16.0 SALE OF STOCK & ELECTION OF INTERNAL REVENUE CODE (IRC) SECTION 338(H)(10)

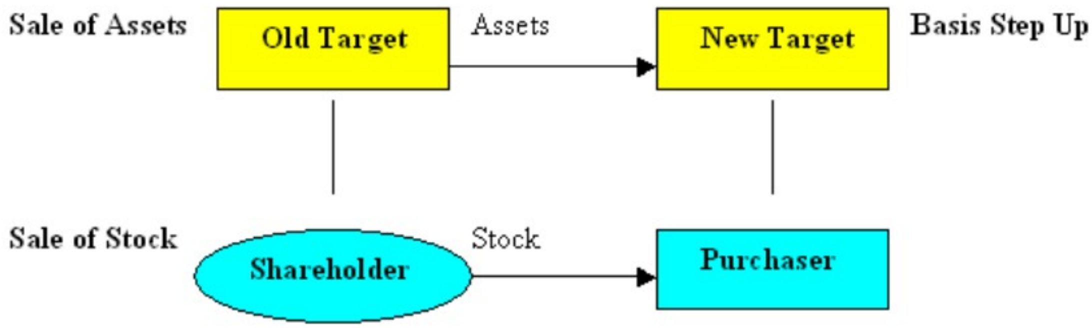
16.1 CORPORATION ACQUISITION – IN GENERAL

There are two basic ways to acquire a corporation – (1) stock purchase and (2) asset purchase.

A stock purchase is simple. In general, a purchaser buys stock from shareholders of a corporation. The selling shareholders treat the transaction as a sale of stock and realize capital gain or loss. The selling shareholders' amount realized is the stock selling price. The adjusted basis is the adjusted basis in the stock sold. When the stock transaction is completed, the purchaser owns the corporation, also referred to as a target corporation. The target corporation continues to operate as if nothing had happened. The basis of the assets held by the target corporation (now owned by the new shareholder) stays the same.

When a purchaser purchases the target corporation's assets, the purchaser's basis in the assets acquired is the purchaser's cost allocated among the assets pursuant to Internal Revenue Code (IRC) Section 1060. Therefore, the basis of assets held by the purchaser is stepped up by the amount of gain that is realized by the target corporation (providing the purchase price of assets is more than the adjusted basis of assets). Having higher basis is beneficial to taxpayers for various reasons. However, this method can be quite troublesome for the seller and the purchaser because there may be certain restrictions or additional costs due to, for example, sales tax consequences, property title transfer, relocation of tangible assets, and non-transferable key contracts.

One way to have the ease of a stock purchase together with the benefit of basis step-up is for the purchaser to purchase stock and make an election under IRC Section 338. The election of IRC Section 338 treats the stock sale as if the target corporation's assets were sold to an unrelated person. In this scenario, the target corporation is referred to as the Old Target. The deemed sale of assets usually results in a basis step-up in the assets deemed sold andthe target corporation must realize gain on deemed sale of assets. In addition, the selling shareholder must report gain on the sale of stock. Therefore, electing IRC Section 338 results in double taxation.



To avoid double taxation, if certain requirements are met, the selling party and the purchaser can make a joint election under IRC Section 338(h)(10).

For an IRC 338(h)(10) election, the buyer and seller must jointly elect. In order to make a valid election for California tax purposes, the person or entity making the election must be a California taxpayer for California purposes. For a corporation to be considered a California taxpayer, it must be incorporated in California, be qualified to do business in California, conducting business in California, or be a member of a combined reporting group with at least one member that is a California taxpayer. See California Revenue and Taxation Code (R&TC) Sections 23037 and 23038.

Note that only the buyer can be part of a combined reporting group. S corporations cannot file a combined group return.

California has conformed to IRC Section 338 by virtue of its conformity to Subchapter C in R&TC Section 24451.

16.2 IRC SECTION 338(H)(10) ELECTION - OVERVIEW

The election of IRC Section 338(h)(10) treats the stock transaction as if Old Target, transferred all of its assets to an unrelated person (New Target) in exchange for consideration that includes the discharge of liabilities in a single transaction at the close of the acquisition date and then transferred all of its assets (the sales proceeds) in exchange for the stock of the selling shareholders and ceased to exist. (Treasury Regulations (Treas. Reg.) Section 1.338(h)(10)-1(d)(3) and Treas. Reg. Section 1.338(h)(10)-1(d)(4)) The stock transaction is ignored for tax purposes.

