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LEGAL RULING 2006-03 **May 5, 2006**

SUBJECT: Apportionment of Gains Resulting from an Election Made Pursuant to Internal Revenue Code Section 338

ISSUE

How are gains resulting from an election made under either Internal Revenue Code (IRC) section 338(h)(10) or IRC section 338(g) apportioned for California purposes?

FACTS

Individual X owns all of the stock of Corporation A. Corporation A owns 100 percent of the stock of Corporation B. Corporations A and B are the only members of a unitary combined reporting group. Corporation A and Corporation B file a consolidated federal income tax return. The stock of Corporation B constitutes an asset that produces business income to Corporation A, while all of Corporation B's assets constitute assets that produce business income to Corporation B. Corporation C is a separate, independent entity that is unrelated to Individual X, Corporation A or Corporation B.

Assume the following separate scenarios occur:

1. Corporation A sells its stock in Corporation B to Corporation C. Corporation A and Corporation C agree to treat the transaction as a deemed sale of assets pursuant to IRC section 338(h)(10), with Corporation A and Corporation C making the necessary elections. Corporation B is the Old/New Target for purposes of IRC section 338 and the gain on the deemed sale of assets constitutes apportionable business income for Corporation B.

2. Corporation A sells its stock in Corporation B to Corporation C. Thereafter, Corporation B will be included in Corporation C's consolidated federal income tax return. Corporation C elects to treat the transaction as a deemed sale of assets pursuant to IRC section 338(g). Corporation B is the Old/New Target for purposes of IRC section 338 and the gain on the deemed sale of assets by Corporation B constitutes apportionable business income for Corporation B.

3. Individual X sells his stock in Corporation A to Corporation C. Thereafter, Corporation A and Corporation B will be included in Corporation C's consolidated federal income tax return. Corporation C elects to treat the transaction as a

deemed sale of assets pursuant to IRC section 338(g). Corporation A is the Old/New Target for purpose of IRC section 338 and the gain on the deemed sale of assets by Corporation A constitutes apportionable business income for Corporation A.

LAW AND ANALYSIS

Revenue and Taxation Code ("R&TC") section 24451[1] incorporates by reference Subchapter C of Chapter 1 of Subtitle A of the Internal Revenue Code (sections 301 – 386).[2] In general, IRC section 338 allows taxpayers to elect to treat certain stock sales as sales of the underlying assets of the corporation whose stock was sold.

Federal Rules:

Under IRC section 338(b)(3), a corporation that acquires the stock of another corporation may elect to treat the purchase as an asset acquisition. IRC section 338, in subsections (g) and (h)(10), provides two separate types of elections to treat the purchase of stock as a purchase of assets. Pursuant to both election schemes, the acquired corporation ("Old Target") is treated as if it sold all of its assets at the close of the date of acquisition. (IRC § 338(a)(1).) Thereafter, Old Target is treated as a new corporation ("New Target") that purchased the assets of Old Target at the beginning of the day after the acquisition date. (IRC § 338(a)(2).) New Target then allocates the stock purchase price among its assets. (IRC § 338(b)(5).)

IRC Section 338(h)(10) elections

IRC section 338(h)(10) and Treasury Regulation section 1.338(h)(10)-1(c)(3)[3] allow the seller and buyer to make a joint election to treat the sale of Old Target's stock as a sale of its assets. Generally, the consequences of an IRC section 338(h)(10) election are that the sale of stock is disregarded and treated for federal income tax purposes as a deemed sale of assets by Old Target followed by a complete liquidation of Old Target. The seller does not recognize gain on the actual sale of stock (Treas. Reg. § 1.338(h)(10)-1(d)). For federal income tax purposes, the deemed asset sale is reported

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[1] All section references are to the California Revenue & Taxation Code, unless otherwise specifically noted.

[2] The Franchise Tax Board has not issued any regulations pertaining to section 24451. Consequently, pursuant to section 23051.5, subdivision (d), the federal regulations are applicable for California purposes.

