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QUESTION(S) PRESENTED

1. If a buyer and seller have properly elected to apply Internal Revenue Code section 338(h)(10) to the sale of stock, if the seller does not want the same election to apply for California tax purposes, must both the buyer and seller agree to elect out of the application of section 338(h)(10) for California tax purposes?
2. If the conclusion to question 1., above, is yes, and if the buyer in a transaction to which the buyer and seller have elected to apply Internal Revenue Code section 338(h)(10) for federal tax purposes is not a California taxpayer and is not included in a combined report with at least one California taxpayer member, but the seller is a California taxpayer, can the buyer and seller jointly elect out of section 338(h)(10) treatment for California purposes?
3. What constitutes an election out of a federal election for California tax purposes?
4. If the seller, a California taxpayer, attaches a note to the California franchise or income tax return stating that it does not want the federal 338(h)(10) election to apply but the buyer, not a California taxpayer and not a member of a combined report with at least one California taxpayer member, applies the federal election, should audit adjust the seller's California tax return to include the gain on the sale of assets or should audit disallow the purchaser's step up of the basis of the assets of the target corporation?

CONCLUSION(S)

1. Yes, the buyer and seller must jointly file an election not to apply section 338(h)(10) for California tax purposes.
2. No, both parties making the California election to not apply the federal election must be, at the time of the election, a California taxpayer or member of a combined report that includes at least one California taxpayer member.
3. A valid election out of a federal 338(h)(10) election requires joint signature by buyer and seller evidencing the joint election out and must be filed with the Franchise Tax Board no later than the due date for the federal 338(h)(10) election.

4. Under these facts, the buyer and seller cannot elect out of the federal election nor will the federal election automatically apply. Since one of the parties is not a California taxpayer or included in a combined report with at least one California taxpayer member, the parties are not eligible to make a 338(h)(10) election. For California tax purposes, the transaction is the sale of stock. The purchaser will not be required to file a return since it is not subject to California tax. The seller should report the gain from the sale of stock.

LAW

Revenue and Taxation Code section 24451 conforms California law to all of Subchapter C of Chapter 1 of Subtitle A of the Internal Revenue Code, which includes Internal Revenue Code section 338. Internal Revenue Code section 338(g) allows a corporation that purchases the stock of another corporation (the target corporation) to make an election to treat the purchase of the target stock as an asset acquisition. The purchaser is able to step up the basis of the assets of the target corporation but must file a one-day return that reports the gain and recapture items triggered from the deemed sale of assets. The seller of the stock is not involved in the 338(g) election and will report the gain on the sale of the stock it owned in the target. Thus, the transaction results in gain being reported on both the sale of the stock and the deemed sale of the assets.

Internal Revenue Code section 338(h)(10) was enacted, in part, to provide some relief to the double taxation of the same transaction where the target was included in the selling corporation's consolidated group. Section 338(h)(10) allows for a joint election by the buyer and the common parent of the selling consolidated group. The target is deemed to have sold all of its assets at fair market value and liquidated into its old parent corporation. The gain from the deemed sale of assets is included in the selling consolidated group but the gain from the sale of stock is not recognized.¹

Treasury Regulation section 1.338(h)(10)-1T(c)(3) states that a section 338(h)(10) election is irrevocable and a section 338(h)(10) election is a deemed 338 election. Treasury Regulation section 1.338(h)(10)-1T(c)(4) provides that if a section 338(h)(10) election is not valid, then the section 338 election is similarly not valid. The 338(h)(10) election must be made no later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs. (Treas. Reg. §1.338(h)(10)-1T(c)(2).)

