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Chief Counsel Ruling 2021 - 01

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Re: Request for Chief Counsel Ruling on Internal Revenue Code section 338(h)(10) Transaction Addressing Gain or Loss and Basis Implications of Distribution of Appreciated Unwanted Assets

Dear ** *****:

This letter is in response to your Chief Counsel Ruling request dated January 28, 2021. In the request, you ask for the Franchise Tax Board's ("FTB") guidance with respect to the California franchise and income tax treatment of the transfer of unwanted appreciated property by an insurance company to a general corporation in a transaction in which the parties made an election under Internal Revenue Code ("IRC") section 338(h)(10). Specifically, you ask (i) whether the target or the seller would recognize a gain on the distribution of the unwanted assets (and the related impact on the amount of the earnings and profits that the seller would include in income under California Revenue and Taxation Code ("CRTC") section 24465(h)(2)(B)) and (ii) the basis that the distributee would take in the unwanted assets.

FACTS

***** ("Target") is an insurance company under subsection (a) of section 28 of Article 13 of the California Constitution and is not subject to the corporate franchise and income tax imposed by Part 11 of the CRTC. Target was a wholly-owned subsidiary of ***** ("Seller"), a general corporation, whose ultimate parent is ***** ("*****"). Target owned an interest in ***** & ***** a ***** corporation that conducts insurance-related activities in ***** (together with its subsidiary, *****). In a transaction that closed on ***** **, 20** ("Transaction"), ***** ("Buyer") purchased the stock of Target from Seller. Immediately prior to the Transaction, Target distributed the unwanted assets to Seller. The parties intend to make an election under IRC section 338(h)(10) under which, for federal income tax purposes, Target will be deemed to sell their assets to Buyer and then liquidate into Seller. *****

represents that, to the best of its knowledge, the liquidation of Target into Seller will be treated as an IRC section 332 liquidation for federal tax purposes by the Internal Revenue Service.

ISSUES

Do either Seller or Target recognize gain on the distribution of the unwanted assets and is the basis of the unwanted assets in the hands of Seller a carry-over basis or fair market value basis?

HOLDING

Pursuant to 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 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.

Pursuant to Treasury Regulation section 1.338(h)(10)-1(d)(4), the transfer of the unwanted assets is treated as part of an IRC section 332 liquidation of Target into Seller.

Other than the deemed dividend treatment to the extent of the earnings and profits described in Treasury Regulation section 1.367(b)-3(b)(3)(i), the Transaction will be treated as a liquidation under IRC section 332. As a result, under IRC section 337(a), Target does not recognize income on the distribution of the unwanted assets. Under IRC section 334(b)(1), Seller takes a carry-over basis in the unwanted assets.

DISCUSSION

I. California Treatment of Deemed Sale under IRC section 338(h)(10).

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 sells all of its assets to an unrelated person and recognizes a 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 a gain on the deemed sale of its assets, the target corporation is treated as if it

has distributed the proceeds from the deemed asset sale to the seller in a tax-free liquidation for which IRC sections 332 and 337 apply.¹

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 such regulations 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.

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, 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 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 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 Target, the distributee, in this case Seller, must treat any related distribution as a distribution of the earnings and profits of the insurance company. CRTC section 24465(h)(3) further provides that, with respect to the distribution of the insurance company's earnings and profits,² 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 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 100 percent of the stock of 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

¹ See also Bittker & Eustice, *Federal Income Taxation of Corporations & Shareholders* (7th ed. 2020 & Supp. 2020-3) ¶ 10.42[1], fn. 669.

² The applicable rules for determining earnings and profits are contained in the federal Treasury Regulations. See Treas. Reg. section 1.312-6 *et seq.*

extent of the actual deduction is a function of the amount of the 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.

II. Distribution of Unwanted Assets

IRC section 332 provides that no gain or loss shall be recognized on the receipt of property by a corporation distributed in complete liquidation of another corporation.

IRC section 334(b)(1) and Treasury Regulation 1.334-1(b) provide that, when property is received pursuant to a distribution in complete liquidation under IRC section 332, the distributee will take a carryover basis from the transferor in the property.

IRC section 337(a) provides that no gain or loss shall be recognized to a liquidating corporation on the distribution to the 80-percent distributee of any property in a complete liquidation to which IRC section 332 applies.

