See § 1.338(h)(10)–1(c)(2) for special rules concerning section 338(h)(10) elections in certain multistep transactions.

(ii) The following examples illustrate this paragraph (c)(1):

Example 1. On January 1 of Year 1, P purchases 100 percent of the outstanding common stock of T. On June 1 of Year 1, P sells the T stock to an unrelated person. Assuming that P is considered for tax purposes as the purchaser of the T stock, P remains eligible, after June 1 of Year 1, to make a section 338 election for T that results in a deemed asset sale of T's assets on January 1 of Year 1.

Example 2. On January 1 of Year 1, P makes a qualified stock purchase of T. On that date, T owns the stock of T1. On March 1 of Year 1, T sells the T1 stock to an unrelated person. On April 1 of Year 1, P makes a section 338 election for T. Notwithstanding that the T1 stock was sold on March 1 of Year 1, the section 338 election for T on April 1 of Year 1 results in a qualified stock purchase by T of T1 on January 1 of Year 1. See paragraph (b)(4)(i) of this section.

(2) Post-acquisition elimination of the purchasing corporation. An election under section 338 may be made for target after the acquisition of assets of the purchasing corporation by another corporation in a transaction described in section 381(a), provided that the purchasing corporation is considered for tax purposes as the purchaser of the

target stock. The acquiring corporation in the section 381(a) transaction may make an election under section 338 for target.

(d) Consequences of post-acquisition elimination of target where section 338 election not made—(1) Scope. The rules of this paragraph (d) apply to the transfer of target assets to the purchasing corporation (or another member of the same affiliated group as the purchasing corporation) (the transferee) following a qualified stock purchase of target stock, if the purchasing corporation does not make a section 338 election for target. Notwithstanding the rules of this paragraph (d), section 354(a) (and so much of section 356 as relates to section 354) cannot apply to any person other than the purchasing corporation or another member of the same affiliated group as the purchasing corporation unless the transfer of target assets is pursuant to a reorganization as determined without regard to this paragraph (d).

(2) Continuity of interest. By virtue of section 338, in determining whether the continuity of interest requirement of § 1.368–1(b) is satisfied on the transfer of assets from target to the transferee, the purchasing corporation's target stock acquired in the qualified stock purchase represents an interest on the part of a person who was an owner of the target's business enterprise prior to the transfer that can be continued in a reorganization.

(3) Control requirement. By virtue of section 338, the acquisition of target stock in the qualified stock purchase will not prevent the purchasing corporation from qualifying as a shareholder of the target transferor for the purpose of determining whether, immediately

after the transfer of target assets, a shareholder of the transferor is in control of the corporation to which the assets are transferred within the meaning of section 368(a)(1)(D).

(4) Solely for voting stock requirement. By virtue of section 338, the acquisition of target stock in the qualified stock purchase for consideration other than voting stock will not prevent the subsequent transfer of target assets from satisfying the solely for voting stock requirement for purposes of determining if the transfer of target assets qualifies as a reorganization under section 368(a)(1)(C).

(5) Example. The following example illustrates this paragraph (d):

Example. (i) Facts. P, T, and X are domestic corporations. T and X each operate a trade or business. A and K, individuals unrelated to P, own 85 and 15 percent, respectively, of the stock of T. P owns all of the stock of X. The total adjusted basis of T's property exceeds the sum of T's liabilities plus the amount of liabilities to which T's property is subject. P purchases all of A's T stock for cash in a qualified stock purchase. P does not make an election under section 338(g) with respect to its acquisition of T stock. Shortly after the acquisition date, and as part of the same plan, T merges under applicable state law into X in a transaction that, but for the question of continuity of interest, satisfies all the requirements of section 368(a)(1)(A). In the merger, all of T's assets are transferred to X. P and K receive X stock in exchange for their T stock. P intends to retain the stock of X indefinitely.

(ii) Status of transfer as a reorganization. By virtue of section 338, for the purpose of determining whether the continuity of interest requirement of § 1.368–1(b) is satisfied, P's T stock acquired in the qualified stock purchase represents an interest on the part of a

person who was an owner of T's business enterprise prior to the transfer that can be continued in a reorganization through P's continuing ownership of X. Thus, the continuity of interest requirement is satisfied and the merger of T into X is a reorganization within the meaning of section 368(a)(1)(A). Moreover, by virtue of section 338, the requirement of section 368(a)(1)(D) that a target shareholder control the transferee immediately after the transfer is satisfied because P controls X immediately after the transfer. In addition, all of T's assets are transferred to X in the merger and P and K receive the X stock exchanged therefor in pursuance of the plan of reorganization. Thus, the merger of T into X is also a reorganization within the meaning of section 368(a)(1)(D).

(iii) Treatment of T and X. Under section 361(a), T recognizes no gain or loss in the merger. Under section 362(b), X's basis in the assets received in the merger is the same as the basis of the assets in T's hands. X succeeds to and takes into account the items of T as provided in section 381.

(iv) Treatment of P. By virtue of section 338, the transfer of T assets to X is a reorganization. Pursuant to that reorganization, P exchanges its T stock solely for stock of X, a party to the reorganization. Because P is the purchasing corporation, section 354 applies to P's exchange of T stock for X stock in the merger of T into X. Thus, P recognizes no gain or loss on the exchange. Under section 358, P's basis in the X stock received in the exchange is the same as the basis of P's T stock exchanged therefor.

(v) Treatment of K. Because K is not the purchasing corporation (or an affiliate thereof), section 354 cannot apply to K's exchange of T stock for X stock in the merger of T into X unless the transfer of T's assets is pursuant to a reorganization as determined without regard to this paragraph (d). Under

general principles of tax law applicable to reorganizations, the continuity of interest requirement is not satisfied because P's stock purchase and the merger of T into X are pursuant to an integrated transaction in which A, the owner of 85 percent of the stock of T, received solely cash in exchange for A's T stock. See, e.g., § 1.368-1(e)(1)(i); *Yoc Heating v. Commissioner*, 61 T.C. 168 (1973); *Kass v. Commissioner*, 60 T.C. 218 (1973), *aff'd*, 491 F.2d 749 (3d Cir. 1974). Thus, the requisite continuity of interest under § 1.368-1(b) is lacking and section 354 does not apply to K's exchange of T stock for X stock. K recognizes gain or loss, if any, pursuant to section 1001(c) with respect to its T stock. [T.D. 8940, 66 FR 9929, Feb. 13, 2001; 66 FR 17363, Mar. 30, 2001, as amended by T.D. 9071, 68 FR 40768, July 9, 2003; T.D. 9271, 71 FR 38075, July 5, 2006]

§ 1.338-4 Aggregate deemed sale price; various aspects of taxation of the deemed asset sale.

(a) Scope. This section provides rules under section 338(a)(1) to determine the aggregate deemed sale price (ADSP) for target. ADSP is the amount for which old target is deemed to have sold all of its assets in the deemed asset sale. ADSP is allocated among target's assets in accordance with § 1.338-6 to determine the amount for which each asset is deemed to have been sold. When a subsequent increase or decrease is required under general principles of tax law with respect to an element of ADSP, the redetermined ADSP is allocated among target's assets in accordance with § 1.338-7. This § 1.338-4 also provides rules regarding the recognition of gain or loss on the deemed sale of target affiliate stock. Notwithstanding section 338(h)(6)(B)(ii), stock held by a target affiliate in a foreign corporation or in a corporation that is a DISC or that is described in section 1248(e) is not excluded from the operation

of section 338.

(b) Determination of ADSP—(1) General rule. ADSP is the sum of—

(i) The grossed-up amount realized on the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock (as defined in section 338(b)(6)(A)); and

(ii) The liabilities of old target.

(2) Time and amount of ADSP—(i) Original determination. ADSP is initially determined at the beginning of the day after the acquisition date of target. General principles of tax law apply in determining the timing and amount of the elements of ADSP.

(ii) Redetermination of ADSP. ADSP is redetermined at such time and in such amount as an increase or decrease would be required, under general principles of tax law, for the elements of ADSP. For example, ADSP is redetermined because of an increase or decrease in the amount realized for recently purchased stock or because liabilities not originally taken into account in determining ADSP are subsequently taken into account. Increases or decreases with respect to the elements of ADSP result in the reallocation of ADSP among target's assets under § 1.338-7.

(iii) Example. The following example illustrates this paragraph (b)(2):

Example. In Year 1, T, a manufacturer, purchases a customized delivery truck from X with purchase money indebtedness having a stated principal amount of \$100,000. P acquires all of the stock of T in Year 3 for \$700,000 and makes a section 338 election for T. Assume T has no liabilities other than its purchase money indebtedness to X. In Year

4, when T is neither insolvent nor in a title 11 case, T and X agree to reduce the amount of the purchase money indebtedness to \$80,000. Assume further that the reduction would be a purchase price reduction under section 108(e)(5). T and X's agreement to reduce the amount of the purchase money indebtedness would not, under general principles of tax law that would apply if the deemed asset sale had actually occurred, change the amount of liabilities of old target taken into account in determining its amount realized. Accordingly, ADSP is not redetermined at the time of the reduction. See § 1.338-5(b)(2)(iii) Example 1 for the effect on AGUB.

(c) Grossed-up amount realized on the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock—(1) Determination of amount. The grossed-up amount realized on the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock is an amount equal to—

(i) The amount realized on the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock determined as if the selling shareholder(s) were required to use old target's accounting methods and characteristics and the installment method were not available and determined without regard to the selling costs taken into account under paragraph (c)(1)(iii) of this section;

(ii) Divided by the percentage of target stock (by value, determined on the acquisition date) attributable to that recently purchased target stock;

(iii) Less the selling costs incurred by the selling shareholders in connection with the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock

that reduce their amount realized on the sale of the stock (e.g., brokerage commissions and any similar costs to sell the stock).

(2) Example. The following example illustrates this paragraph (c):

Example. T has two classes of stock outstanding, voting common stock and preferred stock described in section 1504(a)(4). On March 1 of Year 1, P purchases 40 percent of the outstanding T stock from S1 for \$500, 20 percent of the outstanding T stock from S2 for \$225, and 20 percent of the outstanding T stock from S3 for \$275. On that date, the fair market value of all the T voting common stock is \$1,250 and the preferred stock \$750. S1, S2, and S3 incur \$40, \$35, and \$25 respectively of selling costs. S1 continues to own the remaining 20 percent of the outstanding T stock. The grossed-up amount realized on the sale to P of P's recently purchased T stock is calculated as follows: The total amount realized (without regard to selling costs) is \$1,000 ($500 + 225 + 275$). The percentage of T stock by value on the acquisition date attributable to the recently purchased T stock is 50% ($1,000 / (1,250 + 750)$). The selling costs are \$100 ($40 + 35 + 25$). The grossed-up amount realized is \$1,900 ($1,000 / .5 - 100$).

(d) Liabilities of old target—(1) In general. In general, the liabilities of old target are measured as of the beginning of the day after the acquisition date. (But see § 1.338-1(d) (regarding certain transactions on the acquisition date).) In order to be taken into account in ADSP, a liability must be a liability of target that is properly taken into account in amount realized under general principles of tax law that would apply if old target had sold its assets to an unrelated person for consideration that included the discharge of its liabilities. See § 1.1001-2(a). Such

liabilities may include liabilities for the tax consequences resulting from the deemed sale.

(2) Time and amount of liabilities. The time for taking into account liabilities of old target in determining ADSP and the amount of the liabilities taken into account is determined as if old target had sold its assets to an unrelated person for consideration that included the discharge of the liabilities by the unrelated person. For example, if no amount of a target liability is properly taken into account in amount realized as of the beginning of the day after the acquisition date, the liability is not initially taken into account in determining ADSP (although it may be taken into account at some later date).

(e) Deemed sale tax consequences. Gain or loss on each asset in the deemed sale is computed by reference to the ADSP allocated to that asset. ADSP is allocated under the rules of § 1.338-6. Though deemed sale tax consequences may increase or decrease ADSP by creating or reducing a tax liability, the amount of the tax liability itself may be a function of the size of the deemed sale tax consequences. Thus, these determinations may require trial and error computations.

(f) Other rules apply in determining ADSP. ADSP may not be applied in such a way as to contravene other applicable rules. For example, a capital loss cannot be applied to reduce ordinary income in calculating the tax liability on the deemed sale for purposes of determining ADSP.

(g) Examples. The following examples illustrate this section. For purposes of the examples in this paragraph (g), unless otherwise stated, T is a calendar

year taxpayer that files separate returns and that has no loss, tax credit, or other carryovers to Year 1. Depreciation for Year 1 is not taken into account. T has no liabilities other than the Federal income tax liability resulting from the deemed asset sale, and the T shareholders have no selling costs. Assume that T's tax rate for any ordinary income or net capital gain resulting from the deemed sale of assets is 34 percent and that any capital loss is offset by capital gain. On July 1 of Year 1, P purchases all of the stock of T and makes a section 338 election for T. The examples are as follows:

Example 1. One class. (i) On July 1 of Year 1, T's only asset is an item of section 1245 property with an adjusted basis to T of \$50,400, a recomputed basis of \$80,000, and a fair market value of \$100,000. P purchases all of the T stock for \$75,000, which also equals the amount realized for the stock determined as if the selling shareholder(s) were required to use old target's accounting methods and characteristics.

(ii) ADSP is determined as follows (for purposes of this section (g), G is the grossed-up amount realized on the sale to P of P's recently purchased T stock, L is T's liabilities other than T's tax liability for the deemed sale tax consequences, TR is the applicable tax rate, and B is the adjusted basis of the asset deemed sold):

$$\begin{aligned} \text{ADSP} &= G + L + \text{TR} \times (\text{ADSP} - B) \\ \text{ADSP} &= (\$75,000/1) + \$0 + .34 \times (\text{ADSP} - \$50,400) \\ \text{ADSP} &= \$75,000 + .34\text{ADSP} - \$17,136 \\ .66\text{ADSP} &= \$57,864 \\ \text{ADSP} &= \$87,672.72 \end{aligned}$$

(iii) Because ADSP for T (\$87,672.72) does not exceed the fair market value of T's asset (\$100,000), a Class V asset, T's entire ADSP is allocated to that asset. Thus, T's deemed sale results in \$37,272.72 of taxable income

(consisting of \$29,600 of ordinary income and \$7,672.72 of capital gain).

(iv) The facts are the same as in paragraph (i) of this Example 1, except that on July 1 of Year 1, P purchases only 80 of the 100 shares of T stock for \$60,000. The grossed-up amount realized on the sale to P of P's recently purchased T stock (G) is \$75,000 (\$60,000/.8). Consequently, ADSP and the deemed sale tax consequences are the same as in paragraphs (ii) and (iii) of this Example 1.

(v) The facts are the same as in paragraph (i) of this Example 1, except that T also has goodwill (a Class VII asset) with an appraised value of \$10,000. The results are the same as in paragraphs (ii) and (iii) of this Example 1. Because ADSP does not exceed the fair market value of the Class V asset, no amount is allocated to the Class VII asset (goodwill).

Example 2. More than one class. (i) P purchases all of the T stock for \$140,000, which also equals the amount realized for the stock determined as if the selling shareholder(s) were required to use old target's accounting methods and characteristics. On July 1 of Year 1, T has liabilities (not including the tax liability for the deemed sale tax consequences) of \$50,000, cash (a Class I asset) of \$10,000, actively traded securities (a Class II asset) with a basis of \$4,000 and a fair market value of \$10,000, goodwill (a Class VII asset) with a basis of \$3,000, and the following Class V assets:

Asset Basis FMV	
Ratio of	
asset FMV	
to total	
Class V	
FMV	
Land	

.....	
.....	\$5,000 \$35,000
.14	

Building		
.....	10,000	50,000 .20
Equipment A (Recomputed basis \$80,000)		
.....	5,000	
90,000 .36		
Equipment B (Recomputed basis \$20,000)		
.....		
10,000 75,000 .30		
Totals		

..... \$30,000 \$250,000 1.00
(ii) ADSP exceeds \$20,000. Thus, \$10,000 of ADSP is allocated to the cash and \$10,000 to the actively traded securities. The amount allocated to an asset (other than a Class VII asset) cannot exceed its fair market value (however, the fair market value of any property subject to nonrecourse indebtedness is treated as being not less than the amount of such indebtedness; see § 1.338-6(a)(2)). See § 1.338-6(c)(1) (relating to fair market value limitation).

(iii) The portion of ADSP allocable to the Class V assets is preliminarily determined as follows (in the formula, the amount allocated to the Class I assets is referred to as I and the amount allocated to the Class II assets as II):

$$\begin{aligned} \text{ADSPV} &= (G - (I + II)) + L + TR \times [(II - BII) \\ &+ (\text{ADSPV} - BV)] \\ \text{ADSPV} &= (\$140,000 - (\$10,000 + \$10,000)) + \\ &+ \$50,000 + .34 \times [(\$10,000 - \$4,000) + (\text{ADSPV} \\ &- (\$5,000 + \$10,000 + \$5,000 + \$10,000))] \\ \text{ADSPV} &= \$161,840 + .34\text{ADSPV} \\ .66 \text{ ADSPV} &= \$161,840 \\ \text{ADSPV} &= \$245,212.12 \end{aligned}$$

(iv) Because, under the preliminary calculations of ADSP, the amount to be allocated to the Class I, II, III, IV, V, and VI assets does not exceed their aggregate fair market value, no ADSP amount is allocated to goodwill. Accordingly, the deemed sale of the goodwill results in a capital loss of \$3,000. The portion of ADSP allocable to the Class V assets is finally determined by taking

into account this loss as follows:

$$\begin{aligned} \text{ADSPV} &= (G - (I + II)) + L + TR \times [(II - BII) \\ &+ (\text{ADSPV} - BV) + (\text{ADSPV} - B \text{ VII})] \\ \text{ADSPV} &= (\$140,000 - (\$10,000 + \$10,000)) + \\ &+ \$50,000 + .34 \times [(\$10,000 - \$4,000) + (\text{ADSPV} \\ &- \$30,000) + (\$0 - \$3,000)] \\ \text{ADSPV} &= \$160,820 + .34\text{ADSPV} \\ .66 \text{ ADSPV} &= \$160,820 \\ \text{ADSPV} &= \$243,666.67 \end{aligned}$$

(v) The allocation of ADSPV among the Class V assets is in proportion to their fair market values, as follows:

Asset ADSP Gain	
Land	
.....	\$34,113.33 \$29,113.33 (capital gain).
Building	
.....	48,733.34 38,733.34 (capital gain).
Equipment A	
.....	87,720.00 82,720.00 (75,000 ordinary income
	7,720 capital
	gain).
Equipment B	
.....	73,100.00 63,100.00 (10,000 ordinary income
	53,100 capital
	gain).
Totals
	243,666.67 213,666.67.

Example 3. More than one class. (i) The facts are the same as in Example 2, except that P purchases the T stock for \$150,000, rather than \$140,000. The amount realized for the stock determined as if the selling shareholder(s) were required to use old target's accounting methods and characteristics is also \$150,000.

(ii) As in Example 2, ADSP exceeds \$20,000. Thus, \$10,000 of ADSP is allocated to the cash and \$10,000 to the actively traded securities.

(iii) The portion of ADSP allocable to the

Class V assets as preliminarily determined under the formula set forth in paragraph (iii) of Example 2 is \$260,363.64. The amount allocated to the Class V assets cannot exceed their aggregate fair market value (\$250,000). Thus, preliminarily, the ADSP amount allocated to Class V assets is \$250,000.

(iv) Based on the preliminary allocation, the ADSP is determined as follows (in the formula, the amount allocated to the Class I assets is referred to as I, the amount allocated to the Class II assets as II, and the amount allocated to the Class V assets as V):

$$\text{ADSP} = G + L + \text{TR} \times [(II - BII) + (V - BV) + (\text{ADSP} - (I + II + V + BV))]$$

$$\text{ADSP} = \$150,000 + \$50,000 + .34 \times [(\$10,000 - \$4,000) + (\$250,000 - \$30,000) + (\text{ADSP} - (\$10,000 + \$10,000 + \$250,000 + \$3,000))]$$

$$\text{ADSP} = \$200,000 + .34\text{ADSP} - \$15,980$$

$$.66\text{ADSP} = \$184,020$$

$$\text{ADSP} = \$278,818.18$$

(v) Because ADSP as determined exceeds the aggregate fair market value of the Class I, II, III, IV, V, and VI assets, the \$250,000 amount preliminarily allocated to the Class V assets is appropriate. Thus, the amount of ADSP allocated to Class V assets equals their aggregate fair market value (\$250,000), and the allocated ADSP amount for each Class V asset is its fair market value. Further, because there are no Class VI assets, the allocable ADSP amount for the Class VII asset (goodwill) is \$8,818.18 (the excess of ADSP over the aggregate ADSP amounts for the Class I, II, III, IV, V and VI assets).

Example 4. Amount allocated to T1 stock. (i) The facts are the same as in Example 2, except that T owns all of the T1 stock (instead of the building), and T1's only asset is the building. The T1 stock and the building each have a fair market value of \$50,000, and the building has a basis of \$10,000. A section 338 election is made for T1 (as well as T), and T1 has no liabilities other than the tax liability for the deemed sale tax consequences. T is the common parent of a consolidated group

filing a final consolidated return described in § 1.338-10(a)(1).

(ii) ADSP exceeds \$20,000. Thus, \$10,000 of ADSP is allocated to the cash and \$10,000 to the actively traded securities.

(iii) Because T does not recognize any gain on the deemed sale of the T1 stock under paragraph (h)(2) of this section, appropriate adjustments must be made to reflect accurately the fair market value of the T and T1 assets in determining the allocation of ADSP among T's Class V assets (including the T1 stock). In preliminarily calculating ADSPV in this case, the T1 stock can be disregarded and, because T owns all of the T1 stock, the T1 asset can be treated as a T asset. Under this assumption, ADSPV is \$243,666.67. See paragraph (iv) of Example 2.

(iv) Because the portion of the preliminary ADSP allocable to Class V assets (\$243,666.67) does not exceed their fair market value (\$250,000), no amount is allocated to Class VII assets for T. Further, this amount (\$243,666.67) is allocated among T's Class V assets in proportion to their fair market values. See paragraph (v) of Example 2. Tentatively, \$48,733.34 of this amount is allocated to the T1 stock.

(v) The amount tentatively allocated to the T1 stock, however, reflects the tax incurred on the deemed sale of the T1 asset equal to \$13,169.34 (.34 × (\$48,733.34 - \$10,000)).

Thus, the ADSP allocable to the Class V assets of T, and the ADSP allocable to the T1 stock, as preliminarily calculated, each must be reduced by \$13,169.34. Consequently, these amounts, respectively, are \$230,497.33 and \$35,564.00. In determining ADSP for T1, the grossed-up amount realized on the deemed sale to new T of new T's recently purchased T1 stock is \$35,564.00.

(vi) The facts are the same as in paragraph (i) of this Example 4, except that the T1

building has a \$12,500 basis and a \$62,500 value, all of the outstanding T1 stock has a \$62,500 value, and T owns 80 percent of the T1 stock. In preliminarily calculating ADSPV, the T1 stock can be disregarded but, because T owns only 80 percent of the T1 stock, only 80 percent of T1 asset basis and value should be taken into account in calculating T's ADSP. By taking into account 80 percent of these amounts, the remaining calculations and results are the same as in paragraphs (ii), (iii), (iv), and (v) of this Example 4, except that the grossed-up amount realized on the sale of the recently purchased T1 stock is \$44,455.00 (\$35,564.00/0.8).

(h) Deemed sale of target affiliate stock—(1) Scope. This paragraph (h) prescribes rules relating to the treatment of gain or loss realized on the deemed sale of stock of a target affiliate when a section 338 election (but not a section 338(h)(10) election) is made for the target affiliate. For purposes of this paragraph (h), the definition of domestic corporation in § 1.338-2(c)(9) is applied without the exclusion therein for DISCs, corporations described in section 1248(e), and corporations to which an election under section 936 applies.

(2) In general. Except as otherwise provided in this paragraph (h), if a section 338 election is made for target, target recognizes no gain or loss on the deemed sale of stock of a target affiliate having the same acquisition date and for which a section 338 election is made if—

(i) Target directly owns stock in the target affiliate satisfying the requirements of section 1504(a)(2);

(ii) Target and the target affiliate are members of a consolidated group filing a final consolidated return described in § 1.338-10(a)(1); or

(iii) Target and the target affiliate file a combined return under § 1.338-10(a)(4).

(3) Deemed sale of foreign target affiliate by a domestic target. A domestic target recognizes gain or loss on the deemed sale of stock of a foreign target affiliate. For the proper treatment of such gain or loss, see, e.g., sections 1246, 1248, 1291 et seq., and 338(h)(16) and § 1.338-9.

(4) Deemed sale producing effectively connected income. A foreign target recognizes gain or loss on the deemed sale of stock of a foreign target affiliate to the extent that such gain or loss is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States.

(5) Deemed sale of insurance company target affiliate electing under section 953(d). A domestic target recognizes gain (but not loss) on the deemed sale of stock of a target affiliate that has in effect an election under section 953(d) in an amount equal to the lesser of the gain realized or the earnings and profits described in section 953(d)(4)(B).

(6) Deemed sale of DISC target affiliate. A foreign or domestic target recognizes gain (but not loss) on the deemed sale of stock of a target affiliate that is a DISC or a former DISC (as defined in section 992(a)) in an amount equal to the lesser of the gain realized or the amount of accumulated DISC income determined with respect to such stock under section 995(c). Such gain is included in gross income as a dividend as provided in sections 995(c)(2) and 996(g).

(7) Anti-stuffing rule. If an asset the adjusted basis of which exceeds its fair

market value is contributed or transferred to a target affiliate as transferred basis property (within the meaning of section 7701(a)(43)) and a purpose of such transaction is to reduce the gain (or increase the loss) recognized on the deemed sale of such target affiliate's stock, the gain or loss recognized by target on the deemed sale of stock of the target affiliate is determined as if such asset had not been contributed or transferred.