Note that under Treas. Reg. Section 1.338(h)(10)-1(d)(2), New Target remains liable for the new tax liabilities of Old Target, including the tax liability for the deemed sale.

The transfer of the sales proceeds to the selling shareholders may be treated, for example (Treas. Reg. Section 1.338(h)(10)-1(d)(4)):

- As a distribution or part of a reorganization
- As a distribution or one in a series of distributions in redemption of stock as part of a plan of liquidation, or
- As a part of a circular cash flow

Treas. Reg. Section 1.338(h)(10)-1(d)(4) states that "[I]n most cases, the transfer will be treated as a distribution in complete liquidation to which [Internal Revenue Code] Section 336 or 337 applies."

The transaction is viewed as if an actual asset sale occurred for all purposes of determining income or franchise tax. If the federal regulations fail to address a particular situation, the issue should be analyzed as if the deemed sale transactions actually occurred. (Treas. Reg. Sections 1.338(h)(10)-1(d)(4) and 1.338(h)(10)-1(d)(9))

16.3 LAW UPDATES

The regulations under IRC Section 338 contain explanations and examples of how the 338 rules apply, including the IRC Section 338(h)(10) rules and their application to S corporation targets. R&TC Section 23051.5(d) states "regulations promulgated in final form or issued as temporary regulations by the 'secretary' shall be applicable as regulations issued under this part to the extent that they do not conflict with this part or with regulation issued by the Franchise Tax Board." Final or temporary federal regulations apply so long as California has conformed to the underlying law. Auditors should look at R&TC Section 17024.5 for the latest conformity dates.

Treas. Reg. Section 1.338(h)(10)-1 applies to IRC Section 338(h)(10) elections in addition to the rules of Treas. Reg. Section 1.338-1 through Treas. Reg. Section 1.338-10, unless a rule within Treas. Reg. Section 1.338(h)(10)-1 overrides those general rules. (Treas. Reg. Section 1.338(h)(10)-1(a))

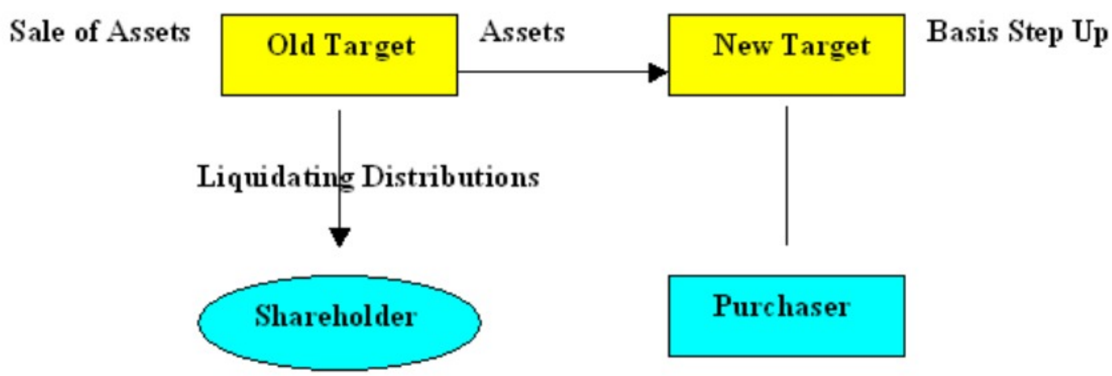
Temporary regulations were promulgated in a piecemeal fashion from 1982 through 1991, with many changes being made during that time period. (See T.D. 7855, 1982-2 C.B. 79, T.D. 7942, 1984-1 C.B. 93, T.D. 7975, 1984-2 C.B. 81, T.D. 8021, 1985-1 C.B. 96, T.D. 8068, 1986-1 C.B. 165, T.D. 8072, 1986-1 C.B. 111, T.D. 8074, 1986-1 C.B. 126, T.D. 8088, 1986-1 C.B. 52, T.D. 8092, 1986-2 C.B. 49, T.D. 8215, 1988-2 C.B. 304 and T.D. 8339, 1991-1 C.B. 52.) Regulations finalized in 1994 apply generally to the acquisition of targets on or after January 20, 1994 but before January 6, 2000. (See T.D. 8515, 1994-1 C.B. 89 and T.D. 8516, 1994-1 C.B. 119.) Many of the 1994 regulations were re-designated or reissued in temporary form in January of 2000. (See T.D. 8858, 2000-4 I.R.B. 332.) For acquisitions occurring after January 5, 2000 but before March 16, 2001, these temporary regulations apply.