[3] Federal regulations referenced are final regulations applicable to any qualified stock purchase occurring after March 15, 2001. See Treas. Reg. § 1.338(i)-1 (2001). Temporary regulations provided similar rules for qualified stock purchases on or before March 15, 2001. See 26 CFR part 1, as revised April 1, 2000, April 1, 1999, and April 1, 1996.

by Old Target in the consolidated federal Form 1120 of the selling corporation's consolidated group.

IRC Section 338(g) elections

IRC section 338(g) allows the acquiring corporation to make an election to treat the purchase of stock as a purchase of assets. The selling corporation does not participate in this election. The election results in Old Target reporting the gain on the deemed sale of assets. The selling shareholder(s) of Old Target also report(s) gain on the actual sale of Old Target stock. Depending upon the ownership structure of the entity(ies) being sold, different return reporting requirements will arise for Old Target:

1. *Old Target is a separate entity.* If Old Target is a separate entity, Old Target will report the gain on its final return for the period leading up to, and including, the date of the acquisition. (Treas. Reg. § 1.338-10(a)(1).)

2. *Old Target is the common parent of a federal consolidated return group and Old Target's group remains intact.* If Old Target is a common parent of a federal consolidated return group, Old Target shall report the gain on the consolidated group's final return for the period leading up to, and including, the date of the acquisition. (Treas. Reg. § 1.338-10(a)(1).)

3. *Old Target is a member of a federal consolidated return group, but not the common parent.* If Old Target is a member of a federal consolidated return group, but not the common parent, Old Target will be considered as having become disaffiliated from its previous federal consolidated return group immediately before the deemed sale of assets and thereafter is not treated as an affiliated corporation under IRC section 1504. As a result, Old Target's income from the deemed sale of its assets cannot be included in the federal consolidated return of its prior consolidated return group. Additionally, pursuant to IRC section 338(h)(9), it cannot be treated as a member of the acquiring corporation's federal consolidated return group. Accordingly, Old Target's gain from the deemed sale of assets cannot be included in the income of the acquiring corporation's federal consolidated return group. (Treas. Reg. § 1.338-10(a)(2).) Therefore, Old Target must report the gain on the deemed sale of the assets on what is commonly referred to as a "one-day return."

Because of the different treatments outlined above, the apportionment rules will also differ given the type of election made.

California Apportionment Rules[4]

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[4] Because insurance companies are subject to the gross premiums tax under article XIII, section 28, subdivision (f), of the California Constitution, they are not subject to a tax on their income and they may not be included in a combined report, Legal Ruling 385,

In general, the deemed sale of assets that occurs under an IRC section 338 election will be treated as an actual sale of assets for apportionment purposes. If the gain from the sale constitutes apportionable business income pursuant to section 25120, subdivision (a), the gain must be apportioned to the states where Old Target did business prior to the sale.

For property factor purposes, those assets that are real or tangible personal property are included at the cost basis of that property according to section 25130, with the numerator values being determined by the location of those assets in accordance with the rules contained in section 25129. Intangible property is generally not included in the property factor.

For sales factor purposes, the sourcing of the proceeds from the deemed sale of tangible personal property will be governed by section 25135. For those assets that are other than tangible personal property, the sourcing of the proceeds from the deemed sale of those assets will be governed by section 25136. California Code of Regulations, title 18, section 25137, subsection (c)(1)(A), provides that if substantial amounts of gross receipts arise from the occasional sale of fixed assets or other property held or used in the taxpayer's regular trade or business, then the gross receipts are disregarded for purposes of the sales factor numerator and denominator. Therefore, if the deemed sale of the Old Target's assets generates substantial amounts of gross receipts, then the gross receipts should be excluded from Old Target's sales factor numerator and denominator, except in the case of a single-day return, as discussed below.

<u>IRC Section 338(h)(10) elections</u>

Old Target reports the gain on the deemed sale of assets in the tax return for the period immediately prior to and including the acquisition date. If the selling corporation and Old Target are unitary, and the gain on the deemed sale of the Old Target assets constitutes apportionable business income, then the gain on the deemed sale of Old Target assets is apportioned through the use of the combined report that includes the selling corporation and its unitary affiliates.

