Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Ridley-Thomas	Analyst:	Gail Hall	Bill Number:	AB 2830
Related Bills:	See Legislative History	Telephone:	845-6111	Introduced Date:	February 24, 2006
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Election To Treat Certain Stock Purchases As Asset Acquisitions For Federal Purposes Shall Be Treated As a State Election

SUMMARY

This bill provides special rules for taxpayers electing to treat certain sales of stock as sales of assets.

PURPOSE OF THE BILL

According to the author's staff, the purpose of this bill is to promote consistent reporting of income between states so taxpayers pay their fair share of the tax.

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy and would be effective immediately upon enactment, and it would be operative for taxable years beginning on or after January 1, 2006.

POSITION

Pending.

ANALYSIS

Federal Law

Generally, a parent corporation that sells the stock of another corporation will report a gain or loss on the sale of stock. The purchasing corporation records the purchase price as the new stock basis of the purchased corporation's stock.

A purchasing corporation may make a "straight" Internal Revenue Code (IRC) Section 338 election, referred to as a "338" election for this analysis,[1] to treat the purchase of stock of a target corporation as an asset acquisition. The selling corporation still reports its gain or loss from the stock sale, but the target is treated as if it sold its assets for fair market value immediately before the acquisition. A purchasing corporation, along with the selling corporation, may jointly make an IRC Section 338(h)(10) election, referred to as a "338(h)(10)" election for this analysis, whereby

[1] IRC Section 338(g).

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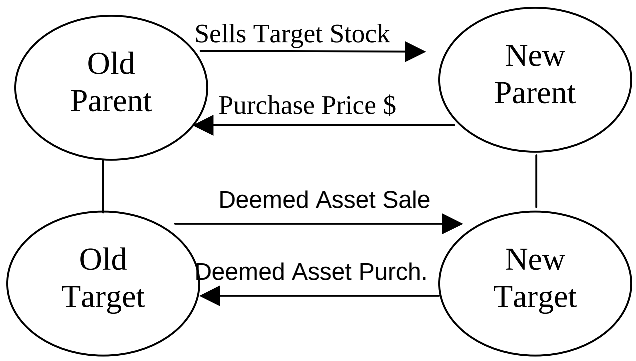
both the seller and the buyer treat the stock sale as a deemed asset sale. Illustrated below are examples of 338 and 338(h)(10) elections:

338 Election

Under a 338 election, a corporation that purchases the stock of a target corporation can elect to treat the transaction as a deemed purchase of the assets of the target corporation. The 338 election is illustrated below:



Facts:

- Old Parent sells the stock of Old Target to New Parent.
- New Parent makes a 338 election to treat the stock purchase as an asset purchase.

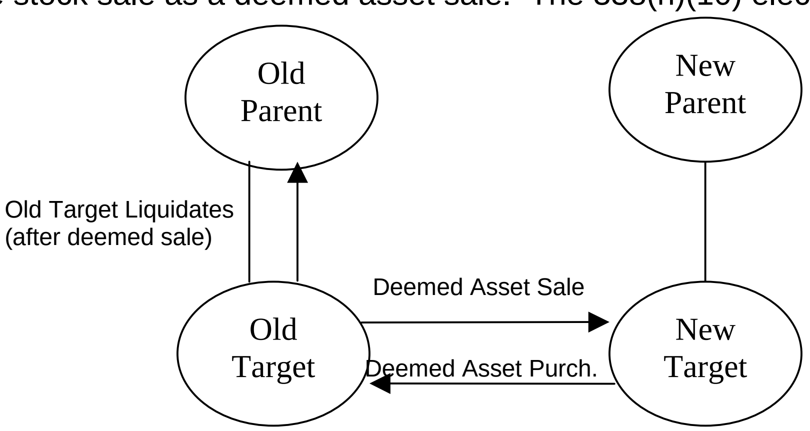
Tax Consequences:

- The Old Parent records a gain or loss on the sale of stock.
- The New Parent has no tax effect and the purchase price is the new stock basis for New Target.
- The Old Target is treated as if it sold its assets for fair market value immediately before the acquisition, and records a gain or loss on sale of assets.
- The New Target will adjust the basis of its purchased assets at the deemed purchase price.

Only the New Parent need make the 338 election in order for it to be a valid federal election.

338(h)(10) Election

A 338(h)(10) election is a variation of the 338 election whereby both the new parent and the old parent treat the stock sale as a deemed asset sale. The 338(h)(10) election is illustrated below:



Facts:

- Old Parent sells to New Parent the stock of Old Target
- Old Parent and New Parent make a 338(h)(10) election, and both treat the stock sale as a deemed asset sale.

Tax Consequences:

- Old Parent does not treat the transaction as a sale of stock and no gain on sale of stock is reported.
- Old Target treats the stock sale as a deemed asset sale and reports the gain or loss on the sale of its assets.
- New Parent treats the transaction as if it purchased a new corporation.
- New Target reports its assets at its deemed purchase price.
- Old Target is deemed to liquidate into its Old Parent tax-free.

