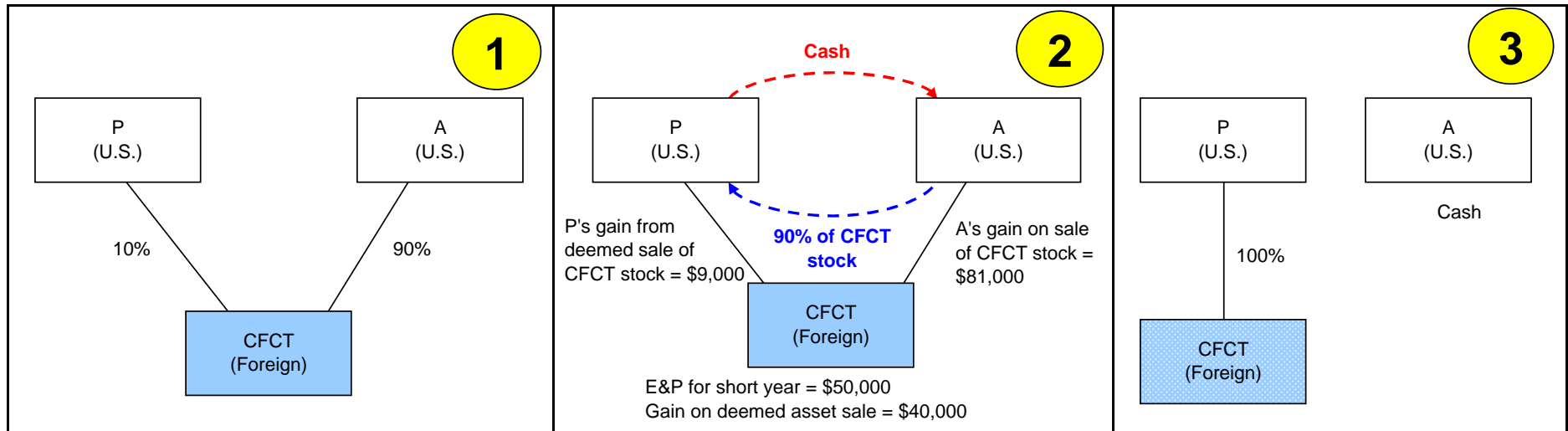


**Section 1248 Gain on QSP of a CFC  
With Gain Recognition Election**

Initial Structure (Since 1989)

QSP & 338 Election (Nov. 1, 1994)

Ending Point



A has owned 90 of the 100 shares of CFCT stock since CFCT was organized in 1989. P has owned the remaining 10 shares of CFCT stock since CFCT was organized. 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). 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. A recognizes gain of \$81,000 on the sale of the CFCT stock. Further, CFCT recognizes gain of \$40,000 by reason of its deemed sale of assets under section 338(a)(1).

A's sale of CFCT stock to P is a transfer to which section 1248 applies. 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)).

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 X 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)).