(8) Examples. The following examples illustrate this paragraph (h):

Example 1. (i) P makes a qualified stock purchase of T and makes a section 338 election for T. T's sole asset, all of the T1 stock, has a basis of \$50 and a fair market value of \$150. T's deemed purchase of the T1 stock results in a qualified stock purchase of T1 and a section 338 election is made for T1. T1's assets have a basis of \$50 and a fair market value of \$150.

(ii) T realizes \$100 of gain on the deemed sale of the T1 stock, but the gain is not recognized because T directly owns stock in T1 satisfying the requirements of section 1504(a)(2) and a section 338 election is made for T1.

(iii) T1 recognizes gain of \$100 on the deemed sale of its assets.

Example 2. The facts are the same as in Example 1, except that P does not make a section 338 election for T1. Because a section 338 election is not made for T1, the \$100 gain realized by T on the deemed sale of the T1 stock is recognized.

Example 3. (i) P makes a qualified stock purchase of T and makes a section 338 election for T. T owns all of the stock of T1 and T2. T's deemed purchase of the T1 and T2 stock results in a qualified stock purchase of

T1 and T2 and section 338 elections are made for T1 and T2. T1 and T2 each own 50 percent of the vote and value of T3 stock. The deemed purchases by T1 and T2 of the T3 stock result in a qualified stock purchase of T3 and a section 338 election is made for T3. T is the common parent of a consolidated group and all of the deemed asset sales are reported on the T group's final consolidated return. See § 1.338-10(a)(1).

(ii) Because T, T1, T2 and T3 are members of a consolidated group filing a final consolidated return, no gain or loss is recognized by T, T1 or T2 on their respective deemed sales of target affiliate stock.

Example 4. (i) T's sole asset, all of the FT1 stock, has a basis of \$25 and a fair market value of \$150. FT1's sole asset, all of the FT2 stock, has a basis of \$75 and a fair market value of \$150. FT1 and FT2 each have \$50 of accumulated earnings and profits for purposes of section 1248(c) and (d). FT2's assets have a basis of \$125 and a fair market value of \$150, and their sale would not generate subpart F income under section 951. The sale of the FT2 stock or assets would not generate income effectively connected with the conduct of a trade or business within the United States. FT1 does not have an election in effect under section 953(d) and neither FT1 nor FT2 is a passive foreign investment company.

(ii) P makes a qualified stock purchase of T and makes a section 338 election for T. T's deemed purchase of the FT1 stock results in a qualified stock purchase of FT1 and a section 338 election is made for FT1. Similarly, FT1's deemed purchase of the FT2 stock results in a qualified stock purchase of FT2 and a section 338 election is made for FT2.

(iii) T recognizes \$125 of gain on the deemed sale of the FT1 stock under paragraph (h)(3) of this section. FT1 does not recognize \$75 of gain on the deemed sale of the

FT2 stock under paragraph (h)(2) of this section. FT2 recognizes \$25 of gain on the deemed sale of its assets. The \$125 gain T recognizes on the deemed sale of the FT1 stock is included in T's income as a dividend under section 1248, because FT1 and FT2 have sufficient earnings and profits for full recharacterization (\$50 of accumulated earnings and profits in FT1, \$50 of accumulated earnings and profits in FT2, and \$25 of deemed sale earnings and profits in FT2). Section 1.338-9(b). For purposes of sections 901 through 908, the source and foreign tax credit limitation basket of \$25 of the recharacterized gain on the deemed sale of the FT1 stock is determined under section 338(h)(16).

[T.D. 8940, 66 FR 9929, Feb. 13, 2001; 66 FR 17466, Mar. 30, 2001]

§ 1.338-5 Adjusted grossed-up basis.

(a) Scope. This section provides rules under section 338(b) to determine the adjusted grossed-up basis (AGUB) for target. AGUB is the amount for which new target is deemed to have purchased all of its assets in the deemed purchase under section 338(a)(2). AGUB is allocated among target's assets in accordance with § 1.338-6 to determine the price at which the assets are deemed to have been purchased. When a subsequent increase or decrease with respect to an element of AGUB is required under general principles of tax law, redetermined AGUB is allocated among target's assets in accordance with § 1.338-7.

(b) Determination of AGUB—(1) General rule. AGUB is the sum of—

(i) The grossed-up basis in the purchasing corporation's recently purchased target stock;

(ii) The purchasing corporation's

basis in nonrecently purchased target stock; and

(iii) The liabilities of new target.

(2) Time and amount of AGUB—(i) Original determination. AGUB is initially determined at the beginning of the day after the acquisition date of target. General principles of tax law apply in determining the timing and amount of the elements of AGUB.

(ii) Redetermination of AGUB. AGUB

is redetermined at such time and in such amount as an increase or decrease would be required, under general principles of tax law, with respect to an element of AGUB. For example, AGUB is redetermined because of an increase or decrease in the amount paid or incurred for recently purchased stock or nonrecently purchased stock or because liabilities not originally taken into account in determining AGUB are subsequently taken into account. An increase or decrease to one element of AGUB also may cause an increase or decrease to another element of AGUB. For example, if there is an increase in the amount paid or incurred for recently purchased stock after the acquisition date, any increase in the basis of nonrecently purchased stock because a gain recognition election was made is also taken into account when AGUB is redetermined. Increases or decreases with respect to the elements of AGUB result in the reallocation of AGUB among target's assets under § 1.338-7.

(iii) Examples. The following examples illustrate this paragraph (b)(2):

Example 1. In Year 1, T, a manufacturer, purchases a customized delivery truck from X with purchase money indebtedness having

a stated principal amount of \$100,000. P acquires all of the stock of T in Year 3 for \$700,000 and makes a section 338 election for T. Assume T has no liabilities other than its purchase money indebtedness to X. In Year 4, when T is neither insolvent nor in a title 11 case, T and X agree to reduce the amount of the purchase money indebtedness to \$80,000. Assume that the reduction would be a purchase price reduction under section 108(e)(5). T and X's agreement to reduce the amount of the purchase money indebtedness would, under general principles of tax law that would apply if the deemed asset sale had actually occurred, change the amount of liabilities of old target taken into account in determining its basis. Accordingly, AGUB is redetermined at the time of the reduction. See paragraph (e)(2) of this section. Thus the purchase price reduction affects the basis of the truck only indirectly, through the mechanism of §§ 1.338-6 and 1.338-7. See § 1.338-4(b)(2)(iii) Example for the effect on ADSP.

Example 2. T, an accrual basis taxpayer, is a chemical manufacturer. In Year 1, T is obligated to remediate environmental contamination at the site of one of its plants. Assume that all the events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy but economic performance has not occurred with respect to the liability within the meaning of section 461(h). P acquires all of the stock of T in Year 1 and makes a section 338 election for T. Assume that, if a corporation unrelated to T had actually purchased T's assets and assumed T's obligation to remediate the contamination, the corporation would not satisfy the economic performance requirements until Year 5. Under section 461(h), the assumed liability would not be treated as incurred and taken into account in basis until that time. The incurrence of the liability in Year 5 under the economic performance rules is an increase in the amount of liabilities

properly taken into account in basis and results in the redetermination of AGUB. (Respecting ADSP, compare § 1.461-4(d)(5), which provides that economic performance occurs for old T as the amount of the liability is properly taken into account in amount realized on the deemed asset sale. Thus ADSP is not redetermined when new T satisfies the economic performance requirements.)

(c) Grossed-up basis of recently purchased stock. The purchasing corporation's grossed-up basis of recently purchased target stock (as defined in section 338(b)(6)(A)) is an amount equal to—

(1) The purchasing corporation's basis in recently purchased target stock at the beginning of the day after the acquisition date determined without regard to the acquisition costs taken into account in paragraph (c)(3) of this section;

(2) Multiplied by a fraction, the numerator of which is 100 minus the number that is the percentage of target stock (by value, determined on the acquisition date) attributable to the purchasing corporation's nonrecently purchased target stock, and the denominator of which is the number equal to the percentage of target stock (by value, determined on the acquisition date) attributable to the purchasing corporation's recently purchased target stock;

(3) Plus the acquisition costs the purchasing corporation incurred in connection with its purchase of the recently purchased stock that are capitalized in the basis of such stock (e.g., brokerage commissions and any similar costs incurred by the purchasing corporation to acquire the stock).

(d) Basis of nonrecently purchased stock; gain recognition election—(1) No gain recognition election. In the absence of a gain recognition election under section 338(b)(3) and this section, the purchasing corporation retains its basis in the nonrecently purchased stock.

(2) Procedure for making gain recognition election. A gain recognition election may be made for nonrecently purchased stock of target (or a target affiliate) only if a section 338 election is made for target (or the target affiliate). The gain recognition election is made by attaching a gain recognition statement to a timely filed Form 8023 for target. The gain recognition statement must contain the information specified in the form and its instructions. The gain recognition election is irrevocable. If a section 338(h)(10) election is made for target, see § 1.338(h)(10)–1(d)(1) (providing that the purchasing corporation is automatically deemed to have made a gain recognition election for its nonrecently purchased T stock).

(3) Effect of gain recognition election—

(i) In general. If the purchasing corporation makes a gain recognition election, then for all purposes of the Internal Revenue Code—

(A) The purchasing corporation is treated as if it sold on the acquisition date the nonrecently purchased target stock for the basis amount determined under paragraph (d)(3)(ii) of this section; and

(B) The purchasing corporation's basis on the acquisition date in nonrecently purchased target stock immediately following the deemed sale in paragraph (d)(3)(i)(A) of this section is

the basis amount.

(ii) Basis amount. The basis amount is equal to the amount in paragraphs (c)(1) and (2) of this section (the purchasing corporation's grossed-up basis in recently purchased target stock at the beginning of the day after the acquisition date determined without regard to the acquisition costs taken into account in paragraph (c)(3) of this section) multiplied by a fraction the numerator of which is the percentage of target stock (by value, determined on the acquisition date) attributable to the purchasing corporation's nonrecently purchased target stock and the denominator of which is 100 percent minus the numerator amount. Thus, if target has a single class of outstanding stock, the purchasing corporation's basis in each share of nonrecently purchased target stock after the gain recognition election is equal to the average price per share of the purchasing corporation's recently purchased target stock.

(iii) Losses not recognized. Only gains (unreduced by losses) on the nonrecently purchased target stock are recognized.

(iv) Stock subject to election. The gain recognition election applies to—

(A) All nonrecently purchased target stock; and

(B) Any nonrecently purchased stock in a target affiliate having the same acquisition date as target if such target affiliate stock is held by the purchasing corporation on such date.

(e) Liabilities of new target—(1) In general. The liabilities of new target are the liabilities of target as of the beginning of the day after the acquisition

date (but see § 1.338–1(d) (regarding certain transactions on the acquisition date)). In order to be taken into account in AGUB, a liability must be a liability of target that is properly taken into account in basis under general principles of tax law that would apply if new target had acquired its assets from an unrelated person for consideration that included discharge of the liabilities of that unrelated person. Such liabilities may include liabilities for the tax consequences resulting from the deemed sale.

(2) Time and amount of liabilities. The time for taking into account liabilities of old target in determining AGUB and the amount of the liabilities taken into account is determined as if new target had acquired its assets from an unrelated person for consideration that included the discharge of its liabilities.

(3) Interaction with deemed sale tax consequences. In general, see § 1.338–4(e). Although ADSP and AGUB are not necessarily linked, if an increase in the amount realized for recently purchased stock of target is taken into account after the acquisition date, and if the tax on the deemed sale tax consequences is a liability of target, any increase in that liability is also taken into account in redetermining AGUB.

(f) Adjustments by the Internal Revenue Service. In connection with the examination of a return, the Commissioner may increase (or decrease) AGUB under the authority of section 338(b)(2) and allocate such amounts to target's assets under the authority of section 338(b)(5) so that AGUB and the basis of target's assets properly reflect the cost to the purchasing corporation of its interest in target's assets. Such items may include distributions from target to the purchasing corporation, capital contributions from the purchasing corporation to target during the 12-month

acquisition period, or acquisitions of target stock by the purchasing corporation after the acquisition date from minority shareholders. See also § 1.338–1(d) (regarding certain transactions on the acquisition date).

(g) Examples. The following examples illustrate this section. For purposes of the examples in this paragraph (g), T has no liabilities other than the tax liability for the deemed sale tax consequences, T shareholders incur no costs in selling the T stock, and P incurs no costs in acquiring the T stock. The examples are as follows:

Example 1. (i) Before July 1 of Year 1, P purchases 10 of the 100 shares of T stock for \$5,000. On July 1 of Year 2, P purchases 80 shares of T stock for \$60,000 and makes a section 338 election for T. As of July 1 of Year 2, T's only asset is raw land with an adjusted basis to T of \$50,400 and a fair market value of \$100,000. T has no loss or tax credit carryovers to Year 2. T's marginal tax rate for any ordinary income or net capital gain resulting from the deemed asset sale is 34 percent. The 10 shares purchased before July 1 of Year 1 constitute nonrecently purchased T stock with respect to P's qualified stock purchase of T stock on July 1 of Year 2.

(ii) The ADSP formula as applied to these facts is the same as in § 1.338–4(g) Example 1. Accordingly, the ADSP for T is \$87,672.72. The existence of nonrecently purchased T stock is irrelevant for purposes of the ADSP formula, because that formula treats P's nonrecently purchased T stock in the same manner as T stock not held by P.

(iii) The total tax liability resulting from T's deemed asset sale, as calculated under the ADSP formula, is \$12,672.72.

(iv) If P does not make a gain recognition election, the AGUB of new T's assets is \$85,172.72, determined as follows (In the following formula below, GRP is the grossed-up

basis in P's recently purchased T stock, BNP is P's basis in nonrecently purchased T stock, L is T's liabilities, and X is P's acquisition costs for the recently purchased T stock):

$$\text{AGUB} = \text{GRP} + \text{BNP} + \text{L} + \text{X}$$

$$\text{AGUB} = \$60,000 \times [(1 - .1)/.8] + \$5,000 + \$12,672.72 + 0$$

$$\text{AGUB} = \$85,172.72$$

(v) If P makes a gain recognition election, the AGUB of new T's assets is \$87,672.72, determined as follows:

$$\text{AGUB} = \$60,000 \times [(1 - .1)/.8] + \$60,000 \times [(1 - .1)/.8] \times [.1/(1 - .1)] + \$12,672.72$$

$$\text{AGUB} = \$87,672.72$$

(vi) The calculation of AGUB if P makes a gain recognition election may be simplified as follows:

$$\text{AGUB} = \$60,000/.8 + \$12,672.72$$

$$\text{AGUB} = \$87,672.72$$

(vii) As a result of the gain recognition election, P's basis in its nonrecently purchased T stock is increased from \$5,000 to \$7,500 (i.e., $\$60,000 \times [(1 - .1)/.8] \times [.1/(1 - .1)]$). Thus, P recognizes a gain in Year 2 with respect to its nonrecently purchased T stock of \$2,500 (i.e., $\$7,500 - \$5,000$).

Example 2. On January 1 of Year 1, P purchases one-third of the T stock. On March 1 of Year 1, T distributes a dividend to all of its shareholders. On April 15 of Year 1, P purchases the remaining T stock and makes a section 338 election for T. In appropriate circumstances, the Commissioner may decrease the AGUB of T to take into account the payment of the dividend and properly reflect the fair market value of T's assets deemed purchased.

Example 3. (i) T's sole asset is a building worth \$100,000. At this time, T has 100 shares of stock outstanding. On August 1 of Year 1, P purchases 10 of the 100 shares of T stock for \$8,000. On June 1 of Year 2, P purchases 50

shares of T stock for \$50,000. On June 15 of Year 2, P contributes a tract of land to the capital of T and receives 10 additional shares of T stock as a result of the contribution. Both the basis and fair market value of the land at that time are \$10,800. On June 30 of Year 2, P purchases the remaining 40 shares of T stock for \$40,000 and makes a section 338 election for T. The AGUB of T is \$108,800.

(ii) To prevent the shifting of basis from the contributed property to other assets of T, the Commissioner may allocate \$10,800 of the AGUB to the land, leaving \$98,000 to be allocated to the building. See paragraph (f) of this section. Otherwise, applying the allocation rules of § 1.338-6 would, on these facts, result in an allocation to the recently contributed land of an amount less than its value of \$10,800, with the difference being allocated to the building already held by T.

(h) **Effective/applicability date.** Paragraph (d)(3)(ii) of this section is applicable to any qualified stock purchase or qualified stock disposition (as defined in § 1.336-1(b)(6)) for which the acquisition date or disposition date (as defined in § 1.336-1(b)(8)), respectively, is on or after May 15, 2013.

[T.D. 8940, 66 FR 9929, Feb. 13, 2001, as amended by T.D. 9619, 78 FR 28489, May 15, 2013]

§ 1.338-6 Allocation of ADSP and AGUB among target assets.

(a) **Scope—(1)** In general. This section prescribes rules for allocating ADSP and AGUB among the acquisition date assets of a target for which a section 338 election is made.

(2) **Fair market value—(i)** In general. Generally, the fair market value of an asset is its gross fair market value (i.e., fair market value determined without regard to mortgages, liens,

pledges, or other liabilities). However, for purposes of determining the amount of old target's deemed sale tax consequences, the fair market value of any property subject to a nonrecourse indebtedness will be treated as being not less than the amount of such indebtedness. (For purposes of the preceding sentence, a liability that was incurred because of the acquisition of the property is disregarded to the extent that such liability was not taken into account in determining old target's basis in such property.)

(ii) Transaction costs. Transaction costs are not taken into account in allocating ADSP or AGUB to assets in the deemed sale (except indirectly through their effect on the total ADSP or AGUB to be allocated).

(iii) Internal Revenue Service authority. In connection with the examination of a return, the Internal Revenue Service may challenge the taxpayer's determination of the fair market value of any asset by any appropriate method and take into account all factors, including any lack of adverse tax interests between the parties.

(b) General rule for allocating ADSP and AGUB—(1) Reduction in the amount of consideration for Class I assets. Both ADSP and AGUB, in the respective allocation of each, are first reduced by the amount of Class I assets. Class I assets are cash and general deposit accounts (including savings and checking accounts) other than certificates of deposit held in banks, savings and loan associations, and other depository institutions. If the amount of Class I assets exceeds AGUB, new target will immediately realize ordinary income in an amount equal to such excess. The amount of ADSP or AGUB remaining after the reduction is to be allocated to the remaining acquisition date assets.

(2) Other assets—(i) In general. Subject to the limitations and other rules of paragraph (c) of this section, ADSP and AGUB (as reduced by the amount of Class I assets) are allocated among Class II acquisition date assets of target in proportion to the fair market values of such Class II assets at such time, then among Class III assets so held in such proportion, then among Class IV assets so held in such proportion, then among Class V assets so held in such proportion, then among Class VI assets so held in such proportion, and finally to Class VII assets. If an asset is described below as includible in more than one class, then it is included in such class with the lower or lowest class number (for instance, Class III has a lower class number than Class IV).

(ii) Class II assets. Class II assets are actively traded personal property within the meaning of section 1092(d)(1) and § 1.1092(d)-1 (determined without regard to section 1092(d)(3)). In addition, Class II assets include certificates of deposit and foreign currency even if they are not actively traded personal property. Class II assets do not include stock of target affiliates, whether or not of a class that is actively traded, other than actively traded stock described in section 1504(a)(4). Examples of Class II assets include U.S. government securities and publicly traded stock.

(iii) Class III assets. Class III assets are assets that the taxpayer marks to market at least annually for Federal income tax purposes and debt instruments (including accounts receivable). However, Class III assets do not include—

(A) Debt instruments issued by persons related at the beginning of the

day following the acquisition date to the target under section 267(b) or 707;

(B) Contingent debt instruments subject to § 1.1275–4, § 1.483–4, or section 988, unless the instrument is subject to the non-contingent bond method of § 1.1275–4(b) or is described in § 1.988–2(b)(2)(i)(B)(2); and

(C) Debt instruments convertible into the stock of the issuer or other property.

(iv) Class IV assets. Class IV assets are stock in trade of the taxpayer or other property of a kind that would properly be included in the inventory of taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.

(v) Class V assets. Class V assets are all assets other than Class I, II, III, IV, VI, and VII assets.

(vi) Class VI assets. Class VI assets are all section 197 intangibles, as defined in section 197, except goodwill and going concern value.

(vii) Class VII assets. Class VII assets are goodwill and going concern value (whether or not the goodwill or going concern value qualifies as a section 197 intangible).

(3) Other items designated by the Internal Revenue Service. Similar items may be added to any class described in this paragraph (b) by designation in the Internal Revenue Bulletin by the Internal Revenue Service (see § 601.601(d)(2) of this chapter).

(c) Certain limitations and other rules for allocation to an asset—(1) Allocation not to exceed fair market value. The

amount of ADSP or AGUB allocated to an asset (other than Class VII assets) cannot exceed the fair market value of that asset at the beginning of the day after the acquisition date.

(2) Allocation subject to other rules. The amount of ADSP or AGUB allocated to an asset is subject to other provisions of the Internal Revenue Code or general principles of tax law in the same manner as if such asset were transferred to or acquired from an unrelated person in a sale or exchange. For example, if the deemed asset sale is a transaction described in section 1056(a) (relating to basis limitation for player contracts transferred in connection with the sale of a franchise), the amount of AGUB allocated to a contract for the services of an athlete cannot exceed the limitation imposed by that section. As another example, section 197(f)(5) applies in determining the amount of AGUB allocated to an amortizable section 197 intangible resulting from an assumption-reinsurance transaction.

(3) Special rule for allocating AGUB when purchasing corporation has nonrecently purchased stock—(i) Scope. This paragraph (c)(3) applies if at the beginning of the day after the acquisition date—

(A) The purchasing corporation holds nonrecently purchased stock for which a gain recognition election under section 338(b)(3) and § 1.338–5(d) is not made; and

(B) The hypothetical purchase price determined under paragraph (c)(3)(ii) of this section exceeds the AGUB determined under § 1.338–5(b).

(ii) Determination of hypothetical purchase price. Hypothetical purchase

price is the AGUB that would result if a gain recognition election were made.

(iii) Allocation of AGUB. Subject to the limitations in paragraphs (c)(1) and

(2) of this section, the portion of AGUB (after reduction by the amount of Class I assets) to be allocated to each Class II, III, IV, V, VI, and VII asset of target held at the beginning of the day after the acquisition date is determined by multiplying—

(A) The amount that would be allocated to such asset under the general rules of this section were AGUB equal to the hypothetical purchase price; by

(B) A fraction, the numerator of which is actual AGUB (after reduction by the amount of Class I assets) and the denominator of which is the hypothetical purchase price (after reduction by the amount of Class I assets).

(4) Liabilities taken into account in determining amount realized on subsequent disposition. In determining the amount realized on a subsequent sale or other disposition of property deemed purchased by new target, § 1.1001-2(a)(3) shall not apply to any liability that was taken into account in AGUB.

(5) Allocation to certain nuclear decommissioning funds—(i) General rule. For purposes of allocating ADSP or AGUB among the acquisition date assets of a target (and for no other purpose), a taxpayer may elect to treat a nonqualified nuclear decommissioning fund (as defined in paragraph (c)(5)(ii) of this section) of the target as if—

(A) Such fund were an entity classified as a corporation;

(B) The stock of the corporation were among the acquisition date assets of the target and a Class V asset;

(C) The corporation owned the assets of the fund;

(D) The corporation bore the responsibility for decommissioning one or more nuclear power plants to the extent assets of the fund are expected to be used for that purpose; and

(E) A section 338(h)(10) election were made for the corporation (regardless of whether the requirements for a section 338(h)(10) election are otherwise satisfied).

(ii) Definition of nonqualified nuclear decommissioning fund. A nonqualified nuclear decommissioning fund means a trust, escrow account, Government fund or other type of agreement—

(A) That is established in writing by the owner or licensee of a nuclear generating unit for the exclusive purpose of funding the decommissioning of one or more nuclear power plants;

(B) That is described to the Nuclear Regulatory Commission in a report described in 10 CFR 50.75(b) as providing assurance that funds will be available for decommissioning;

(C) That is not a Nuclear Decommissioning Reserve Fund, as described in section 468A;

(D) That is maintained at all times in the United States; and

(E) The assets of which are to be used only as permitted by 10 CFR 50.82(a)(8).

(iii) Availability of election. P may

make the election described in this paragraph (c)(5) regardless of whether the selling consolidated group (or the selling affiliate or the S corporation shareholders) also makes the election. In addition, the selling consolidated group (or the selling affiliate or the S corporation shareholders) may make the election regardless of whether P also makes the election. If T is an S corporation, all of the S corporation shareholders, including those that do not sell their stock, must consent to the election for the election to be effective as to any S corporation shareholder.

(iv) Time and manner of making election. The election described in this paragraph (c)(5) is made by taking a position on an original or amended tax return for the taxable year of the qualified stock purchase that is consistent with having made the election. Such tax return must be filed no later than the later of 30 days after the date on which the section 338 election is due or the day the original tax return for the taxable year of the qualified stock purchase is due (with extensions).

(v) Irrevocability of election. An election made pursuant to this paragraph (c)(5) is irrevocable.

(vi) Effective/applicability date. This paragraph (c)(5) applies to qualified stock purchases occurring on or after September 11, 2007. For qualified stock purchases occurring before September 11, 2007 and on or after September 15, 2004, see § 1.338-6T as contained in 26 CFR part 1 in effect on April 1, 2007. For qualified stock purchases occurring before September 15, 2004, see § 1.338-6 as contained in 26 CFR part 1 in effect on April 1, 2004.

(d) Examples. The following examples

illustrate §§ 1.338-4, 1.338-5, and this section:

Example 1. (i) T owns 90 percent of the outstanding T1 stock. P purchases 100 percent of the outstanding T stock for \$2,000. There are no acquisition costs. P makes a section 338 election for T and, as a result, T1 is considered acquired in a qualified stock purchase. A section 338 election is made for T1. The grossed-up basis of the T stock is \$2,000 (i.e., \$2,000 + 1/1).