Under Treasury Regulation section 1.338(h)(10)-1(d)(4), the transfer from a target corporation that is the subject of an election under IRC section 338(h)(10) is characterized for federal income tax purposes in the same manner as if the parties had actually engaged in the transactions deemed to occur and take into account other transactions that actually occurred or are deemed to occur. As a result, as provided by Treasury Regulation section 1.338(h)(10)-1(d)(4), the distribution of assets from a target to a seller prior to a transaction in which the parties made a valid election under IRC section 338(h)(10) election would be deemed to be included as part of a plan of liquidation.

Treasury Regulation section 1.338(h)(10)-1(e), Example (2), describes a deemed liquidation of a corporation that is the subject of an election under IRC section 338(h)(10), in which the liquidating corporation distributed some of its assets to its parent prior to the liquidation. Pursuant to Treasury Regulation section 1.338(h)(10)-1(d)(4), the distribution in Example (2) was treated as part of a plan of complete liquidation under IRC section 332.

FTB Notice 2019-01 (Feb. 25, 2019) states that, in the case of the complete liquidation of an insurance company, CRTC section 24465(h)(2)(B) overrides IRC section 332 to treat the liquidating distribution as a dividend to the extent of earnings and profits under CRTC 24410. Notice 2019-01 indicates that the FTB intends to rely upon Treasury Regulations promulgated under IRC section 367 to administer CRTC section 24465 to the extent that such regulations address similar transactions.

Pursuant to Treasury Regulation section 1.367(b)-3(a), Treasury Regulation section 1.367(b)-3 applies to an acquisition by a domestic corporation of the assets of a foreign corporation in a liquidation described in IRC section 332. Pursuant to Treasury Regulation section 1.367(b)-3(b)(3)(i), a domestic corporation shall include in its income a deemed

dividend equal to the acquired earnings and profits with respect to the stock in the foreign corporation.

In Treasury Regulation section 1.367(b)-3(b)(3)(ii), Example (2), a domestic corporation owns all the outstanding stock of a foreign corporation. The foreign corporation distributes all its property to the domestic corporation, in a liquidation described in IRC section 332. Under IRC section 337(a), the foreign corporation does not recognize a gain or a loss in the assets it distributes to the domestic corporation. Pursuant to Treasury Regulation section 1.367(b)-3(b)(3)(i), the domestic corporation includes in its income an amount equal to the earnings and profits of the foreign subsidiary as a deemed dividend. Under IRC section 334(b), the domestic corporation takes a carry-over basis in the distributed assets.

In the present case, as set forth above, pursuant to Treasury Regulation section 1.338(h)(10)-1(d)(4), and similar to the distribution from the target corporation in Treasury Regulation section 1.338(h)(10)-1(e), Example (2), Target's distribution of the unwanted assets will be treated as one in a series of distributions in the deemed liquidation of Target for which IRC section 332 is applicable.

As described in FTB Notice 2019-01, because Target is an insurance company, CRTC section 24465(h)(2)(B) overrides IRC section 332 to treat the liquidating distribution as a dividend to the extent of Target's earnings and profits under CRTC section 24410. FTB Notice 2019-01 provides that the FTB intends to apply Treasury Regulations promulgated under IRC section 367 to administer CRTC section 24465 to the extent that they address similar transactions. Pursuant to Treasury Regulation section 1.367(b)-3, other than the dividend treatment of Target's earnings and profits, the Transaction will be treated as a liquidating distribution under IRC section 332. Under IRC section 337(a) Target does not recognize income on the distribution of the unwanted assets. Likewise, Seller does not recognize income from the distribution of the unwanted assets pursuant to IRC section 332. Under IRC section 334(b), Seller takes a carry-over basis in the distributed assets.

CONCLUSION

Seller will include Target's earnings and profits in its income as a deemed dividend. IRC section 332 and 337 will apply to the deemed liquidation such that gain would not otherwise be recognized on the distribution of the unwanted assets. IRC section 334(b) applies to give Seller a carry-over basis in the unwanted assets. Since the distribution of the unwanted assets is treated as part of a plan of complete liquidation, it will not impact Target's earnings and profits.

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.

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 Revenue and Taxation Code. 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,

Brian L. Beck
Tax Counsel III