Treasury Regulation section 1.338(h)(10)-1T(c)(2) makes it very clear that the section 338(h)(10) election is made jointly by the purchaser and the selling consolidated group. It states that a section 338(h)(10) election is made jointly by the purchasing corporation "and the selling consolidated group (or the selling affiliate or the S corporation shareholders) on Form 8023 in accordance with the instructions to that form." The instructions to federal Form 8023 state that the common parent of the selling consolidated group (or the selling affiliate or S corporation shareholder(s)) must sign the form to make the election. A selling affiliate is a domestic corporation that owns on the acquisition date 80 percent or more of the value of the

¹ Special rules apply for 338(h)(10) elections involving S corporations which will not be addressed herein.

stock in a domestic target and does not join in filing a consolidated return with the target. (Treas. Reg. § 1.338(h)(10)-1T(b)(3).) On the purchaser side, the form instructions state that if the common parent of a consolidated group is the agent of the purchasing corporation under Regulations section 1.1502-77, the person authorized to sign the Form 8023, Elections Under Section 338 for Corporations Making Qualified Stock Purchases, is the person authorized to act on behalf of that common parent. If the target is acquired by two or more corporations that are members of the same affiliated group (but not consolidated), the form must be signed by a person authorized to sign on behalf of each corporation.

For combined reporting purposes, the taxpayer members of the combined reporting group may elect to determine the total separate net income of each member of the group under accounting methods and other elections as authorized by Division 2, Part 11 of the Revenue and Taxation Code. (Cal. Code Regs., tit. 18, §25106.5-3(a).) In the event that the taxpayer members do not file in a consistent manner, the Franchise Tax Board may, in its discretion, resolve the inconsistency as it deems necessary or appropriate, taking into account the totality of facts and circumstances relating to the applicable accounting methods or elections. (Cal. Code Regs., tit. 18, §25106.5-3(a)(1).) If it is determined by the Franchise Tax Board that a corporation, itself not a California taxpayer, was erroneously excluded from the combined reporting group, the taxpayer members of the group may elect to determine the net income of that corporation whether or not the election being made was required to be made on a timely filed return. For the election to be effective, all taxpayer members must agree to the same election for the erroneously excluded entity. (Cal. Code Regs., tit. 18, §25106.5-3(b).) If, however, the erroneously excluded corporation was obligated to file a U.S. income tax return, the taxpayer members cannot make an election to determine the net income of that corporation. Instead, an election made on its U.S. return shall apply. (Cal. Code Regs., tit. 18, §25106.5-3(b)(1).)

If some or all the members of a combined reporting group elect to file a group return, then the key corporation acts as agent for the electing members. (Cal. Code Regs., tit. 18, §25106.5(b)(14).)

Revenue and Taxation Code section 23051.1(e)(1) states that "whenever this part allows a *taxpayer* to make an election," "a proper election filed with the Internal Revenue Service . . . shall be deemed a proper election for California tax purposes unless expressly provided otherwise . . ." ² [Emphasis added.]

"Taxpayer" is defined in Revenue and Taxation Code section 23037 as any person subject to the tax imposed under Chapter 2, 2.5 or 3. A "person" is defined under Title 18, California Code of Regulations section 23037 to include corporations.

² Section 338 elections made by S corporations cannot be treated differently for California tax purposes. See Revenue and Taxation Code section 23806(a) and (b).

Revenue and Taxation Code section 23051.5(e)(3) states that to obtain treatment otherwise (i.e., differently from the federal election), "a separate election shall be filed with the Franchise Tax Board at the time and in the manner which may be required by the Franchise Tax Board."

FTB Notice 88-254, issued November 15, 1988, states that if a valid 338(h)(10) election is made for federal purposes, the parties (the buyer and seller) may *jointly* elect to not have the federal provisions apply for California purposes pursuant to Revenue and Taxation Code section 23051.5(g)(3) (renumbered after the issuance of the FTB Notice to 23051.5(e)(3)). FTB Notice 88-254 was issued to give direction for circumstances under which a section 338(h)(10) election could be made because California changed from a stand alone statute (Rev. & Tax. Code §24519) to conformity with federal law. The notice states that if a valid federal 338(h)(10) election was made, the election will apply even though, unlike the requirements of former Revenue and Taxation Code section 24519, the target corporation is not a member of the seller's combined report group. The focus of the notice was on the eligibility of the target corporation and not on the eligibility of the buyer and seller to make the election. The notice allows a corporation to be a target even though it is not in a California combined report with the seller so long as it can be a target for federal tax purposes.