(ii) The liabilities of T as of the beginning of the day after the acquisition date (including the tax liability for the deemed sale tax consequences) that would, under general principles of tax law, properly be taken into account at that time, are as follows:

Liabilities (nonrecourse mortgage plus unsecured liabilities)	\$700
Taxes Payable	300
Total	1,000

(iii) The AGUB of T is determined as follows:

Grossed-up basis	\$2,000
Total liabilities	1,000
AGUB	3,000

(iv) Assume that ADSP is also \$3,000.

(v) Assume that, at the beginning of the day after the acquisition date, T's cash and the fair market values of T's Class II, III, IV, and V assets are as follows:

Asset class	Asset	
Fair market value		
I	Cash.....	* \$200
II	Portfolio of actively traded securities	300
III ...	Accounts receivable	600
IV ...	Inventory	300
V	Building	800
V	Land	200
V	Investment in T1	450
Total		2,850

*Amount.

(vi) Under paragraph (b)(1) of this section,

the amount of ADSP and AGUB allocable to T's Class II, III, IV, and V assets is reduced by the amount of cash to \$2,800, i.e., \$3,000—\$200. \$300 of ADSP and of AGUB is then allocated to actively traded securities. \$600 of ADSP and of AGUB is then allocated to accounts receivable. \$300 of ADSP and of AGUB is then allocated to the inventory. Since the remaining amount of ADSP and of AGUB is \$1,600 (i.e., \$3,000—(\$200 + \$300 + \$600 + \$300)), an amount which exceeds the sum of the fair market values of T's Class V assets, the amount of ADSP and of AGUB allocated to each Class V asset is its fair market value:

Building.....	\$800
Land	200
Investment in T1	450
Total	1,450

(vii) T has no Class VI assets. The amount of ADSP and of AGUB allocated to T's Class VII assets (goodwill and going concern value) is \$150, i.e., \$1,600—\$1,450.

(viii) The grossed-up basis of the T1 stock is \$500, i.e., $\$450 \times 1/.9$.

(ix) The liabilities of T1 as of the beginning of the day after the acquisition date (including the tax liability for the deemed sale tax consequences) that would, under general principles of tax law, properly be taken into account at that time, are as follows:

General Liabilities	\$100
Taxes Payable	20
Total	120

(x) The AGUB of T1 is determined as follows:

Grossed-up basis of T1 Stock	\$ 500
Liabilities	120
AGUB	620

(xi) Assume that ADSP is also \$620.

(xii) Assume that at the beginning of the day after the acquisition date, T1's cash and the fair market values of its Class IV and VI

assets are as follows:

Asset class	Asset	Fair market value
I	Cash	*\$50
IV	Inventory	200
VI	Patent	350
Total.....		600

* Amount.

(xiii) The amount of ADSP and of AGUB allocable to T1's Class IV and VI assets is first reduced by the \$50 of cash.

(xiv) Because the remaining amount of ADSP and of AGUB (\$570) is an amount which exceeds the fair market value of T1's only Class IV asset, the inventory, the amount allocated to the inventory is its fair market value (\$200). After that, the remaining amount of ADSP and of AGUB (\$370) exceeds the fair market value of T1's only Class VI asset, the patent. Thus, the amount of ADSP and of AGUB allocated to the patent is its fair market value (\$350).

(xv) The amount of ADSP and of AGUB allocated to T1's Class VII assets (goodwill and going concern value) is \$20, i.e., \$570—\$550.

Example 2. (i) Assume that the facts are the same as in Example 1 except that P has, for five years, owned 20 percent of T's stock, which has a basis in P's hands at the beginning of the day after the acquisition date of \$100, and P purchases the remaining 80 percent of T's stock for \$1,600. P does not make a gain recognition election under section 338(b)(3).

(ii) Under § 1.338-5(c), the grossed-up basis of recently purchased T stock is \$1,600, i.e., $\$1,600 \times (1-.2)/.8$.

(iii) The AGUB of T is determined as follows:
Grossed-up basis of recently purchased stock as determined under § 1.338-5(c) ($\$1,600 \times (1-.2)/.8$)..... \$1,600
Basis of nonrecently purchased stock 100
Liabilities..... 1,000

AGUB 2,700

(iv) Since P holds nonrecently purchased stock, the hypothetical purchase price of the T stock must be computed and is determined as follows:

Grossed-up basis of recently purchased stock as determined under § 1.338-5(c) ($\$1,600 \times (1-.2)/.8$) \$1,600
 Basis of nonrecently purchased stock as if the gain recognition election under § 1.338-5(d)(2) had been made ($\$1,600 \times .2/(1-.2)$) 400
 Liabilities..... 1,000
 Total 3,000

(v) Since the hypothetical purchase price (\$3,000) exceeds the AGUB (\$2,700) and no gain recognition election is made under section 338(b)(3), AGUB is allocated under paragraph (c)(3) of this section.

(vi) First, an AGUB amount equal to the hypothetical purchase price (\$3,000) is allocated among the assets under the general rules of this section. The allocation is set forth in the column below entitled Original Allocation. Next, the allocation to each asset in Class II through Class VII is multiplied by a fraction having a numerator equal to the actual AGUB reduced by the amount of Class I assets ($\$2,700 - \$200 = \$2,500$) and a denominator equal to the hypothetical purchase price reduced by the amount of Class I assets ($\$3,000 - \$200 = \$2,800$), or $2,500/2,800$. This produces the Final Allocation:

Class	Asset	Original allocation	Final allocation
I	Cash	\$200	\$200
II	Portfolio act traded securities	300	*268
III	Accounts receivable	600	536
IV	Inventory	300	268
V	Building	800	714
V	Land	200	178
V	Investment in T1	450	402
VII	Goodwill, going concern	150	134
	Class Asset	Original allocation	Final allocation
	Total	3,000	2,700

* All numbers rounded for convenience.

[T.D. 8940, 66 FR 9929, Feb. 13, 2001; 66 FR 17363, Mar. 30, 2001; T.D. 9158, 69 FR 55742, Sept. 16, 2004; T.D. 9358, 72 FR 51706, Sept. 11, 2007]

§ 1.338-7 Allocation of redetermined ADSP and AGUB among target assets.

(a) Scope. ADSP and AGUB are redetermined at such time and in such amount as an increase or decrease would be required under general principles of tax law for the elements of ADSP or AGUB. This section provides rules for allocating redetermined ADSP or AGUB.

(b) Allocation of redetermined ADSP and AGUB. When ADSP or AGUB is redetermined, a new allocation of ADSP or AGUB is made by allocating the redetermined ADSP or AGUB amount under the rules of § 1.338-6. If the allocation of the redetermined ADSP or AGUB amount under § 1.338-6 to a given asset is different from the original allocation to it, the difference is added to or subtracted from the original allocation to the asset, as appropriate. (See paragraph (d) of this section for new target's treatment of the amount so allocated.) Amounts allocable to an acquisition date asset (or with respect to a disposed-of acquisition date asset) are subject to all the asset allocation rules (for example, the fair market value limitation in § 1.338-6(c)(1)) as if the redetermined ADSP or AGUB were the ADSP or AGUB on the acquisition date.

(c) Special rules for ADSP—(1) Increases or decreases in deemed sale tax consequences taxable notwithstanding old target ceases to exist. To the extent general principles of tax law would require a seller in an actual asset sale to account for events relating to the sale that occur after the sale date, target must make such an accounting. Target

is not precluded from realizing additional deemed sale tax consequences because the target is treated as a new corporation after the acquisition date.

(2) Procedure for transactions in which section 338(h)(10) is not elected—(i) Deemed sale tax consequences included in new target's return. If an election under section 338(h)(10) is not made, any additional deemed sale tax consequences of old target resulting from an increase or decrease in the ADSP are included in new target's income tax return for new target's taxable year in which the increase or decrease is taken into account. For example, if after the acquisition date there is an increase in the allocable ADSP of section 1245 property for which the recomputed basis (but not the adjusted basis) exceeds the portion of the ADSP allocable to that particular asset on the acquisition date, the additional gain is treated as ordinary income to the extent it does not exceed such excess amount. See paragraph (c)(2)(ii) of this section for the special treatment of old target's carryovers and carrybacks. Although included in new target's income tax return, the deemed sale tax consequences are separately accounted for as an item of old target and may not be offset by income, gain, deduction, loss, credit, or other amount of new target. The amount of tax on income of old target resulting from an increase or decrease in the ADSP is determined as if such deemed sale tax consequences had been recognized in old target's taxable year ending at the close of the acquisition date. However, because the income resulting from the increase or decrease in ADSP is reportable in new target's taxable year of the increase or decrease, not in old target's taxable year ending at the close of the acquisition date, there is not a resulting underpayment

of tax in that past taxable year of old target for purposes of calculation of interest due.

(ii) Carryovers and carrybacks—(A) Loss carryovers to new target taxable years. A net operating loss or net capital loss of old target may be carried forward to a taxable year of new target, under the principles of section 172 or 1212, as applicable, but is allowed as a deduction only to the extent of any recognized income of old target for such taxable year, as described in paragraph (c)(2)(i) of this section. For this purpose, however, taxable years of new target are not taken into account in applying the limitations in section 172(b)(1) or 1212(a)(1)(B) (or other similar limitations). In applying sections 172(b) and 1212(a)(1), only income, gain, loss, deduction, credit, and other amounts of old target are taken into account. Thus, if old target has an unexpired net operating loss at the close of its taxable year in which the deemed asset sale occurred that could be carried forward to a subsequent taxable year, such loss may be carried forward until it is absorbed by old target's income.

(B) Loss carrybacks to taxable years of old target. An ordinary loss or capital loss accounted for as a separate item of old target under paragraph (c)(2)(i) of this section may be carried back to a taxable year of old target under the principles of section 172 or 1212, as applicable. For this purpose, taxable years of new target are not taken into account in applying the limitations in section 172(b) or 1212(a) (or other similar limitations).

(C) Credit carryovers and carrybacks. The principles described in paragraphs (c)(2)(ii)(A) and (B) of this section apply to carryovers and carrybacks of amounts for purposes of determining

the amount of a credit allowable under part IV, subchapter A, chapter 1 of the Internal Revenue Code. Thus, for example, credit carryovers of old target may offset only income tax attributable to items described in paragraph (c)(2)(i) of this section.

(3) Procedure for transactions in which section 338(h)(10) is elected. If an election under section 338(h)(10) is made, any changes in the deemed sale tax consequences caused by an increase or decrease in the ADSP are accounted for in determining the taxable income (or other amount) of the member of the selling consolidated group, the selling affiliate, or the S corporation shareholders to which such income, loss, or other amount is attributable for the taxable year in which such increase or decrease is taken into account.

(d) Special rules for AGUB—(1) Effect of disposition or depreciation of acquisition date assets. If an acquisition date asset has been disposed of, depreciated, amortized, or depleted by new target before an amount is added to the original allocation to the asset, the increased amount otherwise allocable to such asset is taken into account under general principles of tax law that apply when part of the cost of an asset not previously taken into account in basis is paid or incurred after the asset has been disposed of, depreciated, amortized, or depleted. A similar rule applies when an amount is subtracted from the original allocation to the asset. For purposes of the preceding sentence, an asset is considered to have been disposed of to the extent that its allocable portion of the decrease in AGUB would reduce its basis below zero.

(2) Section 38 property. Section 1.47–2(c) applies to a reduction in basis of

section 38 property under this section.

(e) Examples. The following examples illustrate this section. Any amount described in the following examples is exclusive of interest. For rules characterizing deferred contingent payments as principal or interest, see §§ 1.483–4, 1.1274–2(g), and 1.1275–4(c). The examples are as follows:

Example 1. (i)(A) T’s assets other than goodwill and going concern value, and their fair market values at the beginning of the day after the acquisition date, are as follows:

Asset class	Asset	Fair market value
V	Building	\$ 100
V	Stock of X (not a target)	200
Total		300

(B) T has no liabilities other than a contingent liability that would not be taken into account under general principles of tax law in an asset sale between unrelated parties when the buyer assumed the liability or took property subject to it.

(ii)(A) On September 1, 2000, P purchases all of the outstanding stock of T for \$270 and makes a section 338 election for T. The grossed-up basis of the T stock and T’s AGUB are both \$270. The AGUB is ratably allocated among T’s Class V assets in proportion to their fair market values as follows:

Asset Basis	Building ($\$270 \times 100/300$)	\$90
	Stock ($\$270 \times 200/300$)	180
Total		270

(B) No amount is allocated to the Class VII assets. New T is a calendar year taxpayer. Assume that the X stock is a capital asset in the hands of new T.

(iii) On January 1, 2001, new T sells the X stock and uses the proceeds to purchase inventory.

(iv) Pursuant to events on June 30, 2002,

the contingent liability of old T is at that time properly taken into account under general principles of tax law. The amount of the liability is \$60.

(v) T's AGUB increases by \$60 from \$270 to \$330. This \$60 increase in AGUB is first allocated among T's acquisition date assets in accordance with the provisions of § 1.338-6. Because the redetermined AGUB for T (\$330) exceeds the sum of the fair market values at the beginning of the day after the acquisition date of the Class V acquisition date assets (\$300), AGUB allocated to those assets is limited to those fair market values under § 1.338-6(c)(1). As there are no Class VI assets, the remaining AGUB of \$30 is allocated to goodwill and going concern value (Class VII assets). The amount of increase in AGUB allocated to each acquisition date asset is determined as follows:

Asset	Original AGUB	Redet AGUB	Increase
Building	\$90	\$100	\$10
X Stock	180	200	20
Goodwill going concern.....	0	30	30
Total	270	330	60

(vi) Since the X stock was disposed of before the contingent liability was properly taken into account for tax purposes, no amount of the increase in AGUB attributable to such stock may be allocated to any T asset. Rather, such amount (\$20) is allowed as a capital loss to T for the taxable year 2002 under the principles of *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952). In addition, the \$10 increase in AGUB allocated to the building and the \$30 increase in AGUB allocated to the goodwill and going concern value are treated as basis redeterminations in 2002. See paragraph (d)(1) of this section.

Example 2. (i) On January 1, 2002, P purchases all of the outstanding stock of T and makes a section 338 election for T. Assume that ADSP and AGUB of T are both \$500 and are allocated among T's acquisition date assets as follows:

Asset Class	Asset Basis
VMachinery	\$150
VLand	250
VIIGoodwill and going concern value	100
Total	500

(ii) On September 30, 2004, P filed a claim against the selling shareholders of T in a court of appropriate jurisdiction alleging fraud in the sale of the T stock.

(iii) On January 1, 2007, the former shareholders refund \$140 of the purchase price to P in a settlement of the lawsuit. Assume that, under general principles of tax law, both the seller and the buyer properly take into account such refund when paid. Assume also that the refund has no effect on the tax liability for the deemed sale tax consequences. This refund results in a decrease of T's ADSP and AGUB of \$140, from \$500 to \$360.

(iv) The redetermined ADSP and AGUB of \$360 is allocated among T's acquisition date assets. Because ADSP and AGUB do not exceed the fair market value of the Class V assets, the ADSP and AGUB amounts are allocated to the Class V assets in proportion to their fair market values at the beginning of the day after the acquisition date. Thus, \$135 ($\$150 \times (\$360/(\$150 + \$250))$) is allocated to the machinery and \$225 ($\$250 \times (\$360/(\$150 + \$250))$) is allocated to the land. Accordingly, the basis of the machinery is reduced by \$15 (\$150 original allocation—\$135 redetermined allocation) and the basis of the land is reduced by \$25 (\$250 original allocation—\$225 redetermined allocation). No amount is allocated to the Class VII assets. Accordingly, the basis of the goodwill and going concern value is reduced by \$100 (\$100 original allocation—\$0 redetermined allocation).

(v) Assume that, as a result of deductions under section 168, the adjusted basis of the machinery immediately before the decrease in AGUB is zero. The machinery is treated as

if it were disposed of before the decrease is taken into account. In 2007, T recognizes income of \$15, the character of which is determined under the principles of *Arrowsmith v. Commissioner* and the tax benefit rule. No adjustment to the basis of T's assets is made for any tax paid on this amount. Assume also that, as a result of amortization deductions, the adjusted basis of the goodwill and going concern value immediately before the decrease in AGUB is \$40. A similar adjustment to income is made in 2007 with respect to the \$60 of previously amortized goodwill and going concern value.

(vi) In summary, the basis of T's acquisition date assets, as of January 1, 2007, is as follows:

Asset Basis	
Machinery	\$0
Land	225
Goodwill and going concern value	0

Example 3. (i) Assume that the facts are the same as § 1.338-6(d) Example 2 except that the recently purchased stock is acquired for \$1,600 plus additional payments that are contingent upon T's future earnings. Assume that, under general principles of tax law, such later payments are properly taken into account when paid. Thus, T's AGUB, determined as of the beginning of the day after the acquisition date (after reduction by T's cash of \$200), is \$2,500 and is allocated among T's acquisition date assets under § 1.338-6(c)(3)(iii) as follows:

Class Asset Final allocation	
I Cash	\$200
II Portfolio of traded securities.	*268
III Accounts receivable	536
IV Inventory	268
V Building	714
V Land	178
V Investment in T1	402
VII Goodwill and going concern value	134
Total	2,700

* All numbers rounded for convenience.

(ii) At a later point in time, P pays an additional \$200 for its recently purchased T stock. Assume that the additional consideration paid would not increase T's tax liability for the deemed sale tax consequences.

(iii) T's AGUB increases by \$200, from \$2,700 to \$2,900. This \$200 increase in AGUB is accounted for in accordance with the provisions of § 1.338-6(c)(3)(iii).

(iv) The hypothetical purchase price of the T stock is redetermined as follows:

Grossed-up basis of recently purchased stock as determined under § 1.338-5(c) $(\$1,800 \times (1 - .2)/.8)$ \$1,800

Basis of nonrecently purchased stock as if the gain recognition election under § 1.338-5(d)(2) had been made $(\$1,800 \times .2/(1 - .2))$ 450
 Liabilities..... 1,000
 Total 3,250

(v) Since the redetermined hypothetical purchase price (\$3,250) exceeds the redetermined AGUB (\$2,900) and no gain recognition election was made under section 338(b)(3), the rules of § 1.338-6(c)(3)(iii) are reapplied using the redetermined hypothetical purchase price and the redetermined AGUB.

(vi) First, an AGUB amount equal to the redetermined hypothetical purchase price (\$3,250) is allocated among the assets under the general rules of § 1.338-6. The allocation is set forth in the column below entitled Hypothetical Allocation. Next, the allocation to each asset in Class II through Class VII is multiplied by a fraction with a numerator equal to the actual redetermined AGUB reduced by the amount of Class I assets (\$2,900 - \$200 = \$2,700) and a denominator equal to the redetermined hypothetical purchase price reduced by the amount of Class I assets $(\$3,250 - \$200 = \$3,050)$, or $2,700/3,050$. This produces the Final Allocation:

Class Asset Hypothet allocation	Final allocation
I Cash	\$200 \$200

II .. Portfolio of traded securities.	300	*266
III Accounts receivable ...	600	531
IV Inventory	300	266
V Building	800	708
V Land	200	177
V Investment in T1	450	398
VII Goodwill and going concern	400	354
Total	3,250	2900

* All numbers rounded for convenience.

(vii) As illustrated by this example, reapplying § 1.338–6(c)(3) results in a basis increase for some assets and a basis decrease for other assets. The amount of redetermined AGUB allocated to each acquisition date asset is determined as follows:

Asset Original (c)(3) allo Redeterm (c)(3) allo

Increase (decrease) Portfolio of actively traded securities	\$268	\$266	\$(2)
Accounts receivable	536	531	(5)
Inventory	268	266	(2)
Building	714	708	(6)
Land	178	177	(1)
Investment in T1	402	398	(4)
Goodwill and going concern	134	354	220
Total	2,500	2,700	200

Example 4. (i) On January 1, 2001, P purchases all of the outstanding T stock and makes a section 338 election for T. P pays \$700 of cash and promises also to pay a maximum \$300 of contingent consideration at various times in the future. Assume that, under general principles of tax law, such later payments are properly taken into account by P when paid. Assume also, however, that the current fair market value of the contingent payments is reasonably ascertainable. The fair market value of T's assets (other than goodwill and going concern value) as of the beginning of the following day is as follows:

Asset class	Assets	Fair market value
V	Equipment	\$200
V	Non-actively traded secur.....	100

V	Building	500
Total		800

(ii) T has no liabilities. The AGUB is \$700. In calculating ADSP, assume that, under § 1.1001–1, the current amount realized attributable to the contingent consideration is \$200. ADSP is therefore \$900 (\$700 cash plus \$200).

(iii) (A) The AGUB of \$700 is ratably allocated among T's Class V acquisition date assets in proportion to their fair market values as follows:

Asset Basis	
Equipment (\$700 × 200/800)	\$175.00
Non-active traded secur (\$700 × 100/800)	87.50
Building (\$700 × 500/800)	437.50
Total	700.00

(B) No amount is allocated to goodwill or going concern value.

(iv) (A) The ADSP of \$900 is ratably allocated among T's Class V acquisition date assets in proportion to their fair market values as follows:

Asset Basis	
Equipment	\$200
Non-actively traded securities	100
Building	500
Total	800

(B) The remaining ADSP, \$100, is allocated to goodwill and going concern value (Class VII).

(v) P and T file a consolidated return for 2001 and each following year with P as the common parent of the affiliated group.

(vi) In 2004, a contingent amount of \$120 is paid by P. For old T, this payment has no effect on ADSP, because the payment is accounted for as a separate transaction. We have assumed that, under general principles of tax law, the

payment is properly taken into account by P at the time made. Therefore, in 2004, there is an increase in new T's AGUB of \$120. The amount of the increase allocated to each acquisition date asset is determined as follows:

Asset Original AGUB Redeterm AGUB			
Increase	\$175.00	\$200.00	\$25.00

Asset Original AGUB Redeterm AGUB Increase			
Land	87.50	100.00	12.50
Building	437.50	500.00	62.50
Goodwill and going concern ...	0.00	20.00	20.00
Total	700.00	820.00	120.00

[T.D. 8940, 66 FR 9929, Feb. 13, 2001]

§ 1.338-8 Asset and stock consistency.

(a) Introduction—(1) Overview. This section implements the consistency rules of sections 338(e) and (f). Under this section, no election under section 338 is deemed made or required with respect to target or any target affiliate. Instead, the person acquiring an asset may have a carryover basis in the asset.

(2) General application. The consistency rules generally apply if the purchasing corporation acquires an asset directly from target during the target consistency period and target is a subsidiary in a consolidated group. In such a case, gain from the sale of the asset is reflected under the investment adjustment provisions of the consolidated return regulations in the basis of target stock and may reduce gain from the sale of the stock. See § 1.1502-32 (investment adjustment provisions). Under the consistency rules, the purchasing corporation generally takes a carryover basis in the asset, unless a section 338 election is made for target. Similar rules apply if the purchasing corporation acquires an asset directly

from a lower-tier target affiliate if gain from the sale is reflected under the investment adjustment provisions in the basis of target stock.

(3) Extensions of the general rules. If an arrangement exists, paragraph (f) of this section generally extends the carryover basis rule to certain cases in which the purchasing corporation acquires assets indirectly from target (or a lower-tier target affiliate). To prevent avoidance of the consistency rules, paragraph (j) of this section also may extend the consistency period or the 12-month acquisition period and may disregard the presence of conduits.

(4) Application where certain dividends are paid. Paragraph (g) of this section extends the carryover basis rule to certain cases in which dividends are paid to a corporation that is not a member of the same consolidated group as the distributing corporation. Generally, this rule applies where a 100 percent dividends received deduction is used in conjunction with asset dispositions to achieve an effect similar to that available under the investment adjustment provisions of the consolidated return regulations.

(5) Application to foreign target affiliates. Paragraph (h) of this section extends the carryover basis rule to certain cases involving target affiliates that are controlled foreign corporations.

(6) Stock consistency. This section limits the application of the stock consistency rules to cases in which the rules are necessary to prevent avoidance of the asset consistency rules. Following the general treatment of a section 338(h)(10) election, a sale of a corporation's stock is treated as a sale of the corporation's assets if a section

338(h)(10) election is made. Because gain from this asset sale may be reflected in the basis of the stock of a higher-tier target, the carryover basis rule may apply to the assets.

(b) Consistency for direct acquisitions—

(1) General rule. The basis rules of paragraph (d) of this section apply to an asset if—

(i) The asset is disposed of during the target consistency period;

(ii) The basis of target stock, as of the target acquisition date, reflects gain from the disposition of the asset (see paragraph (c) of this section); and

(iii) The asset is owned, immediately after its acquisition and on the target acquisition date, by a corporation that acquires stock of target in the qualified stock purchase (or by an affiliate of an acquiring corporation).

(2) Section 338(h)(10) elections. For purposes of this section, if a section 338(h)(10) election is made for a corporation acquired in a qualified stock purchase—

(i) The acquisition is treated as an acquisition of the corporation's assets (see § 1.338(h)(10)–1); and

(ii) The corporation is not treated as target.

(c) Gain from disposition reflected in basis of target stock. For purposes of this section:

(1) General rule. Gain from the disposition of an asset is reflected in the basis of a corporation's stock if the gain is taken into account under

§ 1.1502–32, directly or indirectly, in determining the basis of the stock, after applying section 1503(e) and other provisions of the Internal Revenue Code.

(2) Gain not reflected if section 338 election made for target. Gain from the disposition of an asset that is otherwise reflected in the basis of target stock as of the target acquisition date is not considered reflected in the basis of target stock if a section 338 election is made for target.