<u>IRC Section 338(g) elections</u>

Because the seller is not a party to an IRC section 338(g) election, the seller will treat the transaction as a sale of stock on its tax return. The seller reports the gain or loss from the stock sale as apportionable business income if the subsidiary was unitary with the seller (*Times-Mirror Co. v. Franchise Tax Bd.* (1980) 102 Cal.App.3d 872; *Jim Beam Brands Co. v. Franchise Tax Bd.* (2005) 133 Cal.App.4th 514).

(March 28, 1975). As a result, this ruling has no application to a 338 election where the target is an insurance company.

For the buyer, the apportionment methodology will depend upon the facts surrounding Old Target. What follows is a discussion of the applicable apportionment rules that will apply in each of the fact patterns described in the federal rules portion of this ruling:

1. Old Target is a separate entity. Because the gain from the deemed sale is treated as income of Old Target, the deemed asset sale is apportioned using the apportionment percentage of Old Target that existed for the taxable year leading up to, and including, the date of the transaction.

2. *Old Target is the common parent of a federal consolidated return group and Old Target's group remains intact.* The deemed asset sale is apportioned using the apportionment percentage of Old Target and its group that existed for the taxable year leading up to, and including, the date of the transaction.

3. Old Target is a member of a federal consolidated return group, but not the common parent. Old Target will be considered as having become disaffiliated from its previous federal consolidated return group immediately before the deemed sale of assets and thereafter is not treated as an affiliated corporation under IRC section 1504. For California franchise and income tax purposes, the gain from the deemed sale of assets is treated as having arisen after Old Target's stock was sold. (See *Appeals of S.C.V. Realty & Development Co., Ltd., et al.*, 94-SBE-015, December 14, 1994.) Because unity of ownership no longer exists under section 25105, that gain cannot be included in a combined report that includes Old Target's selling parent corporation. Because the gain is inherent in Old Target's assets when they are acquired by New Target, the gain does not relate to the unitary business of the acquiring corporation, even if instantly unitary. Therefore, the gain should not be included in the acquiring corporation's combined report, but should be reported on New Target's single day return.

Because the one-day return does not include the results of any day-to-day operations, New Target would not have incurred any payroll expense related to the gain. Therefore, it is inappropriate to use a payroll factor to apportion the gains on the sale, and only the sales factor and the property factor computed for the one-day return are appropriately used to apportion the income associated with the deemed sale.[5] (Cf. *Appeal of Oscar Enterprises, Ltd*., 87-SBE-069, October 6, 1987, where the State Board of Equalization

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[5] An exception exists if the Old Target corporation held an installment obligation. Section 24667, which incorporates by reference IRC section 453B, requires that when an installment obligation is sold, the deferred gain is accelerated and recognized in the year that the installment obligation was sold. Accordingly, pursuant to Legal Ruling 413, October 15, 1979, the Old Target corporation's original year-of-sale apportionment percentage must be used to assign the accelerated recognition of the deferred gain with respect to the installment obligation, instead of using the apportionment percentage from the one-day return. All other gains are apportioned using the factors of the one-day return.

held that it was appropriate to divide the total apportionment factors by two, rather than three, where the denominator of one of the factors was zero.)

For property factor purposes, if the deemed assets treated as sold are real or tangible personal property, the cost basis of that property will be in the property factor denominator, with the numerator values being determined by the location of tangible assets in accordance with the rules contained in section 25129. If the assets constitute intangibles, then their value will be excluded from both the numerator and denominator of the property factor.

California Code of Regulations, title 18, section 25137, subsection (c)(1)(A), provides that if substantial amounts of gross receipts arise from the occasional sale of fixed assets or other property held or used in the taxpayer's regular trade or business, then the gross receipts are disregarded for purposes of the sales factor numerator and denominator. Because the gain from the deemed sale of Old Target's assets is the only activity reported on the one-day return, the deemed sale will not be considered "occasional." Consequently, California Code of Regulations, title 18, section 25137, subsection (c)(1)(A), does not apply and the gross receipts are included in New Target's sales factor numerator and denominator. If the assets constitute other than tangible personal property, the geographical assignment of the gains from the deemed sale of those assets will be governed by section 25136. If the assets constitute tangible personal property, their geographical assignment will be governed by section 25135.