In February of 2001, the temporary regulations were made final and apply to qualified stock purchases occurring after March 15, 2001. (See T.D. 8490, 66 Fed. Reg. 9925 (2/13/01)) References to the regulations contained within this manual are to the final regulations effective March 15, 2001.

For qualified stock purchases occurring prior to that date, please refer to the temporary or final regulations in effect at the time of the purchase. Each version of the regulations contains changes, some of which are significant. Therefore, it is important to make sure that the correct regulations are followed.

16.4 MECHANICS OF IRC SECTION 338(H)(10) ELECTION

In qualifying situations, taxpayers can make a joint election to treat a stock sale transaction as if the target corporation (Old Target) sold assets to another corporation (New Target), followed by the termination of Old Target's existence. Therefore, there are two tax transactions that must be considered – (1) a deemed sale of assets by the target corporation and (2) a deemed transfer of the sales proceeds to the shareholders in exchange for target corporation stock and cessation of the existence of the corporation (typically via a liquidation). The stock sale is ignored for tax purposes. (IRC Section 338(h)(10)(A) and Treas. Reg. Section 1.338(h)(10)-1(d)(5)(iii)) When these transactions are completed, the purchaser owns the New Target, which holds the Old Target's assets with a higher basis.



Note that in reality, New Target and Old Target are the same corporation with the same name, FEIN and CCN.

16.5 REQUIREMENTS

The election of IRC Section 338(h)(10) may be made when a corporation purchases stock of a target corporation in a qualified stock purchase.

Purchaser

A purchaser must be a corporation. (IRC Section 338(d)(1) & (3)) An individual may establish a subchapter C corporation and have the corporation purchase stock from a seller. (Treas. Reg. Section 1.338-3(b)(1))

An S corporation can also be a purchaser. IRC Section 1371(a) provides that rules applicable to C corporations apply to S corporations and its shareholders.

To be eligible to make an IRC Section 338(h)(10) election for California purposes, a purchaser must be a California taxpayer or a member of a combined reporting group that has at least one member that is a California taxpayer. (R&TC Section 23051.5) Note that the determination of the purchaser's eligibility to make an election is made at the time of the election and not at the time of the acquisition.

For detailed discussion as to who is eligible to make an IRC Section 338 election and an IRC Section 338(h)(10) election for California purposes, see Technical Advice Memorandum 200206 (September 15, 2000).

Seller

A seller is defined in Treas. Reg. Section 1.338(h)(10)-1(c) and includes S corporation shareholders. The shareholders must be California taxpayers. If the S corporation owns a subsidiary (a QSub) that is a Target, then the S corporation could be a qualified seller. Changes in IRC Section 1361(b) in 1996 resulted in the ability of S corporations to own subsidiaries.

Events

a. 80 percent ownership requirement

A purchasing corporation must purchase 80 percent or more of a target's stock within a 12-month period. (IRC Section 338(d)(3)) The first day the corporation acquires at least 80 percent of the stock is considered the acquisition date.

Note that under Treas. Reg. Section 1.338(h)(10)-1(d)(1), an automatic election is deemed to have been made for nonrecently purchased target stock. Also, the 12-month requirement may be extended under IRC Section 338(e)(3) and (i). (Treas. Reg. Section 1.338-8(j)(2))

Treas. Reg. Section 1.338(h)(10)-1(d)(3) states that the S election continues in effect through the close of the acquisition date, including the time of the deemed asset sale and termination of Old Target, notwithstanding IRC Section 1362(d)(2)(B). Since the S corporation target is acquired by a qualified purchaser that must be a corporation, the S election will be automatically terminated under IRC Section 1362(d)(2)(B) because corporations are not permitted to be S corporation shareholders.