(3) Gain reflected by reason of distributions. Gain from the disposition of an asset is not considered reflected in the basis of target stock merely by reason of the receipt of a distribution from a target affiliate that is not a member of the same consolidated group as the distributee. See paragraph (g) of this section for the treatment of dividends eligible for a 100 percent dividends received deduction.

(4) Controlled foreign corporations. For a limitation applicable to gain of a target affiliate that is a controlled foreign corporation, see paragraph (h)(2) of this section.

(5) Gain recognized outside the consolidated group. Gain from the disposition of an asset by a person other than target or a target affiliate is not reflected in the basis of a corporation's stock unless the person is a conduit, as defined in paragraph (j)(4) of this section.

(d) Basis of acquired assets—(1) Carryover basis rule. If this paragraph (d) applies to an asset, the asset's basis immediately after its acquisition is, for all purposes of the Internal Revenue Code, its adjusted basis immediately before its disposition.

(2) Exceptions to carryover basis rule for

certain assets. The carryover basis rule of paragraph (d)(1) of this section does not apply to the following assets—

(i) Any asset disposed of in the ordinary course of a trade or business (see section 338(e)(2)(A));

(ii) Any asset the basis of which is determined wholly by reference to the adjusted basis of the asset in the hands of the person that disposed of the asset (see section 338(e)(2)(B));

(iii) Any debt or equity instrument issued by target or a target affiliate (see paragraph (h)(3) of this section for an exception relating to the stock of a target affiliate that is a controlled foreign corporation);

(iv) Any asset the basis of which immediately after its acquisition would otherwise be less than its adjusted basis immediately before its disposition; and

(v) Any asset identified by the Internal Revenue Service in a revenue ruling or revenue procedure.

(3) Exception to carryover basis rule for de minimis assets. The carryover basis rules of this section do not apply to an asset if the asset is not disposed of as part of the same arrangement as the acquisition of target and the aggregate amount realized for all assets otherwise subject to the carryover basis rules of this section does not exceed \$250,000.

(4) Mitigation rule—(i) General rule. If the carryover basis rules of this section apply to an asset and the asset is transferred to a domestic corporation in a transaction to which section 351 applies or as a contribution to capital

and no gain is recognized, the transferor's basis in the stock of the transferee (but not the transferee's basis in the asset) is determined without taking into account the carryover basis rules of this section.

(ii) Time for transfer. This paragraph (d)(4) applies only if the asset is transferred before the due date (including extensions) for the transferor's income tax return for the year that includes the last date for which a section 338 election may be made for target.

(e) Examples—(1) In general. For purposes of the examples in this section, unless otherwise stated, the basis of each asset is the same for determining earnings and profits and taxable income, the exceptions to paragraph (d)(1) of this section do not apply, the taxable year of all persons is the calendar year, and the following facts apply: S is the common parent of a consolidated group that includes T, T1, T2, and T3; S owns all of the stock of T and T3; and T owns all of the stock of T1, which owns all of the stock of T2. B is unrelated to the S group and owns all of the stock of P, which owns all of the stock of P1. Y and Y1 are partnerships that are unrelated to the S group but may be related to the P group. Z is a corporation that is not related to any of the other parties.

(2) Direct acquisitions. Paragraphs (b), (c), and (d) of this section may be illustrated by the following examples:

Example 1. Asset acquired from target by purchasing corporation. (a) On February 1 of Year 1, T sells an asset to P1 and recognizes gain. T's gain from the disposition of the asset is taken into account under § 1.1502-32 in determining S's basis in the T stock. On January 1 of Year 2, P1 makes a qualified stock purchase of T from S. No section 338 election is made for T.

(b) T disposed of the asset during its consistency period, gain from the asset disposition is reflected in the basis of the T stock as of T's acquisition date (January 1 of Year 2), and the asset is owned both immediately after the asset disposition (February 1 of Year 1) and on T's acquisition date by P1, the corporation that acquired T stock in the qualified stock purchase. Consequently, under paragraph (b) of this section, paragraph (d)(1) of this section applies to the asset and P1's basis in the asset is T's adjusted basis in the asset immediately before the sale to P1.

Example 2. Gain from section 338(h)(10) election reflected in stock basis. (a) On February 1 of Year 1, P1 makes a qualified stock purchase of T2 from T1. A section 338(h)(10) election is made for T2 and T2 recognizes gain on each of its assets. T2's gain is taken into account under § 1.1502-32 in determining S's basis in the T stock. On January 1 of Year 2, P1 makes a qualified stock purchase of T from S. No section 338 election is made for T.

(b) Under paragraph (b)(2) of this section, the acquisition of the T2 stock is treated as an acquisition of T2's assets on February 1 of Year 1, because a section 338(h)(10) election is made for T2. The gain recognized by T2 under section 338(h)(10) is reflected in S's basis in the T stock as of T's acquisition date. Because the other requirements of paragraph (b) of this section are satisfied, paragraph (d)(1) of this section applies to the assets and new T2's basis in its assets is old T2's adjusted basis in the assets immediately before the disposition.

Example 3. Corporation owning asset ceases affiliation with corporation purchasing target before target acquisition date. (a) On February 1 of Year 1, T sells an asset to P1 and recognizes gain. On December 1 of Year 1, P disposes of all of the P1 stock while P1 still owns the asset. On January 1 of Year 2, P

makes a qualified stock purchase of T from S. No section 338 election is made for T.

(b) Immediately after T's disposition of the asset, the asset is owned by P1 which is affiliated on that date with P, the corporation that acquired T stock in the qualified stock purchase. However, the asset is owned by a corporation (P1) that is no longer affiliated with P on T's acquisition date. Although the other requirements of paragraph (b) of this section are satisfied, the requirements of paragraph (b)(1)(iii) of this section are not satisfied. Consequently, the basis rules of paragraph (d) of this section do not apply to the asset by reason of P1's acquisition.

(c) If P acquires all of the Z stock and P1 transfers the asset to Z on or before T's acquisition date (January 1 of Year 2), the asset is owned by an affiliate of P both on February 1 of Year 1 (P1) and on January 1 of Year 2 (Z). Consequently, all of the requirements of paragraph (b) of this section are satisfied and paragraph (d)(1) of this section applies to the asset and P1's basis in the asset is T's adjusted basis in the asset immediately before the sale to P1.

Example 4. Gain reflected in stock basis notwithstanding offsetting loss or distribution.

(a) On April 1 of Year 1, T sells an asset to P1 and recognizes gain. In Year 1, T distributes an amount equal to the gain. On March 1 of Year 2, P makes a qualified stock purchase of T from S. No section 338 election is made for T.

(b) Although, as a result of the distribution, there is no adjustment with respect to the T stock under § 1.1502-32 for Year 1, T's gain from the disposition of the asset is considered reflected in S's basis in the T stock. The gain is considered to have been taken into account under § 1.1502-32 in determining the adjustments to S's basis in the T stock because S's basis in the T stock is different from what it would have been had there been no gain.

(c) If T distributes an amount equal to the gain on February 1 of Year 2, rather than in Year 1, the results would be the same because S's basis in the T stock is different from what it would have been had there been no gain. If the distribution in Year 2 is by reason of an election under § 1.1502-32(f)(2), the results would be the same.

(d) If, in Year 1, T does not make a distribution and the S group does not file a consolidated return, but, in Year 2, the S group does file a consolidated return and makes an election under § 1.1502-32(f)(2) for T, the results would be the same. S's basis in the T stock is different from what it would have been had there been no gain. Paragraph (c)(3) of this section (gain not considered reflected by reason of distributions) does not apply to the deemed distribution under the election because S and T are members of the same consolidated group. If T distributes an amount equal to the gain in Year 2 and no election is made under § 1.1502-32(f)(2), the results would be the same.

(e) If, in Year 1, T incurs an unrelated loss in an amount equal to the gain, rather than distributing an amount equal to the gain, the results would be the same because the gain is taken into account under § 1.1502-32 in determining S's basis in the T stock. Example 5. Gain of a target affiliate reflected in stock basis after corporate reorganization. (a) On February 1 of Year 1, T3 sells an asset to P1 and recognizes gain. On March 1 of Year 1, S contributes the T3 stock to T in a transaction qualifying under section 351. On January 15 of Year 2, P1 makes a qualified stock purchase of T from S. No section 338 election is made for T.

(b) T3's gain from the asset sale is taken into account under § 1.1502-32 in determining S's basis in the T3 stock. Under section 358, the gain that is taken into account under § 1.1502-32 in determining S's basis in the T3 stock is also taken into account in determining

S's basis in the T stock following S's contribution of the T3 stock to T. Consequently, under paragraph (b) of this section, paragraph (d)(1) of this section applies to the asset and P1's basis in the asset is T3's adjusted basis in the asset immediately before the sale to P1.

(c) If on March 1 of Year 1, rather than S contributing the T3 stock to T, S causes T3 to merge into T in a transaction qualifying under section 368(a)(1)(D), the results would be the same.

Example 6. Gain not reflected if election under section 338 made. (a) On February 1 of Year 1, T1 sells an asset to P1 and recognizes gain. On January 1 of Year 2, P1 makes a qualified stock purchase of T1 from T. A section 338 election (but not a section 338(h)(10) election) is made for T1.

(b) Under paragraph (c)(2) of this section, because a section 338 election is made for T1, T's basis in the T1 stock is considered not to reflect gain from the disposition. Consequently, the requirement of paragraph (b)(1)(ii) of this section is not satisfied. Thus, P1's basis in the asset is not determined under paragraph (d) of this section. Although the section 338 election for T1 results in a qualified stock purchase of T2, the requirement of paragraph (b)(1)(ii) of this section is not satisfied with respect to T2, whether or not a section 338 election is made for T2.

(c) If, on January 1 of Year 2, P1 makes a qualified stock purchase of T from S and a section 338 election for T, rather than T1, S's basis in the T stock is considered not to reflect gain from T1's disposition of the asset. However, the section 338 election for T results in a qualified stock purchase of T1. Because the gain is reflected in T's basis in the T1 stock, the requirements of paragraph (b) of this section are satisfied. Consequently, P1's basis in the asset is determined under paragraph (d)(1) of this section unless a section 338 election is also made for T1.

(f) Extension of consistency to indirect acquisitions—(1) Introduction. If an arrangement exists (see paragraph (j)(5) of this section), this paragraph (f) generally extends the consistency rules to indirect acquisitions that have the same effect as direct acquisitions. For example, this paragraph (f) applies if, pursuant to an arrangement, target sells an asset to an unrelated person who then sells the asset to the purchasing corporation.

(2) General rule. This paragraph (f) applies to an asset if, pursuant to an arrangement—

(i) The asset is disposed of during the target consistency period;

(ii) The basis of target stock as of, or at any time before, the target acquisition date reflects gain from the disposition of the asset; and

(iii) The asset ownership requirements of paragraph (b)(1)(iii) of this section are not satisfied, but the asset is owned, at any time during the portion of the target consistency period following the target acquisition date, by—

(A) A corporation—

(1) The basis of whose stock, as of, or at any time before, the target acquisition date, reflects gain from the disposition of the asset; and

(2) That is affiliated, at any time during the target consistency period, with a corporation that acquires stock of target in the qualified stock purchase; or

(B) A corporation that at the time it owns the asset is affiliated with a corporation

described in paragraph (f)(2)(iii)(A) of this section.

(3) Basis of acquired assets. If this paragraph (f) applies to an asset, the principles of the basis rules of paragraph (d) of this section apply to the asset as of the date, following the disposition with respect to which gain is reflected in the basis of target's stock, that the asset is first owned by a corporation described in paragraph (f)(2)(iii) of this section. If the principles of the carryover basis rule of paragraph (d)(1) of this section apply to an asset, the asset's basis also is reduced (but not below zero) by the amount of any reduction in its basis occurring after the disposition with respect to which gain is reflected in the basis of target's stock.

(4) Examples. This paragraph (f) may be illustrated by the following examples: Example 1. Acquisition of asset from unrelated party by purchasing corporation. (a) On February 1 of Year 1, T sells an asset to Z and recognizes gain. On February 15 of Year 1, P1 makes a qualified stock purchase of T from S. No section 338 election is made for T. P1 buys the asset from Z on March 1 of Year 1, before Z has reduced the basis of the asset through depreciation or otherwise.

(b) Paragraph (b) of this section does not apply to the asset because the asset ownership requirements of paragraph (b)(1)(iii) of this section are not satisfied. However, the asset ownership requirements of paragraph (f)(2)(iii) of this section are satisfied because, during the portion of T's consistency period following T's acquisition date, the asset is owned by P1 while it is affiliated with T. Consequently, paragraph (f) of this section applies to the asset if there is an arrangement for T to dispose of the asset during T's consistency period, for the gain to be reflected in S's basis in the T stock as of T's acquisition date, and for P1 to own the asset during the

portion of T's consistency period following T's acquisition date. If the arrangement exists, under paragraph (f)(3) of this section, P1's basis in the asset is determined as of March 1 of Year 1, under the principles of paragraph (d) of this section. Consequently, P1's basis in the asset is T's adjusted basis in the asset immediately before the sale to Z.

(c) If P1 acquires the asset from Z on January 15 of Year 2 (rather than on March 1 of Year 1), and Z's basis in the asset has been reduced through depreciation at the time of the acquisition, P1's basis in the asset as of January 15 of Year 2 would be T's adjusted basis in the asset immediately before the sale to Z, reduced (but not below zero) by the amount of the depreciation. Z's basis and depreciation are determined without taking into account the basis rules of paragraph (d) of this section.

(d) If P, rather than P1, acquires the asset from Z, the results would be the same.

(e) If, on March 1 of Year 1, P1 acquires the Z stock, rather than acquiring the asset from Z, paragraph (f) of this section would apply to the asset if an arrangement exists. However, under paragraph (f)(3) of this section, Z's basis in the asset would be determined as of February 1 of Year 1, the date the asset is first owned by a corporation (Z) described in paragraph (f)(2)(iii) of this section. Consequently, Z's basis in the asset as of February 1 of Year 1, determined under the principles of paragraph (d) of this section, would be T's adjusted basis in the asset immediately before the sale to Z.

Example 2. Acquisition of asset from target by target affiliate. (a) On February 1 of Year 1, T contributes an asset to T1 in a transaction qualifying under section 351 and in which T recognizes gain under section 351(b) that is deferred under § 1.1502-13. On March 1 of Year 1, P1 makes a qualified stock purchase of T from S and, pursuant to § 1.1502-13, the deferred gain is taken into account by T

immediately before T ceases to be a member of the S group. No section 338 election is made for T.

(b) Paragraph (b) of this section does not apply to the asset because the asset ownership requirements of paragraph (b)(1)(iii) of this section are not satisfied.

(c) T1 is not described in paragraph (f)(2)(iii)(A) of this section because the basis of the T1 stock does not reflect gain from the disposition of the asset. Although, under section 358(a)(1)(B)(ii), T's basis in the T1 stock is increased by the amount of the gain, the gain is not taken into account directly or indirectly under § 1.1502-32 in determining T's basis in the T1 stock.

(d) T1 is described in paragraph (f)(2)(iii)(B) of this section because, during the portion of T's consistency period following T's acquisition date, T1 owns the asset while it is affiliated with T, a corporation described in paragraph (f)(2)(iii)(A) of this section. Consequently, paragraph (f) of this section applies to the asset if there is an arrangement. Under paragraph (j)(5) of this section, the fact that, at the time T1 acquires the asset from T, T1 is related (within the meaning of section 267(b)) to T indicates that an arrangement exists.

Example 3. Acquisition of asset from target and indirect acquisition of target stock. (a) On February 1 of Year 1, T sells an asset to P1 and recognizes gain. On March 1 of Year 1, Z makes a qualified stock purchase of T from S. No section 338 election is made for T. On January 1 of Year 2, P1 acquires the T stock from Z other than in a qualified stock purchase. (b) The asset ownership requirements of paragraph (b)(1)(iii) of this section are not satisfied because the asset was never owned by Z, the corporation that acquired T stock in the qualified stock purchase (or by a corporation that was affiliated with Z at the time it owned the asset). However, because

the asset is owned by P1 while it is affiliated with T during the portion of T's consistency period following T's acquisition date, paragraph (f) of this section applies to the asset if there is an arrangement. If there is an arrangement, the principles of the carryover basis rule of paragraph (d)(1) of this section apply to determine P1's basis in the asset unless Z makes a section 338 election for T. See paragraph (c)(2) of this section.

(c) If P1 also makes a qualified stock purchase of T from Z, the results would be the same. If there is an arrangement, the principles of the carryover basis rule of paragraph (d)(1) of this section apply to determine P1's basis in the asset unless Z makes a section 338 election for T. However, these principles apply to determine P1's basis in the asset if P1, but not Z, makes a section 338 election for T. The basis of the T stock no longer reflects, as of T's acquisition date by P1, the gain from the disposition of the asset.

(d) Assume Z purchases the T stock other than in a qualified stock purchase and P1 makes a qualified stock purchase of T from Z. Paragraph (b) of this section does not apply to the asset because gain from the disposition of the asset is not reflected in the basis of T's stock as of T's acquisition date (January 1 of Year 2). However, because the gain is reflected in S's basis in the T stock before T's acquisition date and the asset is owned by P1 while it is affiliated with T during the portion of T's consistency period following T's acquisition date, paragraph (f) of this section applies to the asset if there is an arrangement. If there is an arrangement, the principles of the carryover basis rule of paragraph (d)(1) of this section apply to determine P1's basis in the asset even if P1 makes a section 338 election for T. The basis of the T stock no longer reflects, as of T's acquisition date, the gain from the disposition of the asset.

Example 4. Asset acquired from target affiliate by corporation that becomes its affiliate. (a) On February 1 of Year 1, T1 sells an asset to P1 and recognizes gain. On February 15 of Year 1, Z makes a qualified stock purchase of T from S. No section 338 election is made for T. On June 1 of Year 1, P1 acquires the T1 stock from T, other than in a qualified stock purchase. (b) The asset ownership requirements of paragraph (b)(1)(iii) of this section are not satisfied because the asset was never owned by Z, the corporation that acquired T stock in the qualified stock purchase (or by a corporation that was affiliated with Z at the time it owned the asset).

(c) P1 is not described in paragraph (f)(2)(iii)(A) of this section because gain from the disposition of the asset is not reflected in the basis of the P1 stock.

(d) P1 is described in paragraph (f)(2)(iii)(B) of this section because the asset is owned by P1 while P1 is affiliated with T1 during the portion of T's consistency period following T's acquisition date. T1 becomes affiliated with Z, the corporation that acquired T stock in the qualified stock purchase, during T's consistency period, and, as of T's acquisition date, the basis of T1's stock reflects gain from the disposition of the asset.

Consequently, paragraph (f) of this section applies to the asset if there is an arrangement.

Example 5. De minimis rules. (a) On February 1 of Year 1, T sells an asset to P and recognizes gain. On February 15 of Year 1, T1 sells an asset to Z and recognizes gain. The aggregate amount realized by T and T1 on their respective sales of assets is not more than \$250,000. On March 1 of Year 1, T3 sells an asset to P and recognizes gain. On April 1 of Year 1, P makes a qualified stock purchase of T from S. No section 338 election is made for T. On June 1 of Year 1, P1 buys from Z the asset sold by T1.

(b) Under paragraph (b) of this section, the basis rules of paragraph (d) of this section

apply to the asset sold by T. Under paragraph (f) of this section, the principles of the basis rules of paragraph (d) of this section apply to the asset sold by T1 if there is an arrangement. Because T3's gain is not reflected in the basis of the T stock, the basis rules of this section do not apply to the asset sold by T3.

(c) The de minimis rule of paragraph (d)(3) of this section applies to an asset if the asset is not disposed of as part of the same arrangement as the acquisition of T and the aggregate amount realized for all assets otherwise subject to the carryover basis rules does not exceed \$250,000. The aggregate amount realized by T and T1 does not exceed \$250,000. (The asset sold by T3 is not taken into account for purposes of the de minimis rule.) Thus, the de minimis rule applies to the asset sold by T if the asset is not disposed of as part of the same arrangement as the acquisition of T.

(d) If, under paragraph (f) of this section, the principles of the carryover basis rules of paragraph (d)(1) of this section otherwise apply to the asset sold by T1 because of an arrangement, the de minimis rules of this section do not apply to the asset because of the arrangement.

(e) Assume on June 1 of Year 1, Z acquires the T1 stock from T, other than in a qualified stock purchase, rather than P1 buying the T1 asset, and paragraph (f) of this section applies because there is an arrangement. Because the asset was disposed of and the T1 stock was acquired as part of the arrangement, the de minimis rules of this section do not apply to the asset.

(g) Extension of consistency if dividends qualifying for 100 percent dividends received deduction are paid—(1) General rule for direct acquisitions from target. Unless a section 338 election is made for target, the basis rules of paragraph

(d) of this section apply to an asset if—

(i) Target recognizes gain (whether or not deferred) on disposition of the asset during the portion of the target consistency period that ends on the target acquisition date;

(ii) The asset is owned, immediately after the asset disposition and on the target acquisition date, by a corporation that acquires stock of target in the qualified stock purchase (or by an affiliate of an acquiring corporation); and

(iii) During the portion of the target consistency period that ends on the target acquisition date, the aggregate amount of dividends paid by target, to which section 243(a)(3) applies, exceeds the greater of—

(A) \$250,000; or

(B) 125 percent of the yearly average amount of dividends paid by target, to which section 243(a)(3) applies, during the three calendar years immediately preceding the year in which the target consistency period begins (or, if shorter, the period target was in existence).

(2) Other direct acquisitions having same effect. The basis rules of paragraph

(d) of this section also apply to an asset if the effect of a transaction described in paragraph (g)(1) of this section is achieved through any combination of disposition of assets and payment of dividends to which section 243(a)(3) applies (or any other dividends eligible for a 100 percent dividends received deduction). See paragraph (h)(4) of this section for additional rules relating to target affiliates that are controlled foreign corporations.

(3) Indirect acquisitions. The principles of paragraph (f) of this section also apply for purposes of this paragraph (g).

(4) Examples. This paragraph (g) may be illustrated by the following examples:

Example 1. Asset acquired from target paying dividends to which section 243(a)(3) applies. (a) The S group does not file a consolidated return. In Year 1, Year 2, and Year 3, T pays dividends to S to which section 243(a)(3) applies of \$200,000, \$250,000, and \$300,000, respectively. On February 1 of Year 4, T sells an asset to P and recognizes gain. On January 1 of Year 5, P makes a qualified stock purchase of T from S. No section 338 election is made for T. During the portion of T's consistency period that ends on T's acquisition date, T pays S dividends to which section 243(a)(3) applies of \$1,000,000.

(b) Under paragraph (g)(1) of this section, paragraph (d) of this section applies to the asset. T recognizes gain on disposition of the asset during the portion of T's consistency period that ends on T's acquisition date, the asset is owned by P immediately after the disposition and on T's acquisition date, and T pays dividends described in paragraph (g)(1)(iii) of this section. Consequently, under paragraph (d)(1) of this section, P's basis in the asset is T's adjusted basis in the asset immediately before the sale to P.

(c) If T is a controlled foreign corporation, the results would be the same if T pays dividends in the amount described in paragraph (g)(1)(iii) of this section that qualify for a 100 percent dividends received deduction. See sections 243(e) and 245.

(d) If S and T3 file a consolidated return in which T, T1, and T2 do not join, the results would be the same because the dividends paid by T are still described in paragraph (g)(1)(iii) of this section.

(e) If T, T1, and T2 file a consolidated return in which S and T3 do not join, the results would be the same because the dividends paid by T are still described in paragraph (g)(1)(iii) of this section.

Example 2. Asset disposition by target affiliate achieving same effect. (a) The S group does not file a consolidated return. On February 1 of Year 1, T2 sells an asset to P and recognizes gain. T pays dividends to S described in paragraph (g)(1)(iii) of this section. On January 1 of Year 2, P makes a qualified stock purchase of T from S. No section 338 election is made for T.

(b) Paragraph (g)(1) of this section does not apply to the asset because T did not recognize gain on the disposition of the asset. However, under paragraph (g)(2) of this section, because the asset disposition by T2 and the dividends paid by T achieve the effect of a transaction described in paragraph (g)(1) of this section, the carryover basis rule of paragraph (d)(1) of this section applies to the asset. The effect was achieved because T2 is a lower-tier affiliate of T and the dividends paid by T to S reduce the value to S of T and its lower-tier affiliates.

(c) If T2 is a controlled foreign corporation, the results would be the same because T2 is a lower-tier affiliate of T and the dividends paid by T to S reduce the value to S of T and its lower-tier affiliates.

(d) If P buys an asset from T3, rather than T2, the asset disposition and the dividends do not achieve the effect of a transaction described in paragraph (g)(1) of this section because T3 is not a lower-tier affiliate of T. Thus, the basis rules of paragraph (d) of this section do not apply to the asset. The results would be the same whether or not P also acquires the T3 stock (whether or not in a qualified stock purchase).

Example 3. Dividends by target affiliate

achieving same effect. (a) The S group does not file a consolidated return. On February 1 of Year 1, T1 sells an asset to P and recognizes gain. On January 1 of Year 2, P makes a qualified stock purchase of T from S. No section 338 election is made for T. T does not pay dividends to S described in paragraph (g)(1)(iii) of this section. However, T1 pays dividends to T that would be described in paragraph (g)(1)(iii) of this section if T1 were a target.

(b) Paragraph (g)(1) of this section does not apply to the asset because T did not recognize gain on the disposition of the asset and did not pay dividends described in paragraph (g)(1)(iii) of this section. Further, paragraph (g)(2) of this section does not apply because the dividends paid by T1 to T do not reduce the value to S of T and its lower-tier affiliates.

(c) If both S and T own T1 stock and T1 pays dividends to S that would be described in paragraph (g)(1)(iii) of this section if T1 were a target, paragraph (g)(2) of this section would apply because the dividends paid by T1 to S reduce the value to S of T and its lower-tier affiliates. If T, rather than T1, sold the asset to P, the results would be the same. Further, if T and T1 pay dividends to S that, only when aggregated, would be described in paragraph (g)(1)(iii) of this section (if they were all paid by T), the results would be the same.

