



09.15.08

CHIEF COUNSEL RULING 2008-2

Subject: Request for Chief Counsel Ruling for *** & *******

Dear *****:

This is in response to your Chief Counsel Ruling Request of September 4, 2008 wherein you seek guidance as to how gains resulting from a California-only election made pursuant to Internal Revenue Code (IRC) section 338(g) are apportioned and reported for California tax purposes when a taxpayer is not a member of the seller's federal consolidated return group because it had a foreign parent corporation prior to the sale.

FACTS

***** owned all of the stock of ***** and Corporation B, both domestic corporations established in the United States. ***** and Corporation B filed separate federal income tax returns because there was no United States common parent and no federal consolidated income tax return election in effect. ***** and Corporation B filed in California on a water's-edge basis that excluded ***** from the unitary combined reporting group. ***** and Corporation B were California taxpayer members in the water's-edge unitary combined reporting group. The stock of ***** and Corporation B constituted assets that produce apportionable business income to ***** , while all of ***** and Corporation B's assets produce apportionable business income to ***** and Corporation B, respectively.

On ***** , ***** (Buyer), a California taxpayer, acquired all of the stock of ***** (*****) from ***** (Seller). ***** will be included in Buyer's federal consolidated return group as of December 29, 2007. Buyer's taxable year-end is December 31, 2007. Pursuant to IRC section 338(g), Buyer will, for California purposes only, elect to treat the transaction as a deemed sale of assets by ***** . The gain on the deemed sale of assets by ***** constitutes apportionable business income for ***** .

RULINGS REQUESTED

1. On a short period return, ***** will report its share of the *****/Corporation B unitary combined reporting group's apportionable business income for the period from January 1, 2007, through December 28, 2007 (pre-sale short period). Partial period combined reporting rules will be used to determine ***** share of the combined reporting group's apportionable business income for pre-sale short period. ***** will report the gain from the deemed sale of assets due to Buyer's IRC section 338(g) election on a "one day return. The IRC section 338(g) gain will be apportioned using factors associated with the deemed

sale of the assets. The property factor will be the basis of ***** assets prior to the stock sale. (Based on an average of the basis at the beginning of the taxable year and the basis at the time of the stock sale). The sales factor equals the sales proceeds from the deemed asset sale. Thereafter, because ***** is not unitary with Buyer, ***** will report the income resulting from ***** operations for the period of December 29, 2007, through December 31, 2007 (post-sale short period), on a short period return.

2. On a short period return, ***** will report its share of the *****/Corporation B unitary combined reporting group's apportionable business income for the period from January 1, 2007, through December 28, 2007 (pre-sale short period). Partial period combined reporting rules will be used to determine ***** share of the combined reporting group's apportionable business income for pre-sale short period. ***** will report the gain from the deemed sale of assets due to Buyer's IRC section 338(g) election on a "one day return. The IRC section 338(g) gain will be apportioned using factors associated with the deemed sale of the assets. The property factor will be the basis of ***** assets prior to the stock sale. (Based on an average of the basis at the beginning of the taxable year and the basis at the time of the stock sale). The sales factor equals the sales proceeds from the deemed asset sale. Thereafter, because ***** is unitary with Buyer, ***** will report its share of the *****/Buyer unitary combined reporting group's apportionable business income for the period of December 29, 2007 through December 31, 2007 on a short period return. Partial period combined reporting rules will be used to determine ***** share of the combined reporting group's apportionable business income.

HOLDINGS

On a "short period" return, ***** will report its share of the *****/Corporation B unitary combined reporting group's apportionable business income from January 1, 2007, through December 28, 2007 (pre-sale short period). Partial period combined reporting rules will be used to determine ***** share of the combined reporting group's apportionable business income.

On another "short period" return, the IRC section 338(g) gain will be apportioned using factors associated with the deemed sale of the assets. The property factor will be the basis of ***** assets prior to the stock sale. (Based on an average of the basis at the beginning of the taxable year and the basis at the time of the stock sale). The sales factor equals the sales proceeds from the deemed asset sale. The apportioned IRC section 338(g) gain will be reported on the post-sale "short period" return, which will also reflect ***** operations from December 29, 2007 through December 31, 2007.

The Franchise Tax Board will not opine about the apportionment issues involving the situation when ***** is either not unitary with Buyer, or unitary with Buyer. The Chief Counsel Ruling Request does not include any facts indicating that relationship between ***** and Buyer. The Franchise Tax Board does not address hypothetical issues in a Chief Counsel Ruling.

