§ 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.

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(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 § 1.338–4(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.

(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 sale 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, 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, 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).

(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 complete cancellation or redemption of all of 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-subsidiary 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 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.
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(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 part 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. 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) Assume that, if the T stock had not itself been sold but T had instead sold both its inventory and Newco stock to P, P would for tax purposes be deemed instead to have sold both its inventory and Newco stock to T. 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 distribute half its assets to its shareholder, 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 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 368(e)(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 § 1.338–6, AGUB would be $100. Under the allocation rules of § 1.338–6, and not section 338(h)(10), the $100 would be allocated to the Class II asset, the actively traded security, and no amount would be allocated to the inventory. 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 thereunder shall produce a Federal income tax result under subtitle A of the Internal Revenue Code that would not occur if the parties had
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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 have occurred. Hence, the deemed sale of assets under section 338(h)(10) should be treated as one of the inventory and actually 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 newly traded security themselves, not of the inventory and the Newco stock. Otherwise, the anti-abuse rule might apply.

Example 6. T, a member of a selling consolidated group, has only one class of stock, all of which is owned by S. On March 1 of Year 2, S 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. S 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).

(i) ADSP of $120,000 ($80,000 + $40,000 + $0) is allocated to each asset as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Basis</th>
<th>FMV</th>
<th>Fraction</th>
<th>Allocable ADSP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$50,000</td>
<td>$75,000</td>
<td>5⁄9</td>
<td>$66,667</td>
</tr>
<tr>
<td>Equipment</td>
<td>30,000</td>
<td>60,000</td>
<td>5⁄9</td>
<td>53,333</td>
</tr>
<tr>
<td>Total</td>
<td>80,000</td>
<td>135,000</td>
<td>1</td>
<td>120,000</td>
</tr>
</tbody>
</table>

(ii) 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).

(iii) 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 upon its deemed sale of the equipment. See paragraph (d)(4) of this section and section 332.

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 remains at $5,000.

(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 upon its deemed sale of the equipment. See section 332.

Example 8. (i) The facts are the same as in Example 7, except that K already owns 20 percent of the T stock that is not acquired by P in the qualified stock purchase. K’s basis in its T stock remains at $5,000.

(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 upon its deemed sale of the equipment. See section 332.
made a gain recognition election for its non-recently purchased T stock. As a result, P recognizes gain of $10,000 and its basis in the nonrecently purchased T stock is increased from $64,000 to $75,000. P’s payment of the $25,000 note and $15,000 of other consideration is treated as a payment of the note and as a payment of the stock. Because section 453(h) applies to B, old T’s deemed liquidating distribution of the note is, under section 453(h)(6), not treated as a taxable disposition by old T.

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’s real estate is encumbered by long-outstanding purchase-money indebtedness of $100,000. The real estate does not have built-in gain subject to section 1374. 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 $100,000. 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. In Year 1, gains attributable 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 × $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 × $25,000) of additional gain.

(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 $150,000 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 ($130,000 selling price – old T’s basis of $55,000). Old T’s gross profit ratio is 0.75 (gross profit of $75,000 ÷ $100,000 contract price). Thus, $62,500 ($75,000 × 0.75). Old T is deemed to receive in Year 1) is Year 1 gain attributable to the sale, and $18,750 ($75,000 – $62,500) 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 453(h), not treated as a taxable disposition by old T.

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
§ 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.