Old Target must be a part of the affiliated group as Old Parent before a 338(h)(10) election is allowed. In addition, both the Old Parent and the New Parent are required to make the 338(h)(10) election before it is a valid federal election.

State Law

California generally conforms to IRC 338 and the elections discussed above. A 338 or 338(h)(10) election filed with the Internal Revenue Service (IRS) is deemed to be an election for California purposes unless the taxpayer expressly elects not to apply the federal election. Also, current law allows a California taxpayer subject to the Corporation Tax Law to make a 338 or 338(h)(10) election, even though the taxpayer did not make the election for federal purposes.

Corporations are taxed in California only on income from California sources. There are two broad categories of source: business income and nonbusiness income. If an income item is part of a business conducted within and without the state, that income item is apportioned (assigned to California based on a formula). If an income item is a passive investment, it is usually allocated to commercial domicile. Commercial domicile is defined as the principal place where the business of the taxpayer is directed or managed.

THIS BILL

This bill would provide that:

- a federal election under 338 or 338(h)(10) shall be treated as a binding election for state purposes, without exception, and
- a valid federal 338 or 338(h)(10) election must be made before the state election is allowed.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would not significantly impact the department’s programs and operations.

LEGISLATIVE HISTORY

AB 1525 (Levine, 2005/2006) would have provided provisions relating to 338 elections identical to this bill. In addition, AB 1525 would have provided a tax credit for members of the California National Guard and their families that purchase health care. AB 1525 did not pass both houses by the constitutional deadline.

AB 2891 (Stats. 1986, Ch. 550) provided that a proper federal election is deemed to be a proper California election. It also provided that a taxpayer may elect to not follow the federal election. In addition, the bill provided that a taxpayer may make a separate state election that is different from federal.

AB 2797 (Cardoza, Stats. 1998, Ch. 322) enacted the 338 election requirements discussed in this bill, but only for “S” corporations.

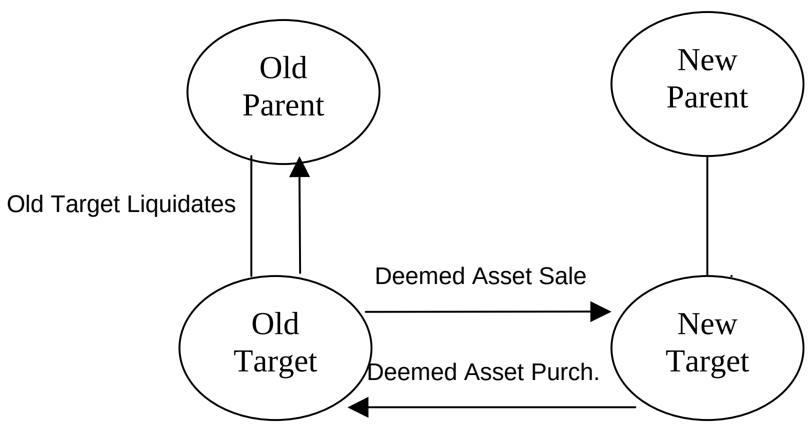
PROGRAM BACKGROUND

Corporations make different federal versus state 338 elections for a number of reasons, including changing where the income will be taxed for state and federal purposes.

Current law allows taxpayers flexibility in making 338 elections. Because the rules for assigning income to California differ between a gain on the sale of stock and a gain on the sale of assets (based on whether the income generated is business or nonbusiness income), a taxpayer has the ability to choose how to assign income to California.

The ability to make a 338 election for California purposes that is different than the federal election allows taxpayers to choose inconsistent sourcing rules between the states, even if the states have otherwise identical rules for assigning income. By choosing inconsistent sourcing rules, taxpayers have the opportunity to create “nowhere income.” “Nowhere income” exists when the sum of the income amounts assigned to the various states by their respective sourcing rules don’t add up to 100% of the taxpayer’s income. “Nowhere income” is seen as inequitable because it allows multistate and multinational corporations to avoid taxation of income that “wholly instate” businesses cannot, because a “wholly instate” business has no opportunity to take advantage of inconsistent application of law between states.

Below are examples showing how a California taxpayer can use the 338(h)(10) election to create “nowhere income.”
Example 1:



Facts:

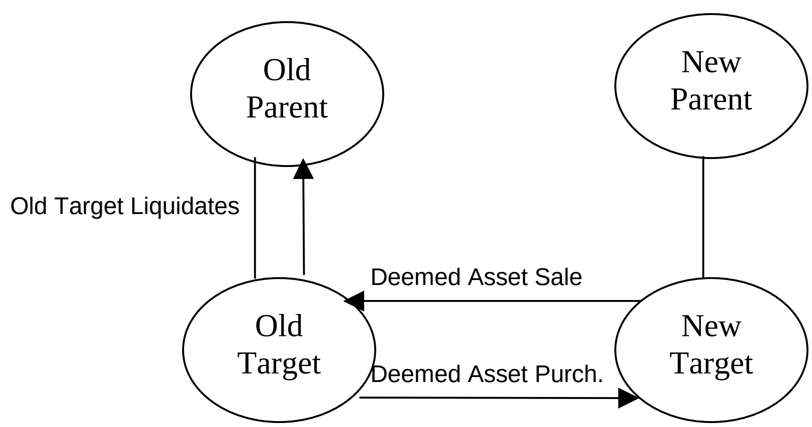
- Old Parent is located in California, and in addition, does business in Illinois.
- Old Target apportions 10% of it income to California and 90% to Illinois.
- Old Target is not part of Old Parent's business operations and is considered an investment.
- Old Parent sells the stock of Old Target to New Parent.
- Old Parent and New Parent make a 338(h)(10) election for California only.

Tax Consequences:

- Illinois would treat this transaction as a "sale of stock" because, for Illinois tax purposes, Old Parent and New Parent did not elect 338(h)(10) treatment. The gain from the sale of stock, because it is nonbusiness income, would not be taxed in Illinois but instead would be allocated to California, the commercial domicile of Old Parent.
- California would treat this transaction as a "sale of assets" by Old Target. Assuming the gain generated is business income, Old Target would apportion 10% of the gain on sale of assets to California and 90% to Illinois.

This example shows that a taxpayer can make a 338(h)(10) election for California purposes and create "nowhere" income. As the example shows, 10% of the gain is taxable in California, but 90% of the gain is apportioned to Illinois. The 90% apportioned to Illinois would not be taxed by Illinois because, for Illinois purposes, there was no sale of assets but just a sale of Old Target's stock, and is therefore considered "nowhere" income.

Example 2



Facts:

- Old Parent is located in Illinois, and in addition, is subject to California tax.
- Old Target is a subsidiary of Old Parent, is not part of Old Parent's business operation, and is considered an investment.
- Old Target apportions 50% of its income to California and 50% of its income to Nevada.
- Old Parent and New Parent make a 338(h)(10) election for federal and Illinois purposes.

Tax Consequences:

- California would treat this transaction as a sale of stock because no 338(h)(10) election was made. The gain from this transaction would not be taxable in California, but instead would be allocated 100% to Illinois, Old Parent's commercial domicile.
- A 338(h)(10) election was made for Illinois tax purposes; therefore, Illinois will treat the transaction as a sale of assets by Old Target and apportion the gain 50% to California, 50% to Nevada, and 0% to Illinois.

As this example shows, since Illinois made a 338(h)(10) election for Illinois tax purposes only, the tax burden shifts to California and Nevada. The tax burden shifts to Illinois because no election was made for California tax purposes. There is no corporate tax in Nevada. In this example, this gain is not taxed in any state, creating "nowhere income" to the extent of 100% of the Old Target's gain.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Minnesota*, and *New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

- *Florida* binds all federal elections where applicable. The *Florida* Department of Revenue may consent to a separate election if the Department of Revenue determines that the federal election would not clearly reflect income.
- *Illinois* binds all federal elections where applicable. *Illinois* provides if a 338 election is made, no separate Illinois election is necessary (or possible).
- *Massachusetts* generally binds all federal elections. *Massachusetts* does not have a published position on whether a separate 338 election is allowed, and instead recommends that taxpayers request a ruling on specific reorganizations where separate 338 elections are desired.
- *Michigan* binds a separate 338 election.
- *Minnesota* generally binds all federal elections. Research did not disclose whether *Minnesota* allows separate 338 elections.
- *New York* generally binds all federal elections. Research did not disclose whether *New York* allows separate 338 elections.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this bill would generate the following revenue gains.

Estimated Revenue Impact of AB 2830 As Introduced 2/24/06 [$ In Millions]		
2006-07	2007-08	2008-09
$55	$60	$65

Revenue Discussion

The revenue impact of the bill would be determined by the difference in income assigned to California under the proposal compared with present law, the average apportionment factor, and the average tax rate of corporations making elections for treatment of certain acquisitions.

Based on available data, merger and acquisition spending in the U.S. totaled $777 billion in 2004. The following adjustments were applied to this data.

- Acquisition spending is assumed to represent one-quarter of total merger and acquisition spending, or nearly $195 billion ($777 billion x 1/4 = $195 billion);
- Of total acquisition spending, 50% is assumed gain on transactions, or $98 billion ($195 billion x 50% = $98 billion);
- The portion of gain on transactions affected by inconsistent sourcing rules (i.e., IRC Section 338 elections) and creating "nowhere income" is projected at 12.5%, or $12.3 billion ($98 billion x 12.5% = $12.3 billion);
- An average apportionment factor of 6.5% was applied (6.5% x $12.3 billion = $800 million);
- And an average tax rate of 6% was applied (6% x $800 million = $48 million).

The estimate at the 2004 level is grown to subsequent taxable years by the projected growth in corporate profits as forecasted by the Department of Finance. Taxable year estimates are converted to cash flow estimates in the table.

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