



STATE OF CALIFORNIA
FRANCHISE TAX BOARD
 Legal Division MS A260
 P.O. Box 1720
 Rancho Cordova, CA 95741-1720
 tel: 916.845.5244 fax: 916.843.6080
 Craig.Swieso@ftb.ca.gov

chair **Betty T. Yee** | member **Fiona Ma, CPA** | member **Michael Cohen**

09.16.16

Chief Counsel Ruling 2016-05

RE: *****

Dear *****:

By letter dated May 6, 201X, you requested a Chief Counsel Ruling with respect to the California tax treatment of an Internal Revenue Code (IRC) section 338(h)(10) election when the target corporation is an insurance company.

FACTS

***** Insurance Company (Insurance Company Target) is a California-domiciled property and casualty insurance company under subsection (a) of section 28 of Article 13 of the California Constitution. *****, Inc. (General Corporation Target) is a California-domiciled general corporation. Insurance Company Target and General Corporation Target are wholly owned by *****, Inc. (Seller), a general corporation.

Seller intends to sell all outstanding shares of capital stock of Insurance Company Target and General Corporation Target to ***** Corp. (Buyer). Both Seller and Buyer are California taxpayers and they will jointly elect under IRC section 338(h)(10) to treat the sale of Insurance Company Target's stock and General Corporation Target's stock as a deemed asset sale for federal and California tax purposes.¹

ISSUE

¹ Because it is not an insurance company, the issue addressed in this ruling is not applicable to the sale of General Corporation Target's stock. Moreover, under the terms of the Securities Purchase Agreement, Insurance Company Target will distribute to Seller assets that are unwanted by Buyer prior to the sale of Insurance Company Target's stock. For federal tax purposes, pursuant to Treasury Regulation section 1.338(h)(10)-1(e) Example 2, Insurance Company Target's distribution of unwanted assets will be treated as one in a series of distributions in the deemed liquidation of Insurance Company Target for which IRC section 332 is applicable. According to FTB Information Letter 2014-02, the California treatment of the distribution of unwanted assets will mirror the federal tax treatment.

How will the IRC section 338(h)(10) election pertaining to the sale of Insurance Company Target's stock be treated for California tax purposes?

HOLDING

The IRC section 338(h)(10) election pertaining to the sale of Insurance Company Target's stock will be respected for California tax purposes. However, pursuant to California Revenue and Taxation Code (CRTC) sections 24465(h)(2)(B) and 24465(h)(3), with respect to the applicability of IRC section 332 as it relates to the transaction, Seller will be treated as receiving a distribution of all of Insurance Company Target's earnings and profits, which will be treated as a dividend for purposes of the dividend received deduction allowed pursuant to CRTC section 24410.

DISCUSSION

For federal tax purposes, pursuant to IRC section 338(h)(10)(A), the rules pertaining to an IRC section 338(h)(10) election are contained in Treasury Regulation section 1.338(h)(10)-1. Based on Treasury Regulation section 1.338(h)(10)-1(c), the target corporation, the stock of which is to be sold in a qualified stock purchase, must be either a member of a consolidated return group, a selling affiliate, or, in the case of an S Corporation, the S Corporation shareholders. The seller and the purchaser of the target corporation's stock must make a joint election according to Treasury Regulation section 1.338(h)(10)-1(c)(3). Pursuant to Treasury Regulation section 1.338(h)(10)-1(d)(3), the impact of the election is that the target corporation is treated as if it sold all of its assets to an unrelated person and recognizes gain. Consequently, the seller does not recognize any gain on the sale of the target corporation's stock according to Treasury Regulation section 1.338(h)(10)-1(d)(5)(iii). Thereafter, pursuant to Treasury Regulation section 1.338(h)(10)-1(d)(4)(i), after it has recognized gain on the deemed sale of its assets, the target corporation is treated as if it distributed the proceeds from the deemed asset sale to the seller in a tax-free liquidation for which IRC sections 332 and 337 apply.²

CRTC section 24451 incorporates by reference Subchapter C of Chapter 1 of Subtitle A of the IRC. IRC section 338 is contained within Subchapter C of Chapter 1 of Subtitle A of the IRC. Moreover, pursuant to CRTC section 23051.5(d), for purposes of applying the IRC for California tax purposes, Treasury regulations are applicable to the extent they do not conflict with regulations issued by the Franchise Tax Board. The Franchise Tax Board has not issued any regulations that conflict with Treasury Regulation section 1.338(h)(10)-1. Therefore, the rules and discussion set forth in the preceding analysis are generally applicable for California tax purposes. However, because the target corporation in this instance is an insurance company, as the following analysis will set forth, a different treatment is warranted.

² See also Bittker & Eustice, *Federal Income Taxation of Corporations & Shareholders* (7th ed. 2015) ¶ 10.42[1], fn. 669.

Section 28(b) and (c) of Article 13 of the California Constitution impose a tax on the gross premiums of an insurer not transacting title insurance in this state. Pursuant to Section 28(f) of Article 13 of the California Constitution, the tax on gross premiums is in lieu of all other taxes, including the corporate franchise and income tax imposed by Part 11 of the CRTC. Therefore, in this instance, Insurance Company Target will not be subject to the corporate franchise and income tax imposed by Part 11 of the CRTC on the deemed sale of its assets as a result of the IRC section 338(h)(10) transaction to which Insurance Company Target is subject. However, there are California tax implications with respect to the transaction.

As set forth above, pursuant to Treasury Regulation section 1.338(h)(10)-1(d)(4), which is applicable in this situation, a liquidation pursuant to IRC section 332 is deemed to occur pertaining to the proceeds from the deemed sale of assets by Insurance Company Target to Seller. CRTC section 24465(h)(2)(B) provides that in the case of a IRC section 332 liquidation involving an insurance company, such as Insurance Company Target, the distributee, in this case Seller, must treat any related distribution as a distribution of the earnings and profits of the insurance company.³ CRTC section 24465(h)(3) further provides that with respect to the distribution of the insurance company's earnings and profits,⁴ the distribution will be treated as a dividend for which the insurance company dividend received deduction is available according to CRTC section 24410. Consequently, Seller will be treated as receiving a dividend representing all of Insurance Company Target's earnings and profits. A portion of this dividend will be deductible pursuant to CRTC section 24410.

Pursuant to CRTC section 24410(a), the insurance company dividend received deduction is only allowed if the dividend recipient owned at least 80 percent of the stock of the insurance company. In this case, Seller owned X percent of the stock of Insurance Company Target. According to CRTC section 24410(a)(1)(B), because the dividend will be received after January 1, 2008, 85 percent of the dividend is eligible for deduction. Pursuant to CRTC section 24410(c), the extent of the actual deduction is a function of the amount of premiums written over the preceding five-year period compared to the insurance company's total income over the same preceding five-year period. Depending upon the resulting ratios, 100 percent of the deduction might be allowed or none of the deduction might be allowed.

Please be advised that the tax consequences expressed in this Chief Counsel Ruling are applicable only to the named taxpayer and are based upon and limited to the facts you have submitted. 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.

³ This will include the pre-sale distribution of the unwanted assets mentioned in footnote 1.

⁴ The applicable rules for determining earnings and profits are contained in the federal Treasury Regulations. See Treas. Reg. § 1.312-6 et seq.

This letter is a legal ruling by the Franchise Tax Board's Chief Counsel within the meaning of paragraph (1) of subdivision (a) of section 21012 of the CRTC. 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