b. Qualified Purchase

To qualify, the purchaser and the seller must be unrelated, and the seller must recognize all of the gain or loss on the sale under IRC Section 338(h)(3). (See Treas. Reg. Sections 1.338-3(b)(2) and (3) for a discussion of the term "purchase" and the meaning of "related.") Thus, IRC Section 351, IRC Section 354, IRC Section 355, and IRC Section 356 transactions are not qualified purchases of stock. (IRC Section 338(h)(3))

c. Post Acquisition Event

Because the law requires the purchaser to be a true purchaser, if the purchaser existed only for the purpose of making the election, the qualification of the transaction may be questionable. (Treas. Reg. Section 1.338-3(c)(2)) For example, a taxpayer establishes a corporation to acquire another corporation and elects IRC Section 338(h)(10). If immediately after the election another corporation acquires the purchasing corporation, the purchasing corporation may be a transitory subsidiary and may not be considered a true purchaser. To determine who the true purchaser is, we may use the "step transaction" analysis.

If an individual taxpayer wants to acquire stock of a target and take advantage of IRC Section 338, the individual may form a corporation (New P) to acquire the stock. New P may not be considered the true purchaser if, for example, New P is merged into the target, liquidated or otherwise disposed of after the purported qualified purchase. (Treas. Reg. Section 1.338-3(b)(1)) The same would apply for a partnership that wants to make a qualified purchase.

Elimination of the target (by liquidation, for example) on or after the acquisition date will not invalidate the IRC Section 338 election. (Treas. Reg. Section 1.338-3(c)(1))

16.6 MANNER OF MAKING THE ELECTION

The election must be made by the 15th day of the 9th month after the acquisition date by filing federal Form 8023. (Treas. Reg. Section 1.338(h)(10)-1(c)(2)) Note that as long as taxpayers file federal Form 8023 timely, the election is valid.

The purchaser and the S corporation shareholders must jointly make the election. S corporation shareholders who do not sell their stock must also consent to the election. (Treas. Reg. Section 1.338(h)(10)-1(c)(2)) federal Form 8023 did not clearly reflect the need for the non-selling shareholders to sign the form. Treas. Reg. Section 1.338(i)-1 states that if the non-selling shareholders failed to sign the September 1997 revision of federal Form 8023, the IRC Section 338(h)(10) election will not be invalidated if the S corporation and all its shareholders (including non-selling shareholders) report the tax consequences with the results under IRC Section 338(h)(10).

An IRC Section 338(h)(10) election is irrevocable. (Treas. Reg. Section 1.338(h)(10)-1 (c)(4)) If an IRC Section 338(h)(10) election is made, then an IRC Section 338 election is deemed made. (Treas. Reg. Section 1.338(h)(10)-1(c)(4)) If a valid election is made for federal tax purposes, the election automatically applies for California tax purposes under R&TC Section 17024.5(e), R&TC Section 23051.5(e) and R&TC Section 23806(a) and (b).

S corporations or their shareholders are not allowed to elect out of the federal IRC Section 338(h)(10) election for California under R&TC Section 23806(a) and (b).

If a stock transaction does not qualify for the IRC Section 338(h)(10) election (an invalid election is made), it cannot qualify for the regular IRC Section 338 election. The deemed Section 338 election is invalid as well. (Treas. Reg. Section 1.338(h)(10)-1(c)(5)) When an invalid election is made, the transaction is treated as a simple stock transfer. Therefore, the New Target does not receive basis step up.

16.7 TRANSACTIONS – PURCHASING CORPORATION, NEW TARGET, OLD TARGET CORPORATION, AND SELLING SHAREHOLDERS

As explained in Section 16.4 of this Section (Mechanics of IRC Section 338(h)(10)), there are four parties to the transaction – Old Target, Selling Shareholders, New Target, and Purchasing Corporation. Selling Shareholders sell Old Target stock to Purchasing Corporation, making Purchasing Corporation the new owner of New Target.

To reflect the stock transaction with election of IRC Section 338(h)(10) on their books, each party must do the following:

16.7.1 Purchasing Corporation

A purchasing corporation must determine the grossed-up basis of Target's stock. The grossed-up basis of Target's stock is the cost incurred to purchase stock including capitalized purchasing costs. (IRC Section 1012)

Example A

Susan (a sole shareholder of an S corporation, S Mart) sold all of issued and outstanding S-Mart stock to P-Mart (a C corporation) for $1 million. A valid, joint IRC Section 338(h)(10) election was made regarding the stock sale. P-Mart paid an additional $60,000 to close the stock purchase.