Example 4. Gain reflected by reason of dividends.

(a) S and T file a consolidated return in which T1 and T2 do not join. On February 1 of Year 1, T1 sells an asset to P and recognizes gain. On January 1 of Year 2, P makes a qualified stock purchase of T from S. No section 338 election is made for T. T1 pays dividends to T that would be described in paragraph (g)(1)(iii) of this section if T1 were a target.

(b) The requirements of paragraph (b) of this section are not satisfied because, under paragraph (c)(3) of this section, gain from T1's sale is not reflected in S's basis in the T stock by reason of the dividends paid by T1 to T.

(c) Although the dividends paid by T1 to T do not reduce the value to S of T and its lower-tier affiliates, paragraph (g)(2) of this section applies because the dividends paid by T1 to T are taken into account under § 1.1502-32 in determining S's basis in the T stock. Consequently, the carryover basis rule of paragraph (d)(1) of this section applies to the asset.

(h) Consistency for target affiliates that are controlled foreign corporations—(1) In general. This paragraph (h) applies only if target is a domestic corporation. For additional rules that may apply with respect to controlled foreign corporations, see paragraph (g) of this section. The definitions and nomenclature of § 1.338-2(b) and (c) and paragraph (e) of this section apply for purposes of this section.

(2) Income or gain resulting from asset dispositions—(i) General rule. Income or gain of a target affiliate that is a controlled foreign corporation from the disposition of an asset is not reflected in the basis of target stock under paragraph (c) of this section unless the income or gain results in an inclusion under section 951(a)(1)(A), 951(a)(1)(C), 1291 or 1293.

(ii) Basis of controlled foreign corporation stock. If, by reason of paragraph (h)(2)(i) of this section, the carryover basis rules of this section apply to an asset, no increase in basis in the stock of a controlled foreign corporation under section 961(a) or 1293(d)(1), or under regulations issued pursuant to

section 1297(b)(5), is allowed to target or a target affiliate to the extent the increase is attributable to income or gain described in paragraph (h)(2)(i) of this section. A similar rule applies to the basis of any property by reason of which the stock of the controlled foreign corporation is considered owned under section 958(a)(2) or 1297(a).

(iii) Operating rule. For purposes of this paragraph (h)(2)—

(A) If there is an income inclusion under section 951 (a)(1)(A) or (C), the shareholder's income inclusion is first attributed to the income or gain of the controlled foreign corporation from the disposition of the asset to the extent of the shareholder's pro rata share of such income or gain; and

(B) Any income or gain under section 1293 is first attributed to the income or gain from the disposition of the asset to the extent of the shareholder's pro rata share of the income or gain.

(iv) Increase in asset or stock basis—(A) If the carryover basis rules under paragraph (h)(2)(i) of this section apply to an asset, and the purchasing corporation disposes of the asset to an unrelated party in a taxable transaction and recognizes and includes in its U.S. gross income or the U.S. gross income of its shareholders the greater of the income or gain from the disposition of the asset by the selling controlled foreign corporation that was reflected in the basis of the target stock under paragraph (c) of this section, or the gain recognized on the asset by the purchasing corporation on the disposition of the asset, then the purchasing corporation or the target or a target affiliate, as appropriate, shall increase the basis of the selling controlled foreign

corporation stock subject to paragraph (h)(2)(ii) of this section, as of the date of the disposition of the asset by the purchasing corporation, by the amount of the basis increase that was denied under paragraph (h)(2)(ii) of this section. The preceding sentence shall apply only to the extent that the controlled foreign corporation stock is owned (within the meaning of section 958(a)) by a member of the purchasing corporation's affiliated group.

(B) If the carryover basis rules under paragraph (h)(2)(i) of this section apply to an asset, and the purchasing corporation or the target or a target affiliate, as appropriate, disposes of the stock of the selling controlled foreign corporation to an unrelated party in a taxable transaction and recognizes and includes in its U.S. gross income or the U.S. gross income of its shareholders the greater of the gain equal to the basis increase that was denied under paragraph (h)(2)(ii) of this section, or the gain recognized in the stock by the purchasing corporation or by the target or a target affiliate, as appropriate, on the disposition of the stock, then the purchasing corporation shall increase the basis of the asset, as of the date of the disposition of the stock of the selling controlled foreign corporation by the purchasing corporation or by the target or a target affiliate, as appropriate, by the amount of the basis increase that was denied pursuant to paragraph (h)(2)(i) of this section. The preceding sentence shall apply only to the extent that the asset is owned (within the meaning of section 958(a)) by a member of the purchasing corporation's affiliated group.

(3) Stock issued by target affiliate that is a controlled foreign corporation. The exception to the carryover basis rules of this section provided in paragraph

(d)(2)(iii) of this section does not apply to stock issued by a target affiliate that is a controlled foreign corporation. After applying the carryover basis rules of this section to the stock, the basis in the stock is increased by the amount treated as a dividend under section 1248 on the disposition of the stock (or that would have been so treated but for section 1291), except to the extent the basis increase is attributable to the disposition of an asset in which a carryover basis is taken under this section.

(4) Certain distributions—(i) General rule. In the case of a target affiliate that is a controlled foreign corporation, paragraph (g) of this section applies with respect to the target affiliate by treating any reference to a dividend to which section 243(a)(3) applies as a reference to any amount taken into account under § 1.1502–32 in determining the basis of target stock that is—

(A) A dividend;

(B) An amount treated as a dividend under section 1248 (or that would have been so treated but for section 1291); or

(C) An amount included in income under section 951(a)(1)(B).

(ii) Basis of controlled foreign corporation stock. If the carryover basis rules of this section apply to an asset, the basis in the stock of the controlled foreign corporation (or any property by reason of which the stock is considered owned under section 958(a)(2)) is reduced (but not below zero) by the sum of any amounts that are treated, solely by reason of the disposition of the asset, as a dividend, amount treated as a dividend under section 1248 (or that would have been so treated but for section

1291), or amount included in income under section 951(a)(1)(B). For this purpose, any dividend, amount treated as a dividend under section 1248 (or that would have been so treated but for section 1291), or amount included in income under section 951(a)(1)(B) is considered attributable first to earnings and profits resulting from the disposition of the asset.

(iii) Increase in asset or stock basis—

(A) If the carryover basis rules under paragraphs (g) and (h)(4)(i) of this section apply to an asset, and the purchasing corporation disposes of the asset to an unrelated party in a taxable transaction and recognizes and includes in its U.S. gross income or the U.S. gross income of its shareholders the greater of the gain equal to the basis increase denied in the asset pursuant to paragraphs (g) and (h)(4)(i) of this section, or the gain recognized on the asset by the purchasing corporation on the disposition of the asset, then the purchasing corporation or the target or a target affiliate, as appropriate, shall increase the basis of the selling controlled foreign corporation stock subject to paragraph (h)(4)(ii) of this section, as of the date of the disposition of the asset by the purchasing corporation, by the amount of the basis reduction under paragraph (h)(4)(ii) of this section. The preceding sentence shall apply only to the extent that the controlled foreign corporation stock is owned (within the meaning of section 958(a)) by a member of the purchasing corporation's affiliated group.

(B) If the carryover basis rules under paragraphs (g) and (h)(4)(i) of this section apply to an asset, and the purchasing corporation or the target or a target affiliate, as appropriate, disposes

of the stock of the selling controlled foreign corporation to an unrelated party in a taxable transaction and recognizes and includes in its U.S. gross income or the U.S. gross income of its shareholders the greater of the amount of the basis reduction under paragraph (h)(4)(ii) of this section, or the gain recognized in the stock by the purchasing corporation or by the target or a target affiliate, as appropriate, on the disposition of the stock, then the purchasing corporation shall increase the basis of the asset, as of the date of the disposition of the stock of the selling controlled foreign corporation by the purchasing corporation or by the target or a target affiliate, as appropriate, by the amount of the basis increase that was denied pursuant to paragraphs (g) and (h)(4)(i) of this section. The preceding sentence shall apply only to the extent that the asset is owned (within the meaning of section 958(a)) by a member of the purchasing corporation's affiliated group.

(5) Examples. This paragraph (h) may be illustrated by the following examples:
 Example 1. Stock of target affiliate that is a CFC. (a) The S group files a consolidated return; however, T2 is a controlled foreign corporation. On December 1 of Year 1, T1 sells the T2 stock to P and recognizes gain. On January 2 of Year 2, P makes a qualified stock purchase of T from S. No section 338 election is made for T.

(b) Under paragraph (b)(1) of this section, paragraph (d) of this section applies to the T2 stock. Under paragraph (h)(3) of this section, paragraph (d)(2)(iii) of this section does not apply to the T2 stock. Consequently, paragraph (d)(1) of this section applies to the T2 stock. However, after applying paragraph (d)(1) of this section, P's basis in the T2 stock is increased by the amount of T1's gain on the sale of the T2 stock that is treated as a dividend under section 1248. Because P has a carryover basis in the T2 stock, the T2 stock is not considered purchased within the

meaning of section 338(h)(3) and no section 338 election may be made for T2.

Example 2. Stock of target affiliate CFC; inclusion under subpart F. (a) The S group files a consolidated return; however, T2 is a controlled foreign corporation. On December 1 of Year 1, T2 sells an asset to P and recognizes subpart F income that results in an inclusion in T1's gross income under section 951(a)(1)(A). On January 2 of Year 2, P makes a qualified stock purchase of T from S. No section 338 election is made for T.

(b) Because gain from the disposition of the asset results in an inclusion under section 951(a)(1)(A), the gain is reflected in the basis of the T stock as of T's acquisition date. See paragraph (h)(2)(i) of this section. Consequently, under paragraph (b)(1) of this section, paragraph (d)(1) of this section applies to the asset. In addition, under paragraph (h)(2)(ii) of this section, T1's basis in the T2 stock is not increased under section 961(a) by the amount of the inclusion that is attributable to the sale of the asset.

(c) If, in addition to making a qualified stock purchase of T, P acquires the T2 stock from T1 on January 1 of Year 2, the results are the same for the asset sold by T2. In addition, under paragraph (h)(2)(ii) of this section, T1's basis in the T2 stock is not increased by the amount of the inclusion that is attributable to the gain on the sale of the asset. Further, under paragraph (h)(3) of this section, paragraph (d)(1) of this section applies to the T2 stock. However, after applying paragraph (d)(1) of this section, P's basis in the T2 stock is increased by the amount of T1's gain on the sale of the T2 stock that is treated as a dividend under section 1248. Finally, because P has a carryover basis in the T2 stock, the T2 stock is not considered purchased within the meaning of section 338(h)(3) and no section 338 election may be made for T2.

(d) If P makes a qualified stock purchase of

T2 from T1, rather than of T from S, and T1's gain on the sale of T2 is treated as a dividend under section 1248, under paragraph (h)(1) of this section, paragraphs (h)(2) and (3) of this section do not apply because there is no target that is a domestic corporation. Consequently, the carryover basis rules of paragraph do not apply to the asset sold by T2 or the T2 stock.

Example 3. Gain reflected by reason of section 1248 dividend; gain from non-subpart F asset. (a) The S group files a consolidated return; however, T2 is a controlled foreign corporation. In Years 1 through 4, T2 does not pay any dividends to T1 and no amount is included in T1's income under section 951(a)(1)(B). On December 1 of Year 4, T2 sells an asset with a basis of \$400,000 to P for \$900,000. T2's gain of \$500,000 is not subpart F income. On December 15 of Year 4, T1 sells T2, in which it has a basis of \$600,000, to P for \$1,600,000. Under section 1248, \$800,000 of T1's gain of \$1,000,000 is treated as a dividend. However, in the absence of the sale of the asset by T2 to P, only \$300,000 would have been treated as a dividend under section 1248. On December 30 of Year 4, P makes a qualified stock purchase of T1 from T. No section 338 election is made for T1.

(b) Under paragraph (h)(4) of this section, paragraph (g)(2) of this section applies by reference to the amount treated as a dividend under section 1248 on the disposition of the T2 stock. Because the amount treated as a dividend is taken into account in determining T's basis in the T1 stock under § 1.1502-32, the sale of the T2 stock and the deemed dividend have the effect of a transaction described in paragraph (g)(1) of this section. Consequently, paragraph (d)(1) of this section applies to the asset sold by T2 to P and P's basis in the asset is \$400,000 as of December 1 of Year 4.

(c) Under paragraph (h)(3) of this section, paragraph (d)(1) of this section applies to the T2 stock and P's basis in the T2 stock is

\$600,000 as of December 15 of Year 4. Under paragraphs (h)(3) and (4)(ii) of this section, however, P's basis in the T2 stock is increased by \$300,000 (the amount of T1's gain treated as a dividend under section 1248 (\$800,000), other than the amount treated as a dividend solely as a result of the sale of the asset by T2 to P (\$500,000)) to \$900,000.

(i) [Reserved]

(j) Anti-avoidance rules. For purposes of this section—

(1) Extension of consistency period. The target consistency period is extended to include any continuous period that ends on, or begins on, any day of the consistency period during which a purchasing corporation, or any person related, within the meaning of section 267(b) or 707(b)(1), to a purchasing corporation, has an arrangement—

(i) To purchase stock of target; or

(ii) To own an asset to which the carryover basis rules of this section apply, taking into account the extension.

(2) Qualified stock purchase and 12-month acquisition period. The 12-month acquisition period is extended if, pursuant to an arrangement, a corporation acquires by purchase stock of another corporation satisfying the requirements of section 1504(a)(2) over a period of more than 12 months.

(3) Acquisitions by conduits—(i) Asset ownership—(A) General rule. A corporation is treated as owning any portion of an asset attributed to the corporation from a conduit under section 318(a) (treating any asset as stock for this purpose), for purposes of—

(1) The asset ownership requirements of this section; and

(2) Determining whether a controlled foreign corporation is a target affiliate for purposes of paragraph (h) of this section.

(B) Application of carryover basis rule. If the basis rules of this section apply to the asset, the basis rules of this section apply to the entire asset (not just the portion for which ownership is attributed).

(ii) Stock acquisitions—(A) Purchase by conduit. A corporation is treated as purchasing stock of another corporation attributed to the corporation from a conduit under section 318(a) on the day the stock is purchased by the conduit. The corporation is not treated as purchasing the stock, however, if the conduit purchased the stock more than two years before the date the stock is first attributed to the corporation.

(B) Purchase of conduit by corporation. If a corporation purchases an interest in a conduit (treating the interest as stock for this purpose), the corporation is treated as purchasing on that date any stock owned by a conduit on that date and attributed to the corporation under section 318(a) with respect to the interest in the conduit that was purchased.

(C) Purchase of conduit by conduit. If a conduit (the first conduit) purchases an interest in a second conduit (treating the interest as stock for this purpose), the first conduit is treated as purchasing on that date any stock owned by a conduit on that date and attributed to the first conduit under section 318(a) with respect to the interest in the second conduit that was purchased.

(4) Conduit. A person (other than a corporation) is a conduit as to a corporation if—

(i) The corporation would be treated under section 318(a)(2)(A) and (B) (attribution from partnerships, estates, and trusts) as owning any stock owned by the person; and

(ii) The corporation, together with its affiliates, would be treated as owning an aggregate of at least 50 percent of the stock owned by the person.

(5) Existence of arrangement. The existence of an arrangement is determined under all the facts and circumstances. For an arrangement to exist, there need not be an enforceable, written, or unconditional agreement, and all the parties to the transaction need not have participated in each step of the transaction. One factor indicating the existence of an arrangement is the participation of a related party. For this purpose, persons are related if they are related within the meaning of section 267(b) or 707(b)(1).

(6) Predecessor and successor—(i) Persons. A reference to a person (including target, target affiliate, and purchasing corporation) includes, as the context may require, a reference to a predecessor or successor. For this purpose, a predecessor is a transferor or distributor of assets to a person (the successor) in a transaction—

(A) To which section 381(a) applies; or

(B) In which the successor's basis for the assets is determined, directly or indirectly, in whole or in part, by reference to the basis of the transferor or distributor.

(ii) Assets. A reference to an asset (the first asset) includes, as the context may require, a reference to any asset the basis of which is determined, directly or indirectly, in whole or in

part, by reference to the first asset.

(7) Examples. This paragraph (j) may be illustrated by the following examples:

Example 1. Asset owned by conduit treated as owned by purchaser of target stock. (a) P owns a 60-percent interest in Y. On March 1 of Year 1, T sells an asset to Y and recognizes gain. On January 1 of Year 2, P makes a qualified stock purchase of T from S. No section 338 election is made for T.

(b) Under paragraph (j)(4) of this section, Y is a conduit with respect to P. Consequently, under paragraph (j)(3)(i)(A) of this section, P is treated as owning 60% of the asset on March 1 of Year 1 and January 1 of Year 2. Because P is treated as owning part or all of the asset both immediately after the asset disposition and on T's acquisition date, paragraph (b) of this section applies to the asset. Consequently, paragraph (d)(1) of this section applies to the asset and Y's basis in the asset is T's adjusted basis in the asset immediately before the sale to Y.

Example 2. Corporation whose stock is owned by conduit treated as affiliate. (a) P owns an 80-percent interest in Y. Y owns all of the stock of Z. On March 1 of Year 1, T sells an asset to Z and recognizes gain. On January 1 of Year 2, P makes a qualified stock purchase of T from S. No section 338 election is made for T.

(b) Under paragraph (j)(4) of this section, Y is a conduit with respect to P. Consequently, under paragraph (j)(3)(i)(A) of this section, P is treated as owning 80% of the Z stock and Z is therefore treated as an affiliate of P for purposes of applying the asset ownership requirements of paragraph (b)(1)(iii) of this section. Because Z, an affiliate of P, owns the asset both immediately after the asset disposition and on T's acquisition date, paragraph (b) of this section applies to the asset, and the asset's basis is determined under paragraph (d) of this section.

(c) If, instead of owning an 80-percent interest in Y, P owned a 79-percent interest in Y, Z would not be treated as an affiliate of P and paragraph (b) of this section would not apply to the asset.

Example 3. Qualified stock purchase by reason of stock purchase by conduit. (a) P owns a 90-percent interest in Y. Y owns a 60-percent interest in Y1. On February 1 of Year 2, T sells an asset to P and recognizes gain. On January 1 of Year 3, P purchases 70% of the T stock from S and Y1 purchases the remaining 30% of the T stock from S.

(b) Under paragraph (j)(3)(ii)(A) of this section, P is treated as purchasing on January 1 of Year 3, the 16.2% of the T stock that is attributed to P from Y and Y1 under section 318(a). Thus, for purposes of this section, P is treated as making a qualified stock purchase of T on January 1 of Year 3, paragraph (b) of this section applies to the asset, and the asset's basis is determined under paragraph (d) of this section. However, because P is not treated as having made a qualified stock purchase of T for purposes of making an election under section 338, no election can be made for T.

(c) If Y1 purchases 20% of the T stock from S on December 1 of Year 1, rather than 30% on January 1 of Year 3, P would be treated as purchasing 10.8% of the T stock on December 1 of Year 1. Thus, if paragraph (j)(2) of this section (relating to extension of the 12-month acquisition period) does not apply, P would not be treated as making a qualified stock purchase of T, because P is not treated as purchasing T stock satisfying the requirements of section 1504(a)(2) within a 12-month period.

Example 4. Successor asset. (a) On February 1 of Year 1, T sells stock of X to P1 and recognizes gain. On December 1 of Year 1, P1 exchanges its X stock for stock in new X in a

reorganization qualifying under section 368(a)(1)(F). On January 1 of Year 2, P1 makes a qualified stock purchase of T from S. No section 338 election is made for T.

(b) The asset ownership requirements of paragraph (b)(1)(iii) of this section are satisfied because, under paragraph (j)(6)(ii) of this section, P1 is treated as owning the X stock on T's acquisition date. P1 is treated as owning the X stock on that date because P1 owns the new X stock and P1's basis in the new X stock is determined by reference to P1's basis in the X stock. Consequently, under paragraph (d)(1) of this section, P1's basis in the X stock on February 1 of Year 1 is T's adjusted basis in the X stock immediately before the sale to P1.

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§ 1.338-9 International aspects of section 338.

(a) Scope. This section provides guidance regarding international aspects of section 338. As provided in § 1.338-2(c)(18), a foreign corporation, a DISC, or a corporation for which a section 936 election has been made is considered a target affiliate for all purposes of section 338. In addition, stock described in section 338(h)(6)(B)(ii) held by a target affiliate is not excluded from the operation of section 338.

(b) Application of section 338 to foreign targets—(1) In general. For purposes of subtitle A, the deemed sale tax consequences, as defined in § 1.338-2(c)(7), of a foreign target for which a section 338 election is made (FT), and the corresponding earnings and profits, are taken into account in determining the taxation of FT and FT's direct and indirect

shareholders. See, however, section 338(h)(16). For example, the income and earnings and profits of FT are determined, for purposes of sections 551, 951, 1248, and 1293, by taking into account the deemed sale tax sentence consequences.

(2) Ownership of FT stock on the acquisition date. A person who transfers FT stock to the purchasing corporation on FT's acquisition date is considered to own the transferred stock at the close of FT's acquisition date. See, e.g., § 1.951-1(f) (relating to determination of holding period for purposes of sections 951 through 964). If on the acquisition date the purchasing corporation owns a block of FT stock that was acquired before FT's acquisition date, the purchasing corporation is considered to own such block of stock at the close of the acquisition date.

(3) Carryover FT stock—(i) Definition. FT stock is carryover FT stock if—

(A) FT was a controlled foreign corporation within the meaning of section 957 (taking into account section 953(c)) at any time during the portion of the 12-month acquisition period that ends on the acquisition date; and

(B) Such stock is owned as of the beginning of the day after FT's acquisition date by a person other than a purchasing corporation, or by a purchasing corporation if the stock is nonrecently purchased and is not subject to a gain recognition election under § 1.338-5(d).

(ii) Carryover of earnings and profits. The earnings and profits of old FT (and associated foreign taxes) attributable to the carryover FT stock (adjusted to reflect deemed sale tax sentence consequences) carry over to new FT solely for purposes of—

(A) Characterizing an actual distribution with respect to a share of carryover

FT stock as a dividend;

(B) Characterizing gain on a post-acquisition date transfer of a share of carryover FT stock as a dividend under section 1248 (if such section is otherwise applicable);

(C) Characterizing an investment of earnings in United States property as income under sections 951(a)(1)(B) and 956 (if such sections are otherwise applicable); and

(D) Determining foreign taxes deemed paid under sections 902 and 960 with respect to the amount treated as a dividend or income by virtue of this paragraph (b)(3)(ii) (subject to the operation of section 338(h)(16)).

(iii) Cap on carryover of earnings and profits. The amount of earnings and profits of old FT taken into account with respect to a share of carryover FT stock is limited to the amount that would have been included in gross income of the owner of such stock as a dividend under section 1248 if—

(A) The shareholder transferred that share to the purchasing corporation on FT's acquisition date for a consideration equal to the fair market value of that share on that date; or

(B) In the case of nonrecently purchased FT stock treated as carryover FT stock, a gain recognition election under section 338(b)(3)(A) applied to that share. For purposes of the preceding sentence, a shareholder that is a controlled foreign corporation is considered to be a United States person, and the principle of section 1248(c)(2)(D)(ii) (concerning a United States person's indirect ownership of stock in a foreign corporation) applies in determining the correct holding period.

(iv) Post-acquisition date distribution of old FT earnings and profits. A post-acquisition date distribution with respect

to a share of carryover FT stock is considered to be derived first from earnings and profits derived after FT's acquisition date and then from earnings and profits derived on or before FT's acquisition date.

(v) Old FT earnings and profits unaffected by post-acquisition date deficits. The carryover amount for a share of carryover FT stock is not reduced by deficits in earnings and profits incurred by new FT. This rule applies for purposes of determining the amount of foreign taxes deemed paid regardless of the fact that there are no accumulated earnings and profits. For example, a distribution by new FT with respect to a share of carryover FT stock is treated as a dividend by the distributee to the extent of the carryover amount for that share notwithstanding that new FT has no earnings and profits.

(vi) Character of FT stock as carryover FT stock eliminated upon disposition. A share of FT stock is not considered carryover FT stock after it is disposed of provided that all gain realized on the transfer is recognized at the time of the transfer, or that, if less than all of the realized gain is recognized, the recognized amount equals or exceeds the remaining carryover amount for that share.

(4) Passive foreign investment company stock. Stock that is owned as of the beginning of the day after FT's acquisition date by a person other than a purchasing corporation, or by a purchasing corporation if the FT stock is nonrecently purchased stock not subject to a gain recognition election under § 1.338-5(d), is treated as passive foreign investment company stock to the extent provided in section 1297(b)(1).

(c) Dividend treatment under section 1248(e). The principles of this paragraph (b) apply to shareholders of a domestic

corporation subject to section 1248(e).

(d) Allocation of foreign taxes. If a section 338 election is made for target (whether foreign or domestic), and target's taxable year under foreign law (if any) does not close at the end of the acquisition date, foreign income taxes attributable to the foreign taxable income earned by target during such foreign taxable year are allocated to old target and new target. Such allocation is made under the principles of § 1.1502-76(b).

(e) Operation of section 338(h)(16). [Reserved]

(f) Examples. (1) Except as otherwise provided, all corporations use the calendar year as the taxable year, have no earnings and profits (or deficit) accumulated for any taxable year, and have only one class of outstanding stock.

(2) This section may be illustrated by the following examples:

Example 1. Gain recognition election for carryover FT stock. (a) A has owned 90 of the 100 shares of CFCT stock since CFCT was organized on March 13, 1989. P has owned the remaining 10 shares of CFCT stock since CFCT was organized. Those 10 shares constitute nonrecently purchased stock in P's hands within the meaning of section 338(b)(6)(B). On November 1, 1994, P purchases A's 90 shares of CFCT stock for \$90,000 and makes a section 338 election for CFCT. P also makes a gain recognition election under section 338(b)(3)(A) and § 1.338-5(d).

