§ 1.338–10

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(b) The 10 shares of nonrecently purchased CFCT stock held by P are carryover FT stock under paragraph (b)(3) of this section. Accordingly, the earnings and profits (and attributes of the assets) of $100 of 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 had it made a deemed sale of assets. Y must then determine the extent to which section 1248 dictates any increase in CFCT’s earnings and profits due to the deemed sale of assets. Y’s deemed sale of assets is determined as if the assets deemed sold are used in the conduct of an active trade or business in possession of T for purposes of 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 possession of T for purposes of section 936(a)(1)(A)(ii) 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) For the short taxable year ending June 30, 1995, Y sells its CFCT stock to P. On June 30, 1995, Y sells its CFCT stock to P. P makes a section 338 election for the 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 40% 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 § 1.951–1(b)(2)):

<table>
<thead>
<tr>
<th>FT’s subpart F income for 1994</th>
<th>$500.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>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 ($500×182/365)</td>
<td>249.32</td>
</tr>
</tbody>
</table>

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%×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). To the extent that the assets deemed sold are used in the conduct of an active trade or business in possession of new T for purposes of section 936(a)(1)(A)(ii), 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 §1.1502-76(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
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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 1569(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
§ 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–