As a new stockholder, P-Mart's computes its grossed-up basis of S-Mart stock as follows:

Stock purchase price	$1,000,000
Capitalized cost	60,000
Grossed-up basis of S-Mart stock	$1,060,000

The $1,060,000 is P-Mart's basis in S-Mart stock.

16.7.2 New Target

New Target's basis in asset is the amount for which New Target is deemed to have purchased and is called the adjusted grossed-up basis (AGUB). (IRC Section 338(b)(2) and Treas. Reg. Section 1.338(h)(10)-1(d)(2) and 1.338-5(a))

The AGUB is the sum of (Treas. Reg. Section 1.338-5(b)(1)):

1. The grossed-up basis in the purchasing corporation's recently purchased Target stock (IRC Section 338(b)(1)(A) and Treas. Reg. Section 1.338-5(c));
2. The purchasing corporation's basis in non-recently purchased Target stock (IRC Section 338(b)(1)(B) and Treas. Reg. Section 1.338-5(d)); and
3. The liabilities of New Target (IRC Section 338(b)(2) and Treas. Reg. Section 1.338-5(e)).

Recently purchased stock is stock held by the Purchaser on the acquisition date and purchased by Purchaser during the 12-month acquisition period. (IRC Section 338(b)(6)(A) and (h)) Non-recently purchased stock is stock held by the Purchaser on the acquisition date that was not purchased during the 12-month acquisition period. (IRC Section 338(b)(6)(B) and (h))

1. Grossed-Up Basis in Recently Purchased Stock

The grossed-up basis in the purchasing corporation's recently purchased Target stock is the total price that Purchasing Corporation would have paid for all outstanding Target stock, except for the amount allocated to the non-recently purchased stock.

The basis of recently purchased stock is determined at the beginning of the day after the acquisition date without regard to acquisition costs. This basis is then multiplied by a fraction, the numerator of which is 100 minus the number that is the percentage of Target stock (by value, determined on the acquisition date) attributable to the Purchaser's non-recently purchased stock, and the denominator of which is the number equal to the percentage of Target stock (by value, determined on the acquisition date) attributable to the Purchaser's recently purchased stock. Acquisition costs that Purchaser incurred in connection with its purchase of recently purchased stock, such as brokerage commissions, are then added in to determine the grossed up basis of recently purchased stock. (Treas. Reg. Section 1.338-5(c))

If Target is an S corporation, the grossed-up basis in the purchasing corporation's recently purchased Target stock is the stock sale price plus any capitalized purchasing cost. This result is due to the fact that the Target is an S corporation, and the first time that its stock is purchased by a corporation in a Section 338 transaction, the S election is terminated under IRC Section 1362(d)(2)(B) because it will have a corporate shareholder. However, Treas. Reg. Section 1.338(h)(10)-1(d)(3) specifies that if an S corporation is a target in an IRC Section 338(h)(10) transaction, the S election will continue in effect through the close of the acquisition date, including the time of the deemed asset sale and the deemed transfer, notwithstanding IRC Section 1362(d)(2)(B).

Note, however, that the seller or purchaser could be an S corporation and the acquisition or sale of a subsidiary of an S corporation will not terminate the parent corporation's S election.

2. Basis in Non-recently Purchased Stock

The purchasing corporation's basis in non-recently purchased target stock is Purchaser's basis in that stock, unless it makes an election under IRC Section 338(b)(3).

If Target is an S Corporation, there will be no non-recently purchased stock because the acquisition of the stock of an S corporation by a corporation will terminate the S election under IRC Section 1362(d)(2)(B) (the S corporation cannot have a corporation as a shareholder). In order to qualify for the 338 election, Purchaser must be a corporation.

3. Liabilities of New Target

The liabilities of New Target are Target's liabilities assumed by New Target. (Treas. Reg. Section 1.338-5(e))

AGUB is initially determined at the beginning of the day after the date of the acquisition of Target. (Treas. Reg. Section 1.338-5(b)(2)(i)) AGUB may need to be redetermined if there is an increase or decrease, for example, in the amount paid for the stock. See Treas. Reg. Section 1.338-5(b)(2)(ii) for a discussion regarding the redetermination of AGUB.

Once New Target determines the AGUB, New Target must allocate the AGUB among each class of assets and then to each asset in accordance with Treas. Reg. Section 1.338-6 and Treas. Reg. Section 1.338-7. (Treas. Reg. Section 1.388(h)(10)-1(d)(2)) The method described under Treas. Reg. Section 1.338-6 is called Residual Method.