On another "short period" return, the IRC section 338(g) gain will be apportioned using factors associated with the deemed sale of the assets. The property factor will be the basis of ***** assets prior to the stock sale. (Based on an average of the basis at the beginning of the taxable year and the basis at the time of the stock sale). The sales factor equals the sales proceeds from the deemed asset sale. The apportioned IRC section 338(g) gain will be reported on the post-sale "short period" return, which will reflect ***** share of the ***** /Buyer unitary combined reporting group's apportionable business income for the period of December 29, 2007 through December 31, 2007. Partial period combined reporting rules will be used to determine ***** share of the combined reporting group's apportionable business income.

LAW AND ANALYSIS

On May 5, 2006, the Franchise Tax Board issued Legal Ruling 2006-03 that essentially addressed the issue in question. However, pertinent portions of Legal Ruling 2006-03 are only applicable to taxpayers that had been members of the seller's federal consolidated return group. (See Treasury Regulation (Treas. Reg.) section 1.1502-0 et seq.) As mentioned in the facts above, a foreign corporation owned *****. A taxpayer owned by a foreign corporation cannot be included in a federal consolidated return group. IRC section 1501 provides that "a consolidated return [requires] all corporations [to be] members of an affiliated group". IRC section 1504(a)(1)(A) states "[an] 'affiliated group' [is one] or more chains of includable corporations connected through stock ownership with a common parent which is an includable corporation". Pursuant to IRC section 1504(b)(3), a foreign corporation is explicitly excluded as an includable corporation. Therefore, corporations owned by foreign corporations cannot be included in a federal consolidated return group. This Chief Counsel Ruling is required because Legal Ruling 2006-03 does not address how IRC section 338(g) gains are apportioned and reported if a foreign corporation owned a taxpayer involved in an IRC section 338(g) transaction.

California Revenue & Taxation Code (CRTC) section 24451 incorporates by reference Subchapter C of Chapter 1 of Subtitle A of the IRC, which contains IRC section 338¹. CRTC 24451 does not require that a taxpayer must make a IRC section 338 election for Federal purposes in order for there to be an IRC section 338 election for California purposes. Therefore, a taxpayer can make an IRC section 338 election for California purposes only.

An IRC section 338² election allows a corporation that is acquiring the stock of another corporation to treat the transaction as a purchase of assets and not as a stock sale³. (See IRC section 338(a).)

As stated in Treas. Reg. section 1.338-1(a)(1): "[I]f a section 338 election is made, then two separate corporations, old target⁴ and new target, generally are considered to exist.... old target is treated as transferring all of its assets to an unrelated person in exchange for consideration and new target is treated as acquiring all of [old target's] assets from an unrelated person in exchange for consideration...." This transaction is referred to as a "deemed asset sale." (See Treas. Reg. section 1.338-2(c)(6).) According to Treas. Reg. sections 1.338-2(c)(7) and (10), old target must recognize and report the gain from the "deemed asset sale." Thereafter, for purposes of determining the basis of the assets nominally transferred to new target, the stock sale proceeds are allocated among the assets.⁵ (See IRC section 338(b)(1) and (b)(5).)

Appeal of S.C.V. Realty and Development Co. et al., 94-SBE-15, December 14, 1994; rehear. denied, 94-SBE-15-A, August 2, 1995 states: "The deemed sale ... of the target corporation in the [IRC] section 338 election is deemed to occur immediately after the transfer of the stock of the target to the purchasing corporation." Based on this holding, if old target is an apportioning corporation (see CRTC section 25101), it follows that the gain on the "deemed asset sale" cannot be sourced based

¹ The Franchise Tax Board has not issued any regulations pertaining to CRTC section 24451. Consequently, pursuant to CRTC section 23051.5(d), the federal regulations pertaining to IRC section 338 apply for California purposes.

² IRC section 338(h)(10) is not relevant for purposes of this Chief Counsel Ruling.

³ The corporation that sold the stock is not involved in an IRC section 338 election; it treats the transaction as a stock sale.

⁴ Pursuant to IRC section 338(d)(2), a "target corporation" is any corporation whose stock is acquired by another corporation. Treas. Reg. section 1.338-2(b)(17) provides that the term "old target" refers to "target" before the stock acquisition and "new target" refers to "target" after the stock acquisition.

⁵ A possible motivation for the acquiring corporation is that the depreciable basis of the assets of the acquired corporation will be increased, thereby resulting in a greater depreciation expense and lower taxable income.

on its apportionment factor percentage that existed prior to the sale of target's stock. If gain on the "deemed asset sale" is sourced based on its apportionment factor percentage that existed subsequent to the sale of ***** stock, it will reflect the adjusted basis of the assets acquired by new ***** (See tit. 18, California Code of Regulations (CCR) section 25130(a)(1)). If this occurs, the gain on the deemed sale will not be sourced according to the apportionment factor percentage that existed at the time of the sale⁶. Because ***** pre-sale and post-sale apportionment factor percentages cannot be used to source the gain from the deemed asset sale, it follows that the gain from the deemed asset sale must be sourced by reference to the factors relating to the deemed asset sale.