ANALYSIS AND DISCUSSION

1. The buyer and seller must jointly elect out of the application of the federal 338(h)(10) election. Revenue and Taxation Code section 23051.5(e)(3) grants the Franchise Tax Board the authority to specify the manner in which a taxpayer can elect out of the application of a federal election. FTB Notice 88-254 expressly provides that the buyer and seller must jointly elect out of the federal 338(h)(10) election. Since both the buyer and seller must jointly file the federal election, both must jointly agree not to apply the federal election for California purposes. The joint election insures consistent treatment of the transaction between the buyer and the seller.
2. Technically, both the buyer and seller must be a California taxpayer or a member of a combined report that includes at least one California taxpayer member to be able to jointly elect out for California tax purposes. Revenue and Taxation Code section 23051.5(e) states that "Whenever this part allows a *taxpayer* to make an election, the following rules shall apply" [Emphasis added.] The rules in this section are premised upon the corporation being a taxpayer for California tax purposes. A taxpayer is defined in Revenue and Taxation Code section 23037 as any person subject to the tax imposed under Chapter 2, 2.5 or 3. The only exception or expansion of this rule is provided for in the combined report context. Title 18, California Code of Regulations section 25106.5-3(a) allows the taxpayer members of a combined reporting group to elect to determine the total separate net income of each member (including non-taxpayer members) of the group. Only the taxpayer members of the group are entitled to make that determination. It should be noted that if a member was erroneously excluded from a combined group and if that member filed a federal return and made an election on that return, then the federal

election applies and the taxpayer members cannot change that election. (Cal. Code Regs., tit. 18, § 25106.5-3(b)(1).

In the situation where only the buyer or only the seller is a California taxpayer or a member of a combined report that includes at least one California taxpayer member, technically no election out can be made. This appears to be a harsh result as the seller, itself a California taxpayer under the presented facts, has no control over whether the buyer is a California taxpayer or member of a combined report that has at least one California taxpayer member. It should be remembered, however, that a 338(h)(10) election is a deemed 338 election. If the purchaser is not a California taxpayer or included in a combined report that has at least one California taxpayer member, then the purchaser would not be able to make a 338 election. If it cannot make the 338 election, it should not be eligible to make a 338(h)(10) election. The buyer could remedy the situation by qualifying to do business in California, which will subject the buyer to the minimum franchise tax. The ability to make these elections and the tax consequences associated with such elections (or non-elections) should be taken into account as part of the buyer's and seller's negotiations.

This situation is similar to the election of C corporation status for California purposes by a federal S corporation. In order to be able to elect C status, the corporation must be incorporated in California or must qualify to do business in California. (See Rev. & Tax. Code § 23801(a)(4)(C), (D) and (E).) California law limits the ability of a non-California taxpayer (actually even a smaller group as those corporations that were actually doing business in California are not included) to make a separate election for California purposes.

The determination of whether the buyer and seller are eligible to make the election is made at the time of the election (not the acquisition). Since the election is required to be filed almost nine months after the acquisition, there is ample time for the parties to remedy any problem with the ability to make the election. If the target corporation has California nexus, then upon acquisition, it is possible that the buyer would become a California taxpayer and eligible to make the election.

3. A valid election out must contain the signature of both the buyer and seller and be filed with the Franchise Tax Board by the due date for a section 338 election. FTB Notice 88-254 specifies that the election out must be a joint election. This means that both the buyer and the seller must sign the election out. The election must be filed with the Franchise Tax Board by the date that the federal election is required to be made. Revenue and Taxation Code section 23051.5(e)(3) specifies that an election not to apply the federal election "shall be filed with the Franchise Tax Board." Even if the buyer and seller document in the sales agreement that they intend to not apply the federal 338(h)(10) election for California purposes, the sales agreement cannot be viewed as a proper election out as it was not filed with the Franchise Tax Board. Moreover, the election to not apply the federal election must be made by the due date of the federal election, otherwise the federal election will be deemed to apply by virtue of Revenue and Taxation Code