Using the Residual Method, AGUB is assigned to each class of asset, from Class I through Class IV, up to the fair market value (FMV). Refer to the valuation training material for the discussion of FMV and how to determine FMV. Then, the remainder is assigned to Class V (Goodwill). Assets are classified as follows:

Class I	Cash and Demand Deposit
Class II	Marketable Securities, CD's Foreign Currency
Class III	All others except Classes I, II, IV, and V
Class IV	All intangibles except Goodwill
Class V	Goodwill

Note that in practice, the book value is usually used as the FMV and the remainder is assigned to goodwill. This typically is not an issue unless it was done purposely to avoid or change the character of income.

Once AGUB is allocated among the five classes of assets, New Target must further apportion the new basis (assigned to each class) to each asset within a class proportionately. The amount of basis applied to each asset is the opening balance of the New Target balance sheet.

Example B

In addition to the facts in Example A, S-Mart had $100,000 A/P and a $200,000 Long-Term Loan at the time of the stock sale. New S-Mart computes the adjusted grossed-up basis (AGUB) in the assets deemed acquired from Old S-Mart as follows:

AGUB:	Grossed-up basis of S-Mart stock	$1,060,000
	S-Mart's liabilities assumed (A/P $100,000, N/P $200,000)	300,000
		$1,360,000

Also, Old S-Mart had the following assets at the time of the stock sale:

Assets	A/B	FMV
Cash	$50,000	$50,000
Inventory	150,000	150,000
A/R	100,000	100,000
N/R	20,000	20,000
Equipment	140,000	60,000
Land/Building	170,000	300,000
Total Assets	$630,000	$780,000

Using the residual method, New S-Mart allocates the AGUB among each class of assets as follows:

Class	Assets	FMV	Allocation	Residual
I	Cash	$50,000	$50,000	$1,310,000
II	N/A			1,310,000
III	Inventory	150,000	150,000	1,160,000

	A/R	100,000	100,000	1,060,000
	N/R	20,000	20,000	1,040,000
	Equipment	160,000	160,000	880,000
	Land/Building	300,000	300,000	580,000
IV	N/A			
V	Goodwill		580,000	0
Total Assets			$1,360,000	

New S-Mart's opening balance sheet should look like this:

Assets		Liabilities & Equity	
Cash	$50,000	N/P	$200,000
		A/P	100,000
Inventory	150,000	Total Liab	300,000
A/R	100,000		
N/R	20,000		
Equipment	160,000		
Land/Building	300,000		
Goodwill	580,000	Equity	1,060,000
Total Assets	$1,360,000	Total Liab. & Equity	$1,360,000

S-Mart's assets received a basis step-up when the transaction was completed. As of the day after the acquisition date, New Target is generally treated as a new corporation, unrelated to Old Target, that has no tax attributes (including no net operating losses and no earnings and profit). (Treas. Reg. Section 1.338-1(b)(1)) New Target may make new accounting period and method elections. (Treas. Reg. Section 1.338-1(b)(1)) For non-income/franchise tax purposes, such as payroll tax, New Target is a continuation of Old Target. (Treas. Reg. Section 1.338-1(b)(2))

16.7.3 Old Target Corporation

Old Target Corporation must book transactions as if it had sold all of its assets to an unrelated corporation (New Target) in exchange for consideration that includes the discharge of liabilities in a single transaction at the close of the acquisition date, transferred the proceeds to Seller, and terminated its existence. (Treas. Reg. Section 1.338(h)(10)-1(d)(3) and Treas. Reg. Section 1.338-10(a)(1)) Therefore, except as provided in Treas. Reg. Section 1.338(h)(10)-1(d)(8) (regarding the installment method), Old Target recognizes all the gain realized on the deemed sale of assets and reports the result as an S corporation on its final year return. (Treas. Reg. Section 1.338(h)(10)-1(d)(3) and Treas. Reg. Section 1.338-10(a)(1) and (5)) The return is due on the 15th day of the 3rd month following the month in which the acquisition occurs. (Treas. Reg. Section 1.338(h)(10)-1(d)(3)(i) Target's S election continues in effect through the close of the acquisition date (including the time of the deemed asset and the deemed transfer) notwithstanding IRC Section 1362(d)(2)(B).