Because the deemed asset sale effectively occurs instantaneously, there would be no payroll attributable to it. Accordingly, the gain from the "deemed asset sale" must be sourced with reference only to the relevant property factor and sales factor. (See FTB Legal Ruling 2006-03).

The pre-sale cost basis of the assets that were the subject to the deemed asset sale is used for property factor purposes. (Based on an average of the basis at the beginning of the taxable year and the basis at the time of the stock sale). According to CRTC section 25129, the assets are attributable to California if they were used here prior to the sale.

With respect to the sales factor, sales will be assigned pursuant to CRTC section 25135 (sales of tangible property) and the regulations adopted pursuant thereto and CRTC section 25136 (sales of other than tangible property) and the regulations adopted pursuant thereto. CCR section 25137(c)(1)(A) does not apply. The sale of assets will give rise to substantial amounts of gross receipts. However, because it is the only transaction in the period, it is not an "occasional" sale.

Moreover, not including the gross receipts from the deemed sale of the assets in ***** sales factor numerator and denominator would not fairly represent the ***** activities. Application of CCR section 25137(c)(1)(A) would require that the gain be apportioned by only relying on the property factor. Although the assignment of the gross receipts in the sales factor might be expected to mirror the assignment of the assets according to the property factor rules, this is not the case for two reasons. First, the property factor is based upon historic cost while the sales factor will be based upon the appreciated value of the assets, and the assets in different jurisdictions may have been acquired at different times and different rates of appreciation may have occurred. Second, the proceeds from the sales of intangibles will be included in the sales factor and intangible property is normally not included in the property factor. Therefore, because the property factor and sales factor are likely to be different and the exclusion of the sales factor will not fairly reflect the activities in each state, it is appropriate to deviate from CCR section 25137 (c)(1)(A).

As mentioned in the facts, ***** will join a federal consolidated return group. Pursuant to Treas. Reg. sections 1.1502-75(f)(1) and 1.1502-76(b)(1), when a corporation joins a federal consolidated return group, that corporation must file two short-period returns. The first short-period return will report ***** taxable income before it joined the federal consolidated return group and the second short-period return will report ***** taxable income after it joined the federal consolidated return group. CRTC section 24634(a)(4) requires a taxpayer to file a short-period return for California purposes if it must file a short-period return for Federal purposes. Therefore, in this instance, for California purposes, ***** must file two short-period returns. The first short-period return will report ***** California-sourced income from January 1, 2007 through December 28,

⁶ This position is supported by the policy set forth in FTB Legal Ruling 413, January 15, 1979. The ruling requires gains from installment sale obligations to be sourced using the apportionment factor percentage that existed at the time of the original transaction.

2007, and the second short-period return will report ***** California-sourced income from December 29, 2007, through December 31, 2007. Because the gain from the deemed asset sale is recognized subsequent to the stock sale, (see *Appeal of S.C.V. Reality and Development Co. et al.*, 94-SBE-15, December 14, 1994; *rehear. denied*, 94-SBE-15-A, August 2, 1995), it will be reported on ***** second short-period return. Accordingly, ***** will not be required to file a "one day" return. (See Treas. Reg. section 1.338-10(a)(2)(i).

Both of ***** California short-period returns must indicate its respective California-sourced income. If ***** was a member of a unitary combined reporting group (see CCR section 25106.5(b)(3)), for either, or both, short periods, ***** share of each respective group's apportionable business income will be determined by relying on the Partial Period Combined Reporting rules contained at CCR section 25106.5-9. Because *Appeal of S.C.V. Reality and Development Co. et al.*, 94-SBE-15, December 14, 1994; *rehear. denied*, 94-SBE-15-A, August 2, 1995 declares that the gain of the deemed asset sale occurs after the stock sale, then the gain, apportioned as outlined above, must be reported on the post-sale short-period return.

Please be advised that the tax consequences expressed in this Chief Counsel Ruling are applicable only to the taxpayer and are based upon and limited to the facts you have submitted. All representations of fact are subject to verification by audit examination. In the event of a change in relevant legislation, or judicial or administrative case law, a change in federal interpretation of federal law in cases where our opinion is based upon such an interpretation, or a change in the material facts or circumstances relating to your request upon which this opinion is based, this opinion may no longer be applicable. It is your responsibility to be aware of these changes, should they occur.

This letter is a legal ruling by the Franchise Tax Board's Chief Counsel within the meaning of CRTS 21012(a)(1). Please attach a copy of this letter and your request to the appropriate return(s) (if any) when filed or in response to any notices or inquiries which might be issued.

Very truly yours,

Craig Swieso
Tax Counsel IV