section 23051.5(e)(1). If the federal election was filed before the due date of the federal election, technically, the California election out must be made by that date as well because the federal election under Internal Revenue Code section 338(h)(10) is irrevocable. (Treas. Reg. § 1.338(h)(10)-1T(c)(3).) The taxpayer cannot revoke its election even though the due date for that election has not passed. For administrative convenience, however, we may want to consider allowing the election up until the due date of the federal election. This would be a policy decision and would require approval by management.

In order for a statement attached to the California return to qualify as an election out of the federal treatment, it would need to be signed by both the buyer and the seller and the return would need to be filed by the due date of the federal election (the 15th day of the ninth month beginning after the month in which the date of acquisition occurs). Federal law specifies who can sign the election form on behalf of the buyer and seller. These requirements appear to be adequate for California purposes. Moreover, California tax law allows a key corporation to make an election where the group elected to file a single return. The key corporation could sign the election statement on behalf of the group.

4. There is no valid election out nor can the parties make a 338(h)(10) election. In this case, the joint election to make a 338(h)(10) election is not available because both the buyer and seller are not California taxpayers or members of a combined report with at least one California taxpayer member and the deemed language of 23051.5(e) (which applies only to taxpayers) does not apply.³ The invalidity of the section 338(h)(10) election also invalidates the deemed 338 election so that the purchaser alone cannot obtain a stepped up basis in the assets. Since the buyer has no California filing requirement, there is no return on which we can adjust the step up.⁴ The seller properly reported the transaction as the sale of stock. If the purchaser subsequently becomes a California taxpayer, the basis of its assets for California tax purposes will be the original cost basis adjusted for depreciation allowed or allowable under California law. The purchaser will not get a step up in basis for the federal 338(h)(10) gain as the transaction was a sale of stock for California tax purposes. No tax was paid to California on the sale of the assets such that the purchaser would be entitled to a stepped up basis.⁵

³ If both the buyer and seller were California taxpayers or members of a combined report that had at least one California taxpayer member, then an invalid separate election for California tax purposes to not apply the federal 338(h)(10) election would mean that the federal 338(h)(10) would be deemed to have been made by operation of Revenue and Taxation Code section 23051.5(e)(1).

⁴ If the buyer was erroneously excluded from a California combined report, then the Franchise Tax Board's inclusion of the buyer, assuming it filed a federal return with a section 338(h)(10) election, will result in the federal election applying to the buyer. This would have an impact on the seller. This places the seller in a highly uncertain position at the time of the acquisition and federal election. Wise negotiators would provide in the buy-sell agreement what would happen if the 338(h)(10) election was invalid for federal purposes. A similar provision should probably be included to cover this potential situation. We may want to consider limiting the scope of this regulation so that 338(h)(10) transactions are excluded due to its unique requirement for a joint election or limit the regulation provision to elections required to be made on a tax return.

⁵ Disallowance of the stepped up basis in connection with an invalid 338(h)(10) election is discussed in Multistate Audit Trends, Winter 1999.

The 338(h)(10) election is an unusual election because it requires joint consent by two parties, the buyer and the seller. Most elections are made only by a single taxpayer. This requirement for a joint election is what gives rise to seemingly harsh results. Any policy decision to change the legal results set forth in this memorandum should be limited to situations requiring a joint election. If a policy decision is made to allow the 338(h)(10) election when only one of the parties to the transaction (rather than both the buyer and the seller) is a California taxpayer or member of a combined report with at least one California taxpayer member, my recommendation would be to require that the buyer, in all cases, be a California taxpayer or member of a combined report with at least one California taxpayer member. To allow the election where the buyer is not a California taxpayer or member of a combined report with at least one California taxpayer member would result in the election being allowed where the underlying 338 election, which is made by the buyer only, would not have been. This would violate the basic principles of the 338 election requirements.

Tax Counsel