As mentioned before, New Target is treated as a new corporation that is unrelated to Old Target and receives no tax attributes from Old Target. (Treas. Reg. Section 1.338-1(b)(1))

The gain or loss on the deemed sale of each asset is determined by reference to the aggregate deemed sales price (ADSP). (Treas. Reg. Section 1.338(h)(10)-1(d)(3)(i) and

1.338-4) ADSP is the amount for which Target is deemed to sell its assets. (Treas. Reg. Section 1.338-4(a)) ADSP is the sum of the grossed-up amount realized on the sale to Purchaser of Purchaser's recently purchased Target stock and the liabilities of Old Target. (Treas. Reg. Section 1.338-4(b)(1)) The grossed-up amount realized is the amount realized for the stock minus the selling cost incurred by the selling shareholders (e.g., brokerage commissions and any other similar costs incurred). (Treas. Reg. Section 1.338-4(c)) ADSP is initially determined at the beginning of the day after the acquisition date of Target. (Treas. Reg. Section 1.338-4(b)(2)(ii)) ADSP may need to be redetermined, for example, because of an increase or decrease in the amount realized or because liabilities not originally taken into account are subsequently taken into account. (Treas. Reg. Section 1.338-4(b)(2)(ii)) ADSP may not be applied in such a way as to contravene other applicable rules. (Treas. Reg. Section 1.338-4(f))

For purposes of calculating ADSP, the liabilities of Old Target are measured as of the beginning of the day after the date of acquisition. In order to be taken into account in ADSP, a liability must be a liability of Target that is properly taken into account in the amount realized under general principles of tax law that would apply if Old Target had sold its assets to an unrelated person for consideration that included the discharge of its liabilities. (Treas. Reg. Sections 1.338-4(d)(1) and 1.1001-2(a))

ADSP is then allocated among Target's assets in accordance with Treas. Reg. Section 1.338-6 to determine the amount for which each asset is deemed to have been sold. (Treas. Reg. Section 1.338-4(a)) If ADSP is redetermined, then Treas. Reg. Section 1.338-7 is used to allocate the redetermined ADSP.

Once the ADSP is computed, Old Target allocates ADSP among the assets deemed sold to determine the character and the amount of gain/loss on each asset. (Treas. Reg. Sections 1.338(h)(10)-1(d)(3)(i) and 1.338-6) The method used (the residual method) is the same as the method used by New Target in allocating AGUB among the deemed purchased assets from Old Target.

Example C

Using the facts in Example A and B, Old S-Mart computes the aggregate deemed sales price (ADSP) of the assets deemed sold to New S-Mart. The selling cost incurred for the stock sale was $90,000, and liabilities assumed by New S-Mart totaled $300,000.

ADSP:	Grossed-up basis of S-Mart stock	$1,060,000
	S-Mart liabilities (A/P $100,000, N/P $200,000)	300,000
	Selling cost incurred by the seller	(90,000)
		$1,270,000

Old S-Mart allocates the $1,270,000 among the assets held at the time of stock sale:

Assets	Adjusted Basis	FMV
Cash	$50,000	$50,000
Inventory	150,000	150,000
A/R	100,000	100,000
N/R	20,000	20,000
Equipment	140,000	160,000

Land/Building	170,000	300,000
Total Assets	$630,000	$780,000

Using the residual method, New S-Mart first allocates the $1,270,000 ADSP among each class of assets:

Class	Assets	FMV	Allocation	Residual
I	Cash	$50,000	$50,000	$1,220,000
II	N/A			
III	Inventory	150,000		
	A/R	100,000		
	N/R	20,000		
	Equipment	160,000		
	Land/Building	300,000	730,000*	490,000
IV	N/A			
V	Goodwill		490,000	0
	Total Assets		$1,270,000	

* $730,000 will be allocated to each class III asset proportionately.
Old S-Mart computes the amount and the character of gain on sale of each asset as shown below:

Assets	Amount Realized	Adj. Basis	Gain/(Loss)
Cash	$50,000	$50,000	
Inventory	150,000	150,000	
A/R	100,000	100,000	
N/R	20,000	20,000	
Equipment	160,000	140,000	20,000
Land/Building	300,000	170,000	130,000
Goodwill	490,000	0	490,000
Total Assets	$1,270,000	$630,000	$640,000

Auditors must pay special attention to the types of gains or losses from the deemed sale of assets. They may trigger additional tax issues (such as