(b) CFCT's earnings and profits for its short taxable year ending on November 1, 1994, are \$50,000, determined without taking into account the deemed asset sale. Assume A recognizes gain of \$81,000 on the sale of the CFCT stock. Further, assume that CFCT recognizes gain of \$40,000 by reason of its deemed sale of assets under section 338(a)(1).

(c) A's sale of CFCT stock to P is a transfer

to which section 1248 and paragraphs (b)(1) and (2) of this section apply. For purposes of applying section 1248(a) to A, the earnings and profits of CFCT for its short taxable year ending on November 1, 1994, are \$90,000 (the earnings and profits for that taxable year as determined under § 1.1248-2(e) (\$50,000) plus earnings from the deemed sale (\$40,000)). Thus, A's entire gain is characterized as a dividend under section 1248 (but see section 338(h)(16)).

(d) Assume that P recognizes a gain of \$9,000 with respect to the 10 shares of nonrecently purchased CFCT stock by reason of the gain recognition election. Because P is treated as selling the nonrecently purchased stock for all purposes of the Internal Revenue Code, section 1248 applies. Thus, under § 1.1248-2(e), \$9,000 of the \$90,000 of earnings and profits for 1994 are attributable to the block of 10 shares of CFCT stock deemed sold by P at the close of November 1, 1994 ($\$90,000 \times 10/100$). Accordingly, P's entire gain on the deemed sale of 10 shares of CFCT stock is included under section 1248(a) in P's gross income as a dividend (but see section 338(h)(16)).

Example 2. No gain recognition election for carryover FT stock. (a) Assume the same facts as in Example 1, except that P does not make a gain recognition election.

(b) The 10 shares of nonrecently purchased CFCT stock held by P is carryover FT stock under paragraph (b)(3) of this section. Accordingly, the earnings and profits (and attributable foreign taxes) of old CFCT carry over to new CFCT solely for purposes of that block of 10 shares. The amount of old CFCT's earnings and profits taken into account with respect to that block in the event, for example, of a distribution by new CFCT with respect to that block is the amount of the section 1248 dividend that P would have recognized with respect to that block had it made a gain recognition election under section

338(b)(3)(A). Under the facts of Example 1, P would have recognized a gain of \$9,000 with respect to that block, all of which would have been a section 1248 dividend ($\$90,000 \times 10/100$). Accordingly, the carryover amount for the block of 10 shares of nonrecently purchased CFCT stock is \$9,000.

Example 3. Sale of controlled foreign corporation stock prior to and on the acquisition date.

(a) X and Y, both U.S. corporations, have each owned 50% of the CFCT stock since 1986. Among CFCT's assets are assets the sale of which would generate subpart F income. On December 31, 1994, X sells its CFCT stock to P. On June 30, 1995, Y sells its CFCT stock to P. P makes a section 338 election for CFCT. In both 1994 and 1995, CFCT has subpart F income resulting from operations.

(b) For taxable year 1994, X and Y are United States shareholders on the last day of CFCT's taxable year, so pursuant to section 951(a)(1)(A) each must include in income its pro rata share of CFCT's subpart F income for 1994. Because P's holding period in the CFCT stock acquired from X does not begin until January 1, 1995, P is not a United States shareholder on the last day of 1994 for purposes of section 951(a)(1)(A) (see § 1.951-1(f)). X must then determine the extent to which section 1248 recharacterizes its gain on the sale of CFCT stock as a dividend.

(c) For the short taxable year ending June 30, 1995, Y is considered to own the CFCT stock sold to P at the close of CFCT's acquisition date. Because the acquisition date is the last day of CFCT's taxable year, Y and P are United States shareholders on the last day of CFCT's taxable year. Pursuant to section 951(a)(1)(A), each must include its pro rata share of CFCT's subpart F income for the short taxable year ending June 30, 1995. This includes any income generated on the deemed sale of CFCT's assets. Y must then determine the extent to which

section 1248 recharacterizes its gain on the sale of the CFCT stock as a dividend, taking into account any increase in CFCT's earnings and profits due to the deemed sale of assets.

Example 4. Acquisition of control for purposes of section 951 prior to the acquisition date. FS owns 100% of the FT stock. On July 1, 1994, P buys 60% of the FT stock. On December 31, 1994, P buys the remaining 40% of the FT stock and makes a section 338 election for FT. For tax year 1994, FT has earnings and profits of \$1,000 (including earnings resulting from the deemed sale). The section 338 election results in \$500 of subpart F income. As a result of the section 338 election, P must include in gross income the following amount under section 951(a)(1)(A) (see § 1.951-

(b)(2)):

FT's subpart F income for 1994	\$500.00
Less: reduction under section 951(a)(2)(A) for period (1-1-94 through 7-1-94) during which FT is not a controlled foreign corporation ($\$500 \times 182/365$)	249.32
Subpart F income as limited by section 951(a)(2)(A)	250.68
P's pro rata share of subpart F income as determined under section 951(a)(2)(A) ($60\% \times 250.68$)	150.41

Example 5. Coordination with section 936. (a) T is a corporation for which a section 936 election has been made. P makes a qualified stock purchase of T and makes a section 338 election for T.

(b) T's deemed sale of assets under section 338 constitutes a sale for purposes of subtitle A of the Internal Revenue Code, including section 936(a)(1)(A)(ii). To the extent that the assets deemed sold are used in the conduct of an active trade or business in a possession for purposes of section 936(a)(1)(A)(i), and assuming all the other conditions of section 936 are satisfied, the income from the deemed sale qualifies for the credit granted by section 936(a). The source of income from the deemed sale is determined as if the assets

had actually been sold and is not affected for purposes of section 936 by section 338(h)(16).

(c) Because new T is treated a new corporation for purposes of subtitle A of the Internal Revenue Code, the three year testing period in section 936(a)(2)(A) begins again for new T on the day following T's acquisition date. Thus, if the character or source of old T's gross income disqualified it for the credit under section 936, a fresh start is allowed by a section 338 election.

§ 1.338–10 Filing of returns.

(a) Returns including tax liability from deemed asset sale—(1) In general. Except as provided in paragraphs (a)(2) and (3) of this section, any deemed sale tax consequences are reported on the final return of old target filed for old target's taxable year that ends at the close of the acquisition date. Paragraphs (a)(2), (3) and (4) of this section do not apply to elections under section 338(h)(10). If old target is the common parent of an affiliated group, the final return may be a consolidated return (any such consolidated return must also include any deemed sale tax consequences of any members of the consolidated group that are acquired by the purchasing corporation on the same acquisition date as old target).

(2) Old target's final taxable year otherwise included in consolidated return of selling group—(i) General rule. If the selling group files a consolidated return for the period that includes the acquisition date, old target is disaffiliated from that group immediately before the deemed asset sale and must file a deemed sale return separate from the group, which includes only the deemed sale tax consequences and the carryover items specified in paragraph (a)(2)(iii) of this section. The deemed asset sale occurs at the close of the acquisition date and is the last transaction

of old target and the only transaction reported on the separate return. Except as provided in § 1.338–1(d) (regarding certain transactions on the acquisition date), any transactions of old target occurring on the acquisition date other than the deemed asset sale are included in the selling group's consolidated return. A deemed sale return includes a combined deemed sale return as defined in paragraph (a)(4) of this section.

(ii) Separate taxable year. The deemed asset sale included in the deemed sale return under this paragraph (a)(2) occurs in a separate taxable year, except that old target's taxable year of the sale and the consolidated year of the selling group that includes the acquisition date are treated as the same year for purposes of determining the number of years in a carryover or carryback period.

(iii) Carryover and carryback of tax attributes. Target's attributes may be carried over to, and carried back from, the deemed sale return under the rules applicable to a corporation that ceases to be a member of a consolidated group.

(iv) Old target is a component member of purchasing corporation's controlled group. For purposes of its deemed sale return, target is a component member of the controlled group of corporations including the purchasing corporation unless target is treated as an excluded member under section 1563(b)(2).

(4) Combined deemed sale return—(i) General rule. Under section 338(h)(15), a combined deemed sale return (combined return) may be filed for all targets from a single selling consolidated group (as defined in §1.338(h)(10)–1(b)(3)) that are acquired by the purchasing corporation on the same acquisition

date and that otherwise would be required to file separate deemed sale returns. The combined return must include all such targets. For example, T and T1 may be included in a combined return if—

(A) T and T1 are directly owned subsidiaries of S;

(B) S is the common parent of a consolidated group; and

(C) P makes qualified stock purchases of T and T1 on the same acquisition date.

(ii) Gain and loss offsets. Gains and losses recognized on the deemed asset sales by targets included in a combined return are treated as the gains and losses of a single target. In addition, loss carryovers of a target that were not subject to the separate return limitation year restrictions (SRLY restrictions) of the consolidated return regulations while that target was a member of the selling consolidated group may be applied without limitation to the gains of other targets included in the combined return. If, however, a target has loss carryovers that were subject to the SRLY restrictions while that target was a member of the selling consolidated group, the use of those losses in the combined return continues to be subject to those restrictions, applied in the same manner as if the combined return were a consolidated return. A similar rule applies, when appropriate, to other tax attributes.

(iii) Procedure for filing a combined return. A combined return is made by filing a single corporation income tax return in lieu of separate deemed sale returns for all targets required to be included in the combined return. The combined return reflects the deemed asset sales of all targets required to be included in the combined return. If the targets included in the combined return

constitute a single affiliated group within the meaning of section 1504(a), the income tax return is signed by an officer of the common parent of that group. Otherwise, the return must be signed by an officer of each target included in the combined return. Rules similar to the rules in § 1.1502–75(j) apply for purposes of preparing the combined return. The combined return must include a statement entitled, “ELECTION TO FILE A COMBINED RETURN UNDER SECTION 338(h)(15).” The statement must include—

(A) The name, address, and employer identification number of each target required to be included in the combined return; and

(B) The following declaration: EACH TARGET IDENTIFIED IN THIS ELECTION TO FILE A COMBINED RETURN CONSENTS TO THE FILING OF A COMBINED RETURN.

(iv) Consequences of filing a combined return. Each target included in a combined return is severally liable for any tax associated with the combined return. See § 1.338–1(b)(3).

(5) Deemed sale excluded from purchasing corporation’s consolidated return. Old target may not be considered a member of any affiliated group that includes the purchasing corporation with respect to its deemed asset sale.

(6) Due date for old target’s final return—(i) General rule. Old target’s final return is generally due on the 15th day of the third calendar month following the month in which the acquisition date occurs. See section 6072 (time for filing income tax returns).

(ii) Application of § 1.1502–76(c)—(A) In general. Section 1.1502–76(c) applies to old target’s final return if old target was a member of a selling group that did not file consolidated returns for the taxable year of the

common parent that precedes the year that includes old target's acquisition date. If the selling group has not filed a consolidated return that includes old target's taxable period that ends on the acquisition date, target may, on or before the final return due date (including extensions), either—

(1) File a deemed sale return on the assumption that the selling group will file the consolidated return; or

(2) File a return for so much of old target's taxable period as ends at the close of the acquisition date on the assumption that the consolidated return will not be filed.

(B) Deemed extension. For purposes of applying § 1.1502-76(c)(2), an extension of time to file old target's final return is considered to be in effect until the last date for making the election under section 338.

(C) Erroneous filing of deemed sale return. If, under this paragraph (a)(6)(ii), target files a deemed sale return but the selling group does not file a consolidated return, target must file a substituted return for old target not later than the due date (including extensions) for the return of the common parent with which old target would have been included in the consolidated return. The substituted return is for so much of old target's taxable year as ends at the close of the acquisition date. Under § 1.1502-76(c)(2), the deemed sale return is not considered a return for purposes of section 6011 (relating to the general requirement of filing a return) if a substituted return must be filed.

(D) Erroneous filing of return for regular tax year. If, under this paragraph (a)(6)(ii), target files a return for so much of old target's regular taxable year as ends at the close of the acquisition

date but the selling group files a consolidated return, target must file an amended return for old target not later than the due date (including extensions) for the selling group's consolidated return. (The amended return is a deemed sale return.)

(E) Last date for payment of tax. If either a substituted or amended final return of old target is filed under this paragraph (a)(6)(ii), the last date prescribed for payment of tax is the final return due date (as defined in paragraph (a)(6)(i) of this section).

(7) Examples. The following examples illustrate this paragraph (a):

Example 1. (i) S is the common parent of a consolidated group that includes T. The S group files calendar year consolidated returns. At the close of June 30 of Year 1, P makes a qualified stock purchase of T from S. P makes a section 338 election for T, and T's deemed asset sale occurs as of the close of T's acquisition date (June 30).

(ii) T is considered disaffiliated for purposes of reporting the deemed sale tax consequences. Accordingly, T is included in the S group's consolidated return through T's acquisition date except that the tax liability for the deemed sale tax consequences is reported in a separate deemed sale return of T. Provided that T is not treated as an excluded member under section 1563(b)(2), T is a component member of P's controlled group for the taxable year of the deemed asset sale, and the taxable income bracket amounts available in calculating tax on the deemed sale return must be limited accordingly.

(iii) If P purchased the stock of T at 10 a.m. on June 30 of Year 1, the results would be the same. See paragraph (a)(2)(i) of this section.

Example 2. The facts are the same as in Example 1, except that the S group does not file

consolidated returns. T must file a separate return for its taxable year ending on June 30 of Year 1, which return includes the deemed asset sale.

(b) Waiver—(1) Certain additions to tax. An addition to tax or additional amount (addition) under subchapter A of chapter 68 of the Internal Revenue Code arising on or before the last day for making the election under section 338 because of circumstances that would not exist but for an election under section 338 is waived if—

(i) Under the particular statute the addition is excusable upon a showing of reasonable cause; and

(ii) Corrective action is taken on or before the last day.

(2) Notification. The Internal Revenue Service should be notified at the time of correction (e.g., by attaching a statement to a return that constitutes corrective action) that the waiver rule of this paragraph (b) is being asserted.

(3) Elections or other actions required to be specified on a timely filed return—(i) In general. If paragraph (b)(1) of this section applies or would apply if there were an underpayment, any election or other action that must be specified on a timely filed return for the taxable period covered by the late filed return described in paragraph (b)(1) of this section is considered timely if specified on a late-filed return filed on or before the last day for making the election under section 338.

(ii) New target in purchasing corporation's consolidated return. If new target is includible for its first taxable year in a consolidated return filed by the affiliated group of which the

purchasing corporation is a member on or before the last day for making the election under section 338, any election or other action that must be specified in a timely filed return for new target's first taxable year (but which is not specified in the consolidated return) is considered timely if specified in an amended return filed on or before such last day, at the place where the consolidated return was filed.

(4) Examples. The following examples illustrate this paragraph (b):

Example 1. T is an unaffiliated corporation with a tax year ending March 31. At the close of September 20 of Year 1, P makes a qualified stock purchase of T. P does not join in filing a consolidated return. P makes a section 338 election for T on or before June 15 of Year 2, which causes T's taxable year to end as of the close of September 20 of Year 1. An income tax return for T's taxable period ending on September 20 of Year 1 was due on December 15 of Year 1. Additions to tax for failure to file a return and to pay tax shown on a return will not be imposed if T's return is filed and the tax paid on or before June 15 of Year 2. (This waiver applies even if the acquisition date coincides with the last day of T's former taxable year, i.e., March 31 of Year 2.) Interest on any underpayment of tax for old T's short taxable year ending September 20 of Year 1 runs from December 15 of Year 1. A statement indicating that the waiver rule of this paragraph is being asserted should be attached to T's return.

Example 2. Assume the same facts as in Example 1. Assume further that new T adopts the calendar year by filing, on or before June 15 of Year 2, its first return (for the period beginning on September 21 of Year 1 and ending on December 31 of Year 1) indicating that a calendar year is chosen. See § 1.338-1(b)(1). Any additions to tax or amounts described in this paragraph (b) that arise because of the

late filing of a return for the period ending on December 31 of Year 1 are waived, because they are based on circumstances that would not exist but for the section 338 election. Notwithstanding this waiver, however, the return is still considered due March 15 of Year 2, and interest on any underpayment runs from that date.

Example 3. Assume the same facts as in Example 2, except that T's former taxable year ends on October 31. Although prior to the election old T had a return due on January 15 of Year 2 for its year ending October 31 of Year 1, that return need not be filed because a timely election under section 338 was made. Instead, old T must file a final return for the period ending on September 20 of Year 1, which is due on December 15 of Year 1.

(c) Effective/applicability date. Paragraph (a)(4)(iii) of this section applies to any taxable year beginning on or after May 30, 2006. However, taxpayers may apply paragraph (a)(4)(iii) of this section to any original Federal income tax return (including any amended return filed on or before the due date (including extensions) of such original return) timely filed on or after May 30, 2006. For taxable years beginning before May 30, 2006, see § 1.338–10 as contained in 26 CFR part 1 in effect on April 1, 2006.

[T.D. 8940, 66 FR 9948, Feb. 13, 2001, as amended by T.D. 9264, 71 FR 30596, May 30, 2006; T.D. 9329, 72 FR 32798, June 14, 2007]

§ 1.338–11 Effect of section 338 election on insurance company targets.

(a) In general. This section provides rules that apply when an election under section 338 is made for a target that is an insurance company. The rules in this section apply in addition to those generally applicable upon the making of an election under section

338. In the case of a conflict between the provisions of this section and other provisions of the Internal Revenue Code or regulations, the rules set forth in this section determine the Federal income tax treatment of the parties and the transaction when a section 338 election is made for an insurance company target.

(b) Computation of ADSP and AGUB—
(1) Reserves taken into account as a liability. Old target's tax reserves are the reserves for Federal income tax purposes for any insurance, annuity, and reinsurance contracts deemed sold by old target to new target in the deemed asset sale. The amount of old target's tax reserves is the amount that is properly taken into account by old target for the contracts at the close of the taxable year that includes the deemed sale tax consequences (before giving effect to the deemed asset sale and assumption reinsurance transaction). Old target's tax reserves are a liability of old target taken into account in determining ADSP under § 1.338–4 and a liability of new target taken into account in determining AGUB under § 1.338–5.

(2) Allocation of ADSP and AGUB to specific insurance contracts. For purposes of allocating AGUB and ADSP under §§ 1.338–6 and 1.338–7, the fair market value of a specific insurance, reinsurance or annuity contract or group of insurance, reinsurance or annuity contracts (insurance contracts) is the amount of the ceding commission a willing reinsurer would pay a willing ceding company in an arm's length transaction for the reinsurance of the contracts if the gross reinsurance premium for the contracts were equal to old target's tax reserves for the contracts. See § 1.197–2(g)(5) for rules concerning the treatment of the amount allocable to insurance contracts acquired in the deemed asset sale.

(c) Application of assumption reinsurance principles—(1) In general. If a target

is an insurance company, the deemed sale of insurance contracts is treated for Federal income tax purposes as an assumption reinsurance transaction between old target, as the reinsured or ceding company, and new target, as the reinsurer or acquiring company, at the close of the acquisition date. The Federal income tax treatment of the assumption reinsurance transaction is determined under the applicable provisions of subchapter L, chapter 1, subtitle A of the Internal Revenue Code, as modified by the rules set forth in this section.

(2) Reinsurance premium. Old target is deemed to pay a gross amount of premium in the assumption reinsurance transaction equal to the amount of old target's tax reserves for the insurance contracts that are acquisition date assets (acquired contracts). New target is deemed to receive a reinsurance premium in the amount of old target's tax reserves for the acquired contracts. See paragraph (d) of this section for circumstances in which new target is deemed to receive additional premium. See § 1.817-4(d)(2) for old target's and new target's treatment of the premium.

(3) Ceding commission. Old target is deemed to receive a ceding commission in an amount equal to the amount of ADSP allocated to the acquired contracts, as determined under §§ 1.338-6 and 1.338-7 and paragraph (b) of this section. New target is deemed to pay a ceding commission in an amount equal to the amount of AGUB allocated to the acquired contracts, as determined under §§ 1.338-6 and 1.338-7 and paragraph (b) of this section. See § 1.817-4(d)(2) for old target's and new target's treatment of the ceding commission.

(4) Examples. The following examples illustrate this paragraph (c):

Example 1. (i) Facts. On January 1, 2003, T, an insurance company, has the following assets with the following fair market values: \$10 cash, \$30 of securities, \$10 of equipment,

a life insurance contract having a value, under paragraph (b)(2) of this section, of \$17, and goodwill and going concern value. T has tax reserves of \$50 and no other liabilities. On January 1, 2003, P purchases all of the stock of T for \$16 and makes a section 338 election for T. For purposes of the capitalization requirements of section 848, assume new T has \$20 of general deductions in its first taxable year ending on December 31, 2003, and earns no other premiums during the year.

(ii) Analysis. (A) For Federal income tax purposes, the section 338 election results in a deemed sale of the assets of old T to new T. Old T's ADSP is \$66 (\$16 amount realized for the T stock plus \$50 liabilities). New T's AGUB also is \$66 (\$16 basis for the T stock plus \$50 liabilities). See paragraph (b)(1) of this section. Each of the AGUB and ADSP is allocated under the residual method of § 1.338-6 to determine the purchase or sale price of each asset transferred. Each of the AGUB and ADSP is allocated as follows: \$10 to cash (Class I), \$30 to the securities (Class II), \$10 to equipment (Class V), \$16 to the life insurance contract (Class VI), and \$0 to goodwill and going concern value (Class VII).

(B) Under section 1001, old T's amount realized for the securities is \$30 and for the equipment is \$10. As a result of the deemed asset sale, there is an assumption reinsurance transaction between old T (as ceding company) and new T (as reinsurer) at the close of the acquisition date for the life insurance contract issued by old T. See paragraph (c)(1) of this section. Although the assumption reinsurance transaction results in a \$50 decrease in old T's reserves, which is taxable income to old T, the reinsurance premium paid by old T is deductible by old T. Under paragraph (c)(2) of this section, old T is deemed to pay a reinsurance premium equal to the reserve for the life insurance contract immediately before the deemed asset sale (\$50) and is deemed to receive a

ceding commission from new T. Under paragraph (c)(3) of this section, the portion of the ADSP allocated to the life insurance contract is \$16; thus, the ceding commission is \$16. Old T, therefore, is deemed to pay new T a reinsurance premium of \$34 (\$50 - \$16 = \$34). Old T also has \$34 of net negative consideration for purposes of section 848. See paragraph (f) of this section for rules relating to the effect of a section 338 election on the capitalization of amounts under section 848.

(C) New T obtains an initial basis of \$30 in the securities and \$10 in the equipment. New T is deemed to receive a reinsurance premium from old T in an amount equal to the \$50 of reserves for the life insurance contract and to pay old T a \$16 ceding commission for the contract. See paragraphs (c)(2) and (3) of this section. Accordingly, new T includes \$50 of premium in income and deducts \$50 for its increase in reserves. For purposes of section 848, new T has \$34 of net positive consideration for the deemed assumption reinsurance transaction. Because the only contract involved in the deemed assumption reinsurance transaction is a life insurance contract, new T must capitalize \$2.62 ($\$34 \times 7.7\% = \2.62) under section 848. New T will amortize the \$2.62 as provided under section 848. New T's adjusted basis in the life insurance contract, which is an amortizable section 197 intangible, is \$13.38, the excess of the \$16 ceding commission over the \$2.62 capitalized under section 848. See section 197 and § 1.197-2(g)(5). New T deducts the \$2.62 of the ceding commission that is not amortizable under section 197 because it is reflected in the amount capitalized under section 848 and also deducts the remaining \$17.38 of its general deductions.

Example 2. (i) Facts. Assume the same facts as in Example 1, except the life insurance contract has a value of \$0 and the fair market value of T's securities are \$60. Thus, to reinsure the contract in an arm's length transaction, T

would have to pay the reinsurer a reinsurance premium in excess of T's \$50 of tax reserves for the contract.

(ii) Analysis. (A) For Federal income tax purposes, the section 338 election results in a deemed sale of the assets of old T to new T. Old T's ADSP is \$66 (\$16 amount realized for the T stock plus \$50 liabilities). New T's AGUB also is \$66 (\$16 basis for the T stock plus \$50 liabilities). See paragraph (b)(1) of this section. Each of the AGUB and ADSP is allocated under the residual method of § 1.338-6 to determine the purchase or sale price of each asset transferred. Each of the AGUB and ADSP is allocated as follows: \$10 to cash (Class I), \$56 to the securities (Class II), \$0 to the equipment (Class V), \$0 to the life insurance contract (Class VI), and \$0 to goodwill and going concern value (Class VII).

(B) Under section 1001, old T's amount realized for the securities is \$56 and for the equipment is \$0. As a result of the deemed asset sale, there is an assumption reinsurance transaction between old T (as ceding company) and new T (as reinsurer) at the close of the acquisition date for the life insurance contract issued by old T. See paragraph (c)(1) of this section. Although the assumption reinsurance transaction results in a \$50 decrease in old T's reserves, which is taxable income to old T, the reinsurance premium deemed paid by old T to new T is deductible by old T. Under paragraph (c)(2) of this section, old T is deemed to pay a reinsurance premium equal to the reserve for the life insurance contract immediately before the deemed asset sale (\$50), and is deemed to receive from new T a ceding commission equal to the amount of AGUB allocated to the life insurance contract (\$0), as provided in paragraph (c)(3) of this section. Old T also has \$50 of net negative consideration for purposes of section 848. See paragraph (f) of this section for rules relating to the effect of a section 338 election on capitalization amounts under section 848.