Moreover, not including the gross receipts from the deemed sale of the assets in New Target's sales factor numerator and denominator would not fairly represent the taxpayer's activities. Application of California Code of Regulations, title 18, section 25137, subsection (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 California Code of Regulations, title 18, section 25137, subsection (c)(1)(A).

<u>Combined deemed sale return</u>

IRC section 338(h)(15) allows for a combined deemed sale return for multiple New Target corporations acquired by a single purchasing corporation on the same acquisition date if those New Target corporations were members of the same selling consolidated group on the acquisition date. That means that instead of filing multiple one-day returns for each New Target corporation acquired on the same acquisition date, the acquiring corporation may file a single return that reports the gain on the deemed sales of assets. If the New Target corporations qualify, they may include and/or offset gains and losses from their respective one-day return as if they were a single New Target. (Treas. Reg. § 1.338-10(a)(4)(ii).)

Treasury Regulation section 1.338-10(a)(4) provides the rules for a combined deemed sale return. Treasury Regulation section 1.338-10(a)(4)(i)) states: "a combined deemed sale return … may be filed for *all* targets from a single selling consolidated group…[.]" (Emphasis added.) For federal purposes, because the corporations eligible to file a combined deemed sale return must all have been members of a federal consolidated return group, then *all* targets would necessarily be federal taxpayers. However, with respect to California, not all members of a federal consolidated return are necessarily California taxpayers, and including entities in a combined report is dependent upon the existence of a unitary relationship. Because of the disaffiliation that results due to IRC section 338, a unitary relationship will not exist and therefore, for California purposes each entity must be accounted for separately for purposes of filing the single-day return. Only those corporations that are taxable in California have a California filing requirement.

HOLDING

Scenario 1

Because Corporation A (the selling corporation) and Corporation C (the acquiring corporation) mutually elected to treat the sale of stock in Corporation B (the target corporation) as a deemed asset sale pursuant to IRC section 338(h)(10), for California purposes the gain is included in the combined report of Corporation A and Corporation B for the period ending on the date of the stock sale transaction. The gain is apportioned using the factors reflected in Corporation A and Corporation B's combined report for that same period.

Scenario 2

Corporation A's (the selling corporation) sale of the Corporation B (the target corporation) stock to Corporation C (the acquiring corporation) will cause Corporation B to become disaffiliated from Corporation A's federal consolidated return group. Under IRC section 338(h)(9), because it became disaffiliated, Corporation B cannot be included in any federal consolidated return group, including Corporation C's federal consolidated return group. Consequently, Corporation C's IRC section 338(g) election will cause the gain of the deemed sale of Corporation B's assets to be reported by Corporation B on a "one-day" return for California purposes. The gain will be apportioned using only Corporation B's sales factor and property factor. Because no actual operations are occurring during this one day, no payroll factor will be used to apportion the gain. The deemed sales price of assets treated as sold will constitute the denominator of the sales factor, with the numerator values of the sales factor deemed sold will be determined pursuant to the rules contained in sections 25135 and 25136, and the regulations thereunder.

Scenario 3

Corporation A (the target corporation) is the common parent of a federal consolidated return group that only includes Corporation B. Individual X's sale of the stock in Corporation A to Corporation C (the acquiring corporation) did not cause Corporation A to become disaffiliated from its federal consolidated return group. Accordingly, the gain on the deemed asset sale by Corporation A that results from Corporation C's IRC section 338(g) election is reported by Corporation A and Corporation B on their consolidated final return for the period ending on the date of the stock sale transaction. For California purposes, the gain is reported by Corporation A and is apportioned using the factors reflected in Corporation A and Corporation B 's combined report for that same period.

DRAFTING INFORMATION

The principal author of this ruling is Craig Swieso of the Franchise Tax Board, Legal Department. For further information regarding this ruling, contact Mr. Swieso at the Franchise Tax Board, Legal Department, P.O. Box 1720, Rancho Cordova, CA 95741-1720.