(C) New T obtains an initial basis of \$56 in the securities (with a fair market value of \$60) and \$0 in the equipment (with a fair market value of \$10). New T is deemed to receive a reinsurance premium from old T in an amount equal to the \$50 of reserves for the life insurance contract. Accordingly, new T includes \$50 of premium in income and deducts \$50 for its increase in reserves. For purposes of section 848, new T has \$50 of net positive consideration for the deemed assumption reinsurance transaction. Because the only contract involved in the assumption reinsurance transaction is a life insurance contract, new T must capitalize \$3.85 ($\$50 \times 7.7\%$) under section 848 from the transaction and deducts the remaining \$16.15 of its general deductions. Because new T allocates \$0 of the AGUB to the insurance contract, no amount is amortizable under section 197 with respect to the insurance contract. See § 1.338-11T(d) for rules on adjustments required if new T increases its reserves for, or reinsures at a loss, the acquired life insurance contract.

(d) Reserve increases by new target after the deemed asset sale—(1) In general. If in new target's first taxable year or any subsequent year, new target increases its reserves for any acquired contracts, new target is treated as receiving an additional premium, which is computed under paragraph (d)(3) of this section, in the assumption reinsurance transaction described in paragraph (c)(1) of this section. New target includes the additional premium in gross income for the taxable year in which new target increases its reserves for acquired contracts. New target's increase in reserves for the insurance contracts acquired in the deemed asset sale is a liability of new target not originally taken into account in determining AGUB that is subsequently taken into account. Thus, AGUB is increased by the amount of the additional premium included in new target's gross income. See §§ 1.338-5(b)(2)(ii) and 1.338-7. Old target has no deduction under this paragraph (d) and makes no adjustments under §§ 1.338-

4(b)(2)(ii) and 1.338-7.

(2) Exceptions. New target is not treated as receiving additional premium under paragraph (d)(1) of this section if—

(i) It is under state receivership as of the close of the taxable year for which the increase in reserves occurs; or

(ii) It is required by section 807(f) to spread the reserve increase over the 10 succeeding taxable years.

(3) Amount of additional premium—(i) In general. The additional premium taken into account under this paragraph

(d) is an amount equal to the sum of the positive amounts described in paragraphs (d)(3)(ii) and (d)(3)(iii) of this section. However, the additional premium cannot exceed the limitation described in paragraph (d)(4) of this section.

(ii) Increases in unpaid loss reserves. The positive amount with respect to unpaid loss reserves is computed using the formula $A/B \times (C-[D + E])$ where—

(A) A equals old target's discounted unpaid losses (determined under section 846) included in AGUB under paragraph 11(b)(1) of this section;

(B) B equals old target's undiscounted unpaid losses (determined under section 846(b)(1)) as of the close of the acquisition date;

(C) C equals new target's undiscounted unpaid losses (determined under section 846(b)(1)) at the end of the taxable year that are attributable to losses incurred by old target on or before the acquisition date;

(D) D (which may be a negative number)

equals old target's undiscounted unpaid losses as of the close of the acquisition date, reduced by the cumulative amount of losses, loss adjustment expenses, and reinsurance premiums paid by new target through the end of the taxable year for losses incurred by old target on or before the acquisition date; and

(E) E equals the amount obtained by dividing the cumulative amount of reserve increases taken into account under this paragraph (d) in prior taxable years by A/B.

(iii) Increases in other reserves. The positive amount with respect to reserves other than discounted unpaid loss reserves is the net increase of those reserves due to changes in estimate, methodology, or other assumptions used to compute the reserves (including the adoption by new target of a methodology or assumptions different from those used by old target).

(4) Limitation on additional premium. The additional premium taken into account by new target under paragraph (d)(1) of this section is limited to the excess, if any, of—

(i) The fair market value of old target's assets acquired by new target in the deemed asset sale (other than Class VI and Class VII assets); over

(ii) The AGUB allocated to those assets (including increases in AGUB allocated to those assets as the result of reserve increases by new target in prior taxable years).

(5) Treatment of additional premium under section 848. If a portion of the positive amounts described in paragraphs (d)(3)(ii) and (iii) of this section are attributable to an increase in reserves for specified insurance contracts (as defined in section

848(e)), new target takes an allocable portion of the additional premium in determining its specified policy acquisition expenses under section 848(c) for the taxable year of the reserve increase.

(6) Examples. The following examples illustrate this paragraph (d):

Example 1. (i) Facts. On January 1, 2006, P purchases all of the stock of T, a non-life insurance company, for \$120 and makes a section 338 election for T. On the acquisition date, old T has total reserve liabilities under state law of \$725, consisting of undiscounted unpaid losses of \$625 and unearned premiums of \$100. Old T's tax reserves on the acquisition date are \$580, which consist of discounted unpaid losses (as defined in section 846) of \$500 and unearned premiums (as computed under section 832(b)(4)(B)) of \$80. Old T has Class I through Class V assets with a fair market value of \$800. Old T also has a Class VI asset with a fair market value of \$75, consisting of the future profit stream of certain insurance contracts. During 2006, new T makes loss and loss adjustment expense payments of \$200 with respect to the unpaid losses incurred by old T before the acquisition date. As of December 31, 2006, new T reports undiscounted unpaid losses of \$475 attributable to losses incurred before the acquisition date. The related amount of discounted unpaid losses (as defined in section 846) for those losses is \$390.

(ii) Computation and allocation of AGUB. Under § 1.338–5 and paragraph (b)(1) of this section, as of the acquisition date, AGUB is \$700, reflecting the sum of the amount paid for old T's stock (\$120) and the tax reserves assumed by new T in the transaction (\$580). The fair market value of old T's Class I through V assets is \$800, whereas the AGUB available for such assets under § 1.338–6 is \$700. There is no AGUB available for old T's Class VI assets, even though such assets have a fair market value of \$75 on the acquisition date.

(iii) Adjustments for increases in reserves for unpaid losses. Under paragraph (d) of this section, new T must determine whether there are any amounts by which it increased its unpaid loss reserves that will be treated as an additional premium and an increase in AGUB. New T applies the formula of paragraph (d)(3) of this section, where A equals \$500, B equals \$625, C equals \$475, D equals \$425 (\$625 - \$200), and E equals \$0. Under this formula, new T is treated as having increased its reserves for discounted unpaid losses attributable to losses incurred by old T by \$40 ($\$500/\$625 \times (\$475 - [\$425 + 0])$). The limitation under paragraph (d)(5) of this section based on the difference between the fair market value of old T's Class I through Class V assets and the AGUB allocated to such assets is \$100. Accordingly, new T includes an additional premium of \$40 in gross income for 2006, and increases the AGUB allocated to old T's Class I through Class V assets to reflect this additional premium.

Example 2. (i) Facts. Assume the same facts as in Example 1. Further assume that during 2007 new T deducts total loss and loss expense payments of \$375 with respect to losses incurred by old T before the acquisition date. On December 31, 2007, new T reports undiscounted unpaid losses of \$150 with respect to losses incurred before the acquisition date. The related amount of discounted unpaid losses (as defined in section 846) for those unpaid losses is \$125.

(ii) Analysis. New T must determine whether any amounts by which it increased its unpaid losses during 2007 will be treated as an additional premium in paragraph (d)(3) of this section. New T applies the formula under paragraph (d)(3) of this section, where A equals \$500, B equals \$625, C equals \$150, D equals \$50 (\$625 - \$575), and E equals \$50 (\$40 divided by .8). In paragraph (d)(3) of this section, new T is treated as increasing its reserves for discounted unpaid losses by \$40

during 2007 with respect to losses incurred by old T ($\$500/\$625 \times (\$150 - [\$50 + \$50])$). New T determines the limitation of paragraph (d)(5) of this section by comparing the \$800 fair market value of the Class I through V assets on the acquisition date to the \$740 AGUB allocated to such assets (which includes the \$40 addition to AGUB included during 2006). Thus, new T recognizes \$40 of additional premium as a result of the increase in reserves during 2007, and adjusts the AGUB allocable to the Class I through V assets acquired from old T to reflect such additional premium.

Example 3. (i) Facts. The facts are the same as Example 2, except that on January 1, 2008, new T reinsures the outstanding liability with respect to losses incurred by old T before the acquisition date through a portfolio reinsurance transaction with R, another non-life insurance company. R agrees to assume any remaining liability relating to losses incurred by old T before the acquisition date in exchange for a reinsurance premium of \$200. Accordingly, as of December 31, 2008, new T reports no undiscounted unpaid losses with respect to losses incurred by old T before the acquisition date.

(ii) Analysis. New T must determine whether any amount by which it increased its unpaid loss reserves will be treated as an additional premium under paragraph (d) of this section. New T applies the formula of paragraph (d)(3) of this section, where A equals \$500, B equals \$625, C equals \$0, and D equals \$150 ($\$625 - (\$575 + \$200)$), and E equals \$100 ($\$80 \text{ divided by } .8$). Thus, new T is treated as having increased its discounted unpaid losses by \$40 in 2008 with respect to losses incurred by old T before the acquisition date ($\$500/\$625 \times (0 - [-\$150 + \$100])$). New T includes this positive amount in gross income, subject to the limitation of paragraph (d)(4) of this section. The limitation of paragraph (d)(4) of this section equals \$20, which is computed by comparing the \$800 fair market value of the Class I through V assets acquired from old T with the \$780

AGUB allocated to such assets (which includes the \$40 addition to AGUB in 2006 and the \$40 addition to AGUB in 2007). Thus, New T includes \$20 in additional premium, and increases the AGUB allocated to the Class I through V assets acquired from old T by \$20. As a result of these adjustments, the limitation under paragraph (d)(4) of this section is reduced to zero.

(7) Effective/applicability date—(i) In general. This section applies to increases to reserves made by new target after a deemed asset sale occurring on or after April 10, 2006.

(ii) Application to pre-effective date increases to reserves. If either new target makes an election under §1.338(i)–1(c)(2) or old target makes an election under § 1.338(i)–1(c)(3) to apply the rules of this section, in whole, to a qualified stock purchase occurring before April 10, 2006, then the rules contained in this section shall apply in whole to the qualified stock purchase.

(e) Effect of section 338 election on section 846(e) election—(1) In general. New target and old target are treated as the same corporation for purposes of an election by old target to use its historical loss payment pattern under section 846(e). See §1.338–1(b)(2)(vii). Therefore, if old target has a section 846(e) election in effect on the acquisition date, new target will continue to use the historical loss payment pattern of old target to discount unpaid losses incurred in accident years covered by the election, unless new target elects to revoke the section 846(e) election. In addition, new target may consider old target's historical loss payment pattern when determining whether to make the section 846(e) election for a determination year that includes or is subsequent to the acquisition date.

(2) Revocation of existing section 846(e)

election. New target may revoke old target's section 846(e) election to use its historical loss payment pattern to discount unpaid losses. If new target elects to revoke old target's section 846(e) election, new target will use the industry-wide patterns determined by the Secretary to discount unpaid losses incurred in accident years beginning on or after the acquisition date through the subsequent determination year. New target may revoke old target's section 846(e) election by attaching a statement to new target's original tax return for its first taxable year.

(f) Effect of section 338 election on old target's capitalization amounts under section 848—(1) Determination of net consideration for specified insurance contracts. For purposes of applying section 848 and § 1.848–2(f) to the deemed assumption reinsurance transaction, old target's net consideration (either positive or negative) for each category of specified insurance contracts is an amount equal to—

(i) The allocable portion of the ceding commission (if any) relating to contracts in that category; less

(ii) The amount by which old target's tax reserves for contracts in that category has been reduced as a result of the deemed assumption reinsurance transaction.

(2) Determination of capitalization amount. Except as provided in § 1.381(c)(22)–1(b)(13)—

(i) If, after the deemed asset sale, old target has an amount otherwise required to be capitalized under section 848 for the taxable year or an unamortized balance of specified policy acquisition expenses from prior taxable years, then old target deducts such remaining amount or unamortized balance

as an expense incurred in the taxable year that includes the deemed sale tax consequences; and

(ii) If, after the deemed asset sale, the negative capitalization amount resulting from the reinsurance transaction exceeds the amount that old target can deduct under section 848(f)(1), then old target's capitalization amount is treated as zero at the close of the taxable year that includes the deemed sale tax consequences.

(3) Section 381 transactions. For transactions described in section 381, see § 1.381(c)(22)–1(b)(13).

(g) Effect of section 338 election on policyholders surplus account. Except as specifically provided in § 1.381(c)(22)–1(b)(7), the deemed asset sale effects a distribution of old target's policyholders surplus account to the extent the grossed-up amount realized on the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock (as defined in 1.338(h)(10)–1 § 1.338–4(c)) exceeds old target's shareholders surplus account under section 815(c).

(h) Effect of section 338 election on section 847 special estimated tax payments. If old target had elected to claim an additional deduction under section 847 for the taxable year that includes the deemed sale tax consequences or any earlier years, the amount remaining in old target's special loss discount account under section 847(3) must be reduced to the extent it relates to contracts transferred to new target and the amount of such reduction must be included in old target's gross income for the taxable year that includes the deemed sale tax consequences. Old target may apply the balance of its special estimated tax account as a credit against any tax resulting from such inclusion in gross income. Any special estimated tax payments remaining after this credit are voided and, therefore, are not available for

credit or refund. Under section 847(1), new target is permitted to claim a section 847 deduction for losses incurred before the deemed asset sale, subject to the general requirement that new target makes timely special estimated tax payments equal to the tax benefit resulting from this deduction. See § 1.381(c)(22)–1(c)(14) regarding the carryover of the special loss discount account attributable to contracts transferred in a section 381 transaction.

[T.D. 9257, 71 FR 18000, Apr. 10, 2006, as amended by T.D. 9377, 73 FR 3872, Jan. 23, 2008]

§ 1.338(h)(10)–1 Deemed asset sale and liquidation.

(a) Scope. This section prescribes rules for qualification for a section 338(h)(10) election and for making a section 338(h)(10) election. This section also prescribes the consequences of such election. The rules of this section are in addition to the rules of §§ 1.338–1 through 1.338–10 and, in appropriate cases, apply instead of the rules of §§ 1.338–1 through 1.338–10.

(b) Definitions—(1) Consolidated target. A consolidated target is a target that is a member of a consolidated group within the meaning of § 1.1502–1(h) on the acquisition date and is not the common parent of the group on that date.

(2) Selling consolidated group. A selling consolidated group is the consolidated group of which the consolidated target is a member on the acquisition date.

(3) Selling affiliate; affiliated target. A selling affiliate is a domestic corporation that owns on the acquisition date an amount of stock in a domestic target, which amount of stock is described

in section 1504(a)(2), and does not join in filing a consolidated return with the target. In such case, the target is an affiliated target.

(4) S corporation target. An S corporation target is a target that is an S corporation immediately before the acquisition date.

(5) S corporation shareholders. S corporation shareholders are the S corporation target's shareholders. Unless otherwise indicated, a reference to S corporation shareholders refers both to S corporation shareholders who do and those who do not sell their target stock.

(6) Liquidation. Any reference in this section to a liquidation is treated as a reference to the transfer described in paragraph (d)(4) of this section notwithstanding its ultimate characterization for Federal income tax purposes.

(c) Section 338(h)(10) election—(1) In general. A section 338(h)(10) election may be made for T if P acquires stock meeting the requirements of section 1504(a)(2) from a selling consolidated group, a selling affiliate, or the S corporation shareholders in a qualified stock purchase.

(2) Availability of section 338(h)(10) election in certain multi-step transactions. Notwithstanding anything to the contrary in §1.338-3(c)(1)(i), a section 338(h)(10) election may be made for T where P's acquisition of T stock, viewed independently, constitutes a qualified stock purchase and, after the stock acquisition, T merges or liquidates into P (or another member of the affiliated group that includes P), whether or not, under relevant provisions of law, including the step transaction doctrine, the acquisition of the T stock and the merger or liquidation of T qualify as a reorganization described

in section 368(a). If a section 338(h)(10) election is made in a case where the acquisition of T stock followed by a merger or liquidation of T into P qualifies as a reorganization described in section 368(a), for all Federal tax purposes, P's acquisition of T stock is treated as a qualified stock purchase and is not treated as part of a reorganization described in section 368(a).

(3) Simultaneous joint election requirement. A section 338(h)(10) election is made jointly by P and the selling consolidated group (or the selling affiliate or the S corporation shareholders) on Form 8023 in accordance with the instructions to the form. S corporation shareholders who do not sell their stock must also consent to the election. The section 338(h)(10) election must be made not later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs.

(4) Irrevocability. A section 338(h)(10) election is irrevocable. If a section 338(h)(10) election is made for T, a section 338 election is deemed made for T.

(5) Effect of invalid election. If a section 338(h)(10) election for T is not valid, the section 338 election for T is also not valid.

(d) Certain consequences of section 338(h)(10) election. For purposes of subtitle A of the Internal Revenue Code (except as provided in § 1.338-1(b)(2)), the consequences to the parties of making a section 338(h)(10) election for T are as follows:

(1) P. P is automatically deemed to have made a gain recognition election for its nonrecently purchased T stock, if any. The effect of a gain recognition election includes a taxable deemed sale by P on the acquisition date of any nonrecently purchased target stock. See § 1.338-5(d).

(2) New T. The AGUB for new T's assets is determined under § 1.338-5 and is allocated among the acquisition date assets under §§ 1.338-6 and 1.338-7. Notwithstanding paragraph (d)(4) of this section (deemed liquidation of old T), new T remains liable for the tax liabilities of old T (including the tax liability for the deemed sale tax consequences). For example, new T remains liable for the tax liabilities of the members of any consolidated group that are attributable to taxable years in which those corporations and old T joined in the same consolidated return. See § 1.1502-6(a).

(3) Old T—deemed sale—(i) In general. Old T is treated as transferring all of its assets to an unrelated person in exchange for consideration that includes the discharge of its liabilities in a single transaction at the close of the acquisition date (but before the deemed liquidation). See § 1.338-1(a) regarding the tax characterization of the deemed asset sale. Except as provided in § 1.338(h)(10)-1(d)(8) (regarding the installment method), old T recognizes all of the gain realized on the deemed transfer of its assets in consideration for the ADSP. ADSP for old T is determined under § 1.338-4 and allocated among the acquisition date assets under §§ 1.338-6 and 1.338-7. Old T realizes the deemed sale tax consequences from the deemed asset sale before the close of the acquisition date while old T is a member of the selling consolidated group (or owned by the selling affiliate or owned by the S corporation shareholders). If T is an affiliated target, or an S corporation target, the principles of §§ 1.338-2(c)(10) and 1.338-10(a)(1), (5), and (6)(i) apply to the return on which the deemed sale tax consequences are reported. When T is an S corporation target, T's S election continues in effect through the close of the acquisition date (including the time of the deemed asset sale and the deemed liquidation)

notwithstanding section 1362(d)(2)(B). Also, when T is an S corporation target (but not a qualified subchapter S subsidiary), any direct and indirect subsidiaries of T which T has elected to treat as qualified subchapter S subsidiaries under section 1361(b)(3) remain qualified subchapter S subsidiaries through the close of the acquisition date.

(ii) Tiered targets. In the case of parent-subsidiary chains of corporations making elections under section 338(h)(10), the deemed asset sale of a parent corporation is considered to precede that of its subsidiary. See § 1.338-3(b)(4)(i).

(4) Old T and selling consolidated group, selling affiliate, or S corporation shareholders—deemed liquidation; tax characterization—(i) In general. Old T is treated as if, before the close of the acquisition date, after the deemed asset sale in paragraph (d)(3) of this section, and while old T is a member of the selling consolidated group (or owned by the selling affiliate or owned by the S corporation shareholders), it transferred all of its assets to members of the selling consolidated group, the selling affiliate, or S corporation shareholders and ceased to exist. The transfer from old T is characterized for Federal income tax purposes in the same manner as if the parties had actually engaged in the transactions deemed to occur because of this section and taking into account other transactions that actually occurred or are deemed to occur. For example, the transfer may be treated as a distribution in pursuance of a plan of reorganization, a distribution in complete cancellation or redemption of all its stock, one of a series of distributions in complete cancellation or redemption of all its stock in accordance with a plan of liquidation, or part of a circular flow of cash. In most cases, the transfer will be treated as a distribution in complete liquidation to which section 336 or 337 applies.

(ii) Tiered targets. In the case of parent-subsidary chains of corporations making elections under section 338(h)(10), the deemed liquidation of a subsidiary corporation is considered to precede the deemed liquidation of its parent.

(5) Selling consolidated group, selling affiliate, or S corporation shareholders—

(i) In general. If T is an S corporation target, S corporation shareholders (whether or not they sell their stock) take their pro rata share of the deemed sale tax consequences into account under section 1366 and increase or decrease their basis in T stock under section 1367. Members of the selling consolidated group, the selling affiliate, or S corporation shareholders are treated as if, after the deemed asset sale in paragraph (d)(3) of this section and before the close of the acquisition date, they received the assets transferred by old T in the transaction described in paragraph (d)(4)(i) of this section. In most cases, the transfer will be treated as a distribution in complete liquidation to which section 331 or 332 applies.

(ii) Basis and holding period of T stock not acquired. A member of the selling consolidated group (or the selling affiliate or an S corporation shareholder) retaining T stock is treated as acquiring the stock so retained on the day after the acquisition date for its fair market value. The holding period for the retained stock starts on the day after the acquisition date. For purposes of this paragraph, the fair market value of all of the T stock equals the grossed-up amount realized on the sale to P of P's recently purchased target stock. See § 1.338-4(c).

(iii) T stock sale. Members of the selling consolidated group (or the selling affiliate or S corporation shareholders)

recognize no gain or loss on the sale or exchange of T stock included in the qualified stock purchase (although they may recognize gain or loss on the T stock in the deemed liquidation).

(6) Nonselling minority shareholders other than nonselling S corporation shareholders—(i) In general. This paragraph (d)(6) describes the treatment of shareholders of old T other than the following: Members of the selling consolidated group, the selling affiliate, S corporation shareholders (whether or not they sell their stock), and P. For a description of the treatment of S corporation shareholders, see paragraph (d)(5) of this section. A shareholder to which this paragraph (d)(6) applies is called a minority shareholder.

(ii) T stock sale. A minority shareholder recognizes gain or loss on the shareholder's sale or exchange of T stock included in the qualified stock purchase.

(iii) T stock not acquired. A minority shareholder does not recognize gain or loss under this section with respect to shares of T stock retained by the shareholder. The shareholder's basis and holding period for that T stock is not affected by the section 338(h)(10) election.

(7) Consolidated return of selling consolidated group. If P acquires T in a qualified stock purchase from a selling consolidated group—

(i) The selling consolidated group must file a consolidated return for the taxable period that includes the acquisition date;

(ii) A consolidated return for the selling consolidated group for that period may not be withdrawn on or after the day that a section 338(h)(10) election is made for T; and

(iii) Permission to discontinue filing consolidated returns cannot be granted for, and cannot apply to, that period or any of the immediately preceding taxable periods during which consolidated returns continuously have been filed.

(8) Availability of the section 453 installment method. Solely for purposes of applying sections 453, 453A, and 453B, and the regulations thereunder (the installment method) to determine the consequences to old T in the deemed asset sale and to old T (and its shareholders, if relevant) in the deemed liquidation, the rules in paragraphs (d)(1) through (7) of this section are modified as follows:

(i) In deemed asset sale. Old T is treated as receiving in the deemed asset sale new T installment obligations, the terms of which are identical (except as to the obligor) to P installment obligations issued in exchange for recently purchased stock of T. Old T is treated as receiving in cash all other consideration in the deemed asset sale other than the assumption of, or taking subject to, old T liabilities. For example, old T is treated as receiving in cash any amounts attributable to the grossing-up of amount realized under § 1.338-4(c). The amount realized for recently purchased stock taken into account in determining ADSP is adjusted (and, thus, ADSP is redetermined) to reflect the amounts paid under an installment obligation for the stock when the total payments under the installment obligation are greater or less than the amount realized.

(ii) In deemed liquidation. Old T is treated as distributing in the deemed liquidation the new T installment obligations that it is treated as receiving in the deemed asset sale. The members of the selling consolidated group, the selling affiliate, or the S corporation shareholders are treated as

receiving in the deemed liquidation the new T installment obligations that correspond to the P installment obligations they actually received individually in exchange for their recently purchased stock. The new T installment obligations may be recharacterized under other rules. See for example § 1.453-11(a)(2) which, in certain circumstances, treats the new T installment obligations deemed distributed by old T as if they were issued by new T in exchange for the stock in old T owned by members of the selling consolidated group, the selling affiliate, or the S corporation shareholders. The members of the selling consolidated group, the selling affiliate, or the S corporation shareholders are treated as receiving all other consideration in the deemed liquidation in cash.

(9) Treatment consistent with an actual asset sale. No provision in section 338(h)(10) or this section shall produce a Federal income tax result under subtitle A of the Internal Revenue Code that would not occur if the parties had actually engaged in the transactions deemed to occur because of this section and taking into account other transactions that actually occurred or are deemed to occur. See, however, § 1.338-1(b)(2) for certain exceptions to this rule.

(e) Examples. The following examples illustrate the provisions of this section:

Example 1. (i) S1 owns all of the T stock and T owns all of the stock of T1 and T2. S1 is the common parent of a consolidated group that includes T, T1, and T2. P makes a qualified stock purchase of all of the T stock from S1. S1 joins with P in making a section 338(h)(10) election for T and for the deemed purchase of T1. A section 338 election is not made for T2.

(ii) S1 does not recognize gain or loss on the sale of the T stock and T does not recognize

gain or loss on the sale of the T1 stock because section 338(h)(10) elections are made for T and T1. Thus, for example, gain or loss realized on the sale of the T or T1 stock is not taken into account in earnings and profits. However, because a section 338 election is not made for T2, T must recognize any gain or loss realized on the deemed sale of the T2 stock. See § 1.338-4(h).

(iii) The results would be the same if S1, T, T1, and T2 are not members of any consolidated group, because S1 and T are selling affiliates.

Example 2. (i) S and T are solvent corporations. S owns all of the outstanding stock of T. S and P agree to undertake the following transaction: T will distribute half its assets to S, and S will assume half of T's liabilities. Then, P will purchase the stock of T from S. S and P will jointly make a section 338(h)(10) election with respect to the sale of T. The corporations then complete the transaction as agreed.

(ii) Under section 338(a), the assets present in T at the close of the acquisition date are deemed sold by old T to new T. Under paragraph (d)(4) of this section, the transactions described in paragraph (d) of this section are treated in the same manner as if they had actually occurred. Because S and P had agreed that, after T's actual distribution to S of part of its assets, S would sell T to P pursuant to an election under section 338(h)(10), and because paragraph (d)(4) of this section deems T subsequently to have transferred all its assets to its shareholder, T is deemed to have adopted a plan of complete liquidation under section 332. T's actual transfer of assets to S is treated as a distribution pursuant to that plan of complete liquidation.

Example 3. (i) S1 owns all of the outstanding stock of both T and S2. All three are corporations. S1 and P agree to undertake

the following transaction. T will transfer substantially all of its assets and liabilities to S2, with S2 issuing no stock in exchange therefor, and retaining its other assets and liabilities. Then, P will purchase the stock of T from S1. S1 and P will jointly make a section 338(h)(10) election with respect to the sale of T. The corporations then complete the transaction as agreed.

(ii) Under section 338(a), the remaining assets present in T at the close of the acquisition date are deemed sold by old T to new T. Under paragraph (d)(4) of this section, the transactions described in this section are treated in the same manner as if they had actually occurred. Because old T transferred substantially all of its assets to S2, and is deemed to have distributed all its remaining assets and gone out of existence, the transfer of assets to S2, taking into account the related transfers, deemed and actual, qualifies as a reorganization under section 368(a)(1)(D). Section 361(c)(1) and not section 332 applies to T's deemed liquidation.

Example 4. (i) T owns two assets: an actively traded security (Class II) with a fair market value of \$100 and an adjusted basis of \$100, and inventory (Class IV) with a fair market value of \$100 and an adjusted basis of \$100. T has no liabilities. S is negotiating to sell all the stock in T to P for \$100 cash and contingent consideration. Assume that under generally applicable tax accounting rules, P's adjusted basis in the T stock immediately after the purchase would be \$100, because the contingent consideration is not taken into account. Thus, under the rules of § 1.338-5, AGUB would be \$100. Under the allocation rules of § 1.338-6, the entire \$100 would be allocated to the Class II asset, the actively traded security, and no amount would be allocated to the inventory. P, however, plans immediately to cause T to sell the inventory, but not the actively traded security, so it requests that, prior to the stock sale, S cause T to create a new subsidiary,

Newco, and contribute the actively traded security to the capital of Newco. Because the stock in Newco, which would not be actively traded, is a Class V asset, under the rules of § 1.338–6 \$100 of AGUB would be allocated to the inventory and no amount of AGUB would be allocated to the Newco stock. Newco’s own AGUB, \$0 under the rules of § 1.338–5, would be allocated to the actively traded security. When P subsequently causes T to sell the inventory, T would realize no gain or loss instead of realizing gain of \$100.

(ii) Assume that, if the T stock had not itself been sold but T had instead sold both its inventory and the Newco stock to P, T would for tax purposes be deemed instead to have sold both its inventory and actively traded security directly to P, with P deemed then to have created Newco and contributed the actively traded security to the capital of Newco. Section 338, if elected, generally recharacterizes a stock sale as a deemed sale of assets. However, paragraph (d)(9) of this section states, in general, that no provision of section 338(h)(10) or the regulations hereunder shall produce a Federal income tax result under subtitle A of the Internal Revenue Code that would not occur if the parties had actually engaged in the transactions deemed to occur by virtue of the section 338(h)(10) election, taking into account other transactions that actually occurred or are deemed to occur. Hence, the deemed sale of assets under section 338(h)(10) should be treated as one of the inventory and actively traded security themselves, not of the inventory and Newco stock. The anti-abuse rule of § 1.338–1(c) does not apply, because the substance of the deemed sale of assets is a sale of the inventory and the actively traded security themselves, not of the inventory and the Newco stock. Otherwise, the anti-abuse rule might apply.

Example 5. (i) T, a member of a selling consolidated group, has only one class of stock, all of which is owned by S1. On March 1 of Year 2, S1 sells its T stock to P for \$80,000,

and joins with P in making a section 338(h)(10) election for T. There are no selling costs or acquisition costs. On March 1 of Year 2, T owns land with a \$50,000 basis and \$75,000 fair market value and equipment with a \$30,000 adjusted basis, \$70,000 recomputed basis, and \$60,000 fair market value. T also has a \$40,000 liability. S1 pays old T’s allocable share of the selling group’s consolidated tax liability for Year 2 including the tax liability for the deemed sale tax consequences (a total of \$13,600).

(ii) ADSP of \$120,000 (\$80,000 + \$40,000 + 0) is allocated to each asset as follows:

Assets	Basis	FMV	Fraction	Allocable	ADSP
Land	\$50,000	\$75,000	5/9	\$66,667	
Equipment ...	30,000	60,000	4/9	53,333	
Total	80,000	135,000	1	120,000	

(iii) Under paragraph (d)(3) of this section, old T has gain on the deemed sale of \$40,000 (consisting of \$16,667 of capital gain and \$23,333 of ordinary income).

(iv) Under paragraph (d)(5)(iii) of this section, S1 recognizes no gain or loss upon its sale of the old T stock to P. S1 also recognizes no gain or loss upon the deemed liquidation of T. See paragraph (d)(4) of this section and section 332.

(v) P’s basis in new T stock is P’s cost for the stock, \$80,000. See section 1012.

(vi) Under § 1.338–5, the AGUB for new T is \$120,000, i.e., P’s cost for the old T stock (\$80,000) plus T’s liability (\$40,000). This AGUB is allocated as basis among the new T assets under §§ 1.338–6 and 1.338–7.

Example 6. (i) The facts are the same as in Example 5, except that S1 sells 80 percent of the old T stock to P for \$64,000, rather than 100 percent of the old T stock for \$80,000.

(ii) The consequences to P, T, and S1 are the same as in Example 5, except that:

(A) P’s basis for its 80-percent interest in the new T stock is P’s \$64,000 cost for the

stock. See section 1012.

(B) Under § 1.338–5, the AGUB for new T is \$120,000 (i.e., $\$64,000/.8 + \$40,000 + \$0$).

(C) Under paragraph (d)(4) of this section, S1 recognizes no gain or loss with respect to the retained stock in T. See section 332.

(D) Under paragraph (d)(5)(ii) of this section, the basis of the T stock retained by S1 is \$16,000 (i.e., $\$120,000 - \$40,000$ (the ADSP amount for the old T assets over the sum of new T's liabilities immediately after the acquisition date) $\times .20$ (the proportion of T stock retained by S1))).

Example 7. (i) The facts are the same as in Example 6, except that K, a shareholder unrelated to T or P, owns the 20 percent of the T stock that is not acquired by P in the qualified stock purchase. K's basis in its T stock is \$5,000.

(ii) The consequences to P, T, and S1 are the same as in Example 6.

(iii) Under paragraph (d)(6)(iii) of this section, K recognizes no gain or loss, and K's basis in its T stock remains at \$5,000.

Example 8. (i) The facts are the same as in Example 5, except that the equipment is held by T1, a wholly-owned subsidiary of T, and a section 338(h)(10) election is also made for T1. The T1 stock has a fair market value of \$60,000. T1 has no assets other than the equipment and no liabilities. S1 pays old T's and old T1's allocable shares of the selling group's consolidated tax liability for Year 2 including the tax liability for T and T1's deemed sale tax consequences.

(ii) ADSP for T is \$120,000, allocated \$66,667 to the land and \$53,333 to the stock. Old T's deemed sale results in \$16,667 of capital gain on its deemed sale of the land. Under paragraph

(d)(5)(iii) of this section, old T does not recognize gain or loss on its deemed sale of the T1 stock. See section 332.

(iii) ADSP for T1 is \$53,333 (i.e., $\$53,333 + \$0 + \$0$). On the deemed sale of the equipment, T1 recognizes ordinary income of \$23,333.

(iv) Under paragraph (d)(5)(iii) of this section, S1 does not recognize gain or loss upon its sale of the old T stock to P.

Example 9. (i) The facts are the same as in Example 8, except that P already owns 20 percent of the T stock, which is nonrecently purchased stock with a basis of \$6,000, and that P purchases the remaining 80 percent of the T stock from S1 for \$64,000.

(ii) The results are the same as in Example 8, except that under paragraph (d)(1) of this section and § 1.338–5(d), P is deemed to have made a gain recognition election for its nonrecently purchased T stock. As a result, P recognizes gain of \$10,000 and its basis in the nonrecently purchased T stock is increased from \$6,000 to \$16,000. P's basis in all the T stock is \$80,000 (i.e., $\$64,000 + \$16,000$). The computations are as follows:

(A) P's grossed-up basis for the recently purchased T stock is \$64,000 (i.e., $\$64,000$ (the basis of the recently purchased T stock) $\times (1-.2)/(.8)$ (the fraction in section 338(b)(4))).

(B) P's basis amount for the nonrecently purchased T stock is \$16,000 (i.e., $\$64,000$ (the grossed-up basis in the recently purchased T stock) $\times (.2)/(1.0-.2)$ (the fraction in section 338(b)(3)(B))).

(C) The gain recognized on the nonrecently purchased stock is \$10,000 (i.e., $\$16,000 - \$6,000$).

Example 10. (i) T is an S corporation whose sole class of stock is owned 40 percent each by A and B and 20 percent by C. T, A, B, and

C all use the cash method of accounting. A and B each has an adjusted basis of \$10,000 in the stock. C has an adjusted basis of \$5,000 in the stock. A, B, and C hold no installment obligations to which section 453A applies. On March 1 of Year 1, A sells its stock to P for \$40,000 in cash and B sells its stock to P for a \$25,000 note issued by P and real estate having a fair market value of \$15,000. The \$25,000 note, due in full in Year 7, is not publicly traded and bears adequate stated interest. A and B have no selling expenses. T's sole asset is real estate, which has a value of \$110,000 and an adjusted basis of \$35,000. Also, T's real estate is encumbered by long-outstanding purchase-money indebtedness of \$10,000. The real estate does not have built-in gain subject to section 1374. A, B, and C join with P in making a section 338(h)(10) election for T.

(ii) Solely for purposes of application of sections 453, 453A, and 453B, old T is considered in its deemed asset sale to receive back from new T the \$25,000 note (considered issued by new T) and \$75,000 of cash (total consideration of \$80,000 paid for all the stock sold, which is then divided by .80 in the grossing-up, with the resulting figure of \$100,000 then reduced by the amount of the installment note). Absent an election under section 453(d), gain is reported by old T under the installment method.

(iii) In applying the installment method to old T's deemed asset sale, the contract price for old T's assets deemed sold is \$100,000, the \$110,000 selling price reduced by the indebtedness of \$10,000 to which the assets are subject. (The \$110,000 selling price is itself the sum of the \$80,000 grossed-up in paragraph (ii) above to \$100,000 and the \$10,000 liability.) Gross profit is \$75,000 (\$110,000 selling price - old T's basis of \$35,000). Old T's gross profit ratio is 0.75 (gross profit of \$75,000 ÷ \$100,000 contract price). Thus, \$56,250 ($0.75 \times$ the \$75,000 cash old T is deemed to receive in Year 1) is Year 1 gain attributable to the

sale, and \$18,750 ($\$75,000 - \$56,250$) is recovery of basis.

(iv) In its liquidation, old T is deemed to distribute the \$25,000 note to B, since B actually sold the stock partly for that consideration. To the extent of the remaining liquidating distribution to B, it is deemed to receive, along with A and C, the balance of old T's liquidating assets in the form of cash. Under section 453(h), B, unless it makes an election under section 453(d), is not required to treat the receipt of the note as a payment for the T stock; P's payment of the \$25,000 note in Year 7 to B is a payment for the T stock. Because section 453(h) applies to B, old T's deemed liquidating distribution of the note is, under section 453B(h), not treated as a taxable disposition by old T.

(v) Under section 1366, A reports 40 percent, or \$22,500, of old T's \$56,250 gain recognized in Year 1. Under section 1367, this increases A's \$10,000 adjusted basis in the T stock to \$32,500. Next, in old T's deemed liquidation, A is considered to receive \$40,000 for its old T shares, causing it to recognize an additional \$7,500 gain in Year 1.

(vi) Under section 1366, B reports 40 percent, or \$22,500, of old T's \$56,250 gain recognized in Year 1. Under section 1367, this increases B's \$10,000 adjusted basis in its T stock to \$32,500. Next, in old T's deemed liquidation, B is considered to receive the \$25,000 note and \$15,000 of other consideration. Applying section 453, including section 453(h), to the deemed liquidation, B's selling price and contract price are both \$40,000. Gross profit is \$7,500 ($\$40,000$ selling price - B's basis of \$32,500). B's gross profit ratio is 0.1875 (gross profit of \$7,500 ÷ \$40,000 contract price). Thus, \$2,812.50 ($0.1875 \times \$15,000$) is Year 1 gain attributable to the deemed liquidation. In Year 7, when the \$25,000 note is paid, B has \$4,687.50 ($0.1875 \times \$25,000$) of additional gain.

(vii) Under section 1366, C reports 20 percent, or \$11,250, of old T's \$56,250 gain recognized in Year 1. Under section 1367, this increases C's \$5,000 adjusted basis in its T stock to \$16,250. Next, in old T's deemed liquidation, C is considered to receive \$20,000 for its old T shares, causing it to recognize an additional \$3,750 gain in Year 1. Finally, under paragraph (d)(5)(ii) of this section, C is considered to acquire its stock in T on the day after the acquisition date for \$20,000 (fair market value = grossed-up amount realized of \$100,000 × 20%). C's holding period in the stock deemed received in new T begins at that time.

Example 11. Stock acquisition followed by upstream merger—without section 338(h)(10) election.

(i) P owns all the stock of Y, a newly formed subsidiary. S owns all the stock of T. Each of P, S, T and Y is a domestic corporation. P acquires all of the T stock in a statutory merger of Y into T, with T surviving. In the merger, S receives consideration consisting of 50% P voting stock and 50% cash. Viewed independently of any other step, P's acquisition of T stock constitutes a qualified stock purchase. As part of the plan that includes P's acquisition of the T stock, T subsequently merges into P. Viewed independently of any other step, T's merger into P qualifies as a liquidation described in section 332. Absent the application of paragraph (c)(2) of this section, the step transaction doctrine would apply to treat P's acquisition of the T stock and T's merger into P as an acquisition by P of T's assets in a reorganization described in section 368(a). P and S do not make a section 338(h)(10) election with respect to P's purchase of the T stock.

(ii) Because P and S do not make an election under section 338(h)(10) for T, P's acquisition of the T stock and T's merger into P is treated as part of a reorganization described in section 368(a).

Example 12. Stock acquisition followed by upstream merger—with section 338(h)(10) election.

(i) The facts are the same as in Example 11 except that P and S make a joint election under section 338(h)(10) for T.

(ii) Pursuant to paragraph (c)(2) of this section, as a result of the election under section 338(h)(10), for all Federal tax purposes, P's acquisition of the T stock is treated as a qualified stock purchase and P's acquisition of the T stock is not treated as part of a reorganization described in section 368(a).

Example 13. Stock acquisition followed by brother-sister merger—with section 338(h)(10) election. (i) The facts are the same as in Example 12, except that, following P's acquisition of the T stock, T merges into X, a domestic corporation that is a wholly owned subsidiary of P. Viewed independently of any other step, T's merger into X qualifies as a reorganization described in section 368(a). Absent the application of paragraph (c)(2) of this section, the step transaction doctrine would apply to treat P's acquisition of the T stock and T's merger into X as an acquisition by X of T's assets in a reorganization described in section 368(a).

(ii) Pursuant to paragraph (c)(2) of this section, as a result of the election under section 338(h)(10), for all Federal tax purposes, P's acquisition of T stock is treated as a qualified stock purchase and P's acquisition of T stock is not treated as part of a reorganization described in section 368(a).

Example 14. Stock acquisition that does not qualify as a qualified stock purchase followed by upstream merger. (i) The facts are the same as in Example 11, except that, in the statutory merger of Y into T, S receives only P voting stock.

(ii) Pursuant to § 1.338-3(c)(1)(i) and paragraph

(c)(2) of this section, no election under section 338(h)(10) can be made with respect to P's acquisition of the T stock because, pursuant to relevant provisions of law, including the step transaction doctrine, that acquisition followed by T's merger into P is treated as a reorganization described in section 368(a)(1)(A), and that acquisition, viewed independently of T's merger into P, does not constitute a qualified stock purchase under section 338(d)(3). Accordingly, P's acquisition of the T stock and T's merger into P is treated as a reorganization described in section 368(a).

(f) Inapplicability of provisions. The provisions of section 6043, §§ 1.331-1(d) and 1.332-6 (relating to information returns and recordkeeping requirements for corporate liquidations) do not apply to the deemed liquidation of old T under paragraph (d)(4) of this section.

(g) Required information. The Commissioner may exercise the authority granted in section 338(h)(10)(C)(iii) to require provision of any information deemed necessary to carry out the provisions of section 338(h)(10) by requiring submission of information on any tax reporting form.

(h) Effective date. This section is applicable to stock acquisitions occurring on or after July 5, 2006. For stock acquisitions occurring before July 5, 2006, see § 1.338(h)(10)-1T as contained in the edition of 26 CFR part 1, revised as of April 1, 2006.

[T.D. 8940, 66 FR 8950, Feb. 13, 2001, as amended by T.D. 9071, 68 FR 40768, July 9, 2003; T.D. 9264, 71 FR 30607, May 30, 2006; T.D. 9271, 71 FR 38075, July 5, 2006; T.D. 9329, 72 FR 32808, June 14, 2007]

§ 1.338(i)-1 Effective/applicability date.

(a) In general. The provisions of §§ 1.338-1 through 1.338-7, 1.338-10 and

1.338(h)(10)-1 apply to any qualified stock purchase occurring after March 15, 2001. For rules applicable to qualified stock purchases on or before March 15, 2001, see §§ 1.338-1T through 1.338-7T, 1.338-10T, 1.338(h)(10)-1T and 1.338(i)-1T in effect prior to March 16, 2001 (see 26 CFR part 1 revised April 1, 2000).

(b) Section 338(h)(10) elections for S corporation targets. The requirements of §§ 1.338(h)(10)-1T(c)(2) and 1.338(h)(10)-1(c)(2) that S corporation shareholders who do not sell their stock must also consent to an election under section 338(h)(10) will not invalidate an otherwise valid election made on the September 1997 revision of Form 8023, "Elections Under Section 338 For Corporations Making Qualified Stock Purchases," not signed by the nonselling shareholders, provided that the S corporation and all of its shareholders (including nonselling shareholders) report the tax consequences consistently with the results under section 338(h)(10).

(c) Section 338 elections for insurance company targets—(1) In general. The rules of § 1.338-11 apply to qualified stock purchases occurring on or after April 10, 2006.

(2) New target election for retroactive application—(i) Availability of election. New target may make an irrevocable election to apply the rules in §§ 1.338-11 (including the applicable provisions in §§ 1.197-2(g)(5), 381(c)(22)-1, and 846) in whole, but not in part, to a qualified stock purchase occurring before April 10, 2006 for which a section 338 election is made, provided that new target's first taxable year and all subsequent affected taxable years are years for which an assessment of deficiency or a refund for overpayment is not prevented by any law or rule of law. In the case of a section 338 election for which a section 338(h)(10) election is made (or

a section 338 election for a foreign target), new target may make the election to apply the regulations retroactively without regard to whether old target makes the election. In the case of a section 338 election for a domestic target for which no section 338(h)(10) election is made, new target may make the election to apply the regulations retroactively only if old target also makes the election. Paragraph (c)(2)(ii) of this section prescribes the time and manner of the election for new target.

(ii) Time and manner of making the election for new target. New target may make an election described in paragraph (c)(2)(i) of this section by attaching a statement to its original or amended income tax return for its first taxable year. The statement must be entitled “Election to Retroactively Apply the Rules in §§ 1.338–11 (including the applicable provisions in §§ 1.197–2(g)(5), 1.381(c)(22)–1 and 846) in whole to a transaction completed before April 10, 2006” and must include the following information—

(A) The name and E.I.N. for new target; and

(B) The following declaration (or a substantially similar declaration): New target has amended its income tax returns for its first taxable year and for all affected subsequent years to reflect the rules in §§ 1.338–11 (including the applicable provisions in §§ 1.197–2(g)(5), 1.381(c)(22)–1 and 846). All other parties whose income tax liabilities are affected by new target’s election have amended their income tax returns for all affected years to reflect the rules in §§ 1.338–11 (including the applicable provisions in §§ 1.197–2(g)(5), 1.381(c)(22)–1 and 846).

(3) Old target election for retroactive application—(i) Availability of election. Old target may make an irrevocable

election to apply the rules in §§ 1.338–11 (including the applicable provisions in §§ 1.197–2(g)(5), 1.381(c)(22)–1 and 846) in whole, but not in part, to a qualified stock purchase occurring before April 10, 2006 for which a section 338 election is made, provided that old target’s taxable year that includes the deemed sale tax consequences and all subsequent affected taxable years are years for which an assessment of deficiency or a refund for overpayment is not prevented by any law or rule of law. In the case of a section 338 election for which a section 338(h)(10) election is made (or a section 338 election for a foreign target), old target may make the election to apply the regulations retroactively without regard to whether new target makes the election. In the case of a section 338 election for a domestic target for which no section 338(h)(10) election is made, old target may make the election to apply the regulations retroactively only if new target also makes the election. Paragraph (c)(3)(ii) of this section prescribes the time and manner of the election for old target.

(ii) Time and manner of making the election for old target. Old target may make an election described in paragraph (c)(3)(i) of this section by attaching a statement to each affected party’s original or amended income tax return for the taxable year that includes the deemed sale tax consequences. The statement must be entitled “Election to Retroactively Apply the Rules in §§ 1.338–11 (including the applicable provisions in §§ 1.197–2(g)(5), 1.381(c)(22)–1 and 846) to a transaction completed before April 10, 2006” and must include the following information—

(A) The name and E.I.N. for old target; and

(B) The following declaration (or a substantially similar declaration): Old target has amended its income tax returns for the taxable year that includes the deemed sale tax consequences and

for all affected subsequent years to reflect the rules in §§ 1.338–11 (including the applicable provisions in §§ 1.197–2(g)(5), 1.381(c)(22)–1 and 846). All other parties whose income tax liabilities are affected by old target’s election have amended their income tax returns for all affected years to reflect the rules in §§ 1.338–11 (including the applicable provisions in §§ 1.197–2(g)(5), 1.381(c)(22)–1 and 846).

[T.D. 8940, 66 FR 9954, Feb. 13, 2001, as amended by T.D. 9257, 71 FR 18003, Apr. 10, 2006; T.D. 9377, 73 FR 3873, 3874, Jan. 23, 2008]

COLLAPSIBLE CORPORATIONS; FOREIGN PERSONAL HOLDING COMPANIES

§ 1.341–1 Collapsible corporations; in general.

Subject to the limitations contained in § 1.341–4 and the exceptions contained in § 1.341–6 and § 1.341–7

(a), the entire gain from the actual sale or exchange of stock of a collapsible corporation,

(b) amounts distributed in complete or partial liquidation of a collapsible corporation which are treated, under section 331, as payment in exchange for stock, and

(c) a distribution made by a collapsible corporation which, under section 301(c)(3), is treated, to the extent it exceeds the basis of the stock, in the same manner as a gain from the sale or exchange of property, shall be considered as ordinary income.

[T.D. 7655, 44 FR 68459, Nov. 29, 1979]

§ 1.341–2 Definitions.

(a) Determination of collapsible corporation.

(1) A collapsible corporation

is defined by section 341(b)(1) to be a corporation formed or availed of principally

(i) for the manufacture, construction, or production of property,

(ii) for the purchase of property which (in the hands of the corporation) is property described in section 341(b)(3), or

(iii) for the holding of stock in a corporation so formed or availed of, with a view to

(a) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the taxable income to be derived from such property, and

(b) the realization by such shareholders of gain attributable to such property. See § 1.341–5 for a description of the facts which will ordinarily be considered sufficient to establish whether or not a corporation is a collapsible corporation under the rules of this section. See paragraph (d) of § 1.341–5 for examples of the application of section 341.

(2) Under section 341(b)(1) the corporation must be formed or availed of with a view to the action therein described, that is, the sale or exchange of its stock by its shareholders, or a distribution to them prior to the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the taxable income to be derived from such property, and the realization by the shareholders of gain attributable to such property. This requirement is satisfied in any case in which such action was contemplated by those persons in a position to determine the policies of the corporation, whether by reason of their owning a majority of the voting

stock of the corporation or otherwise. The requirement is satisfied whether such action was contemplated, unconditionally, conditionally, or as a recognized possibility. If the corporation was so formed or availed of, it is immaterial that a particular shareholder was not a shareholder at the time of the manufacture, construction, production, or purchase of the property, or if a shareholder at such time, did not share in such view. Any gain of such a shareholder on his stock in the corporation shall be treated in the same manner as gain of a shareholder who did share in such view. The existence of a bona fide business reason for doing business in the corporate form does not, by itself, negate the fact that the corporation may also have been formed or availed of with a view to the action described in section 341(b).

(3) A corporation is formed or availed of with a view to the action described in section 341(b) if the requisite view existed at any time during the manufacture, production, construction, or purchase referred to in that section. Thus, if the sale, exchange, or distribution is attributable solely to circumstances which arose after the manufacture, construction, production, or purchase (other than circumstances which reasonably could be anticipated at the time of such manufacture, construction, production, or purchase), the corporation shall, in the absence of compelling facts to the contrary, be considered not to have been so formed or availed of. However, if the sale, exchange or distribution is attributable to circumstances present at the time of the manufacture, construction, production, or purchase, the corporation shall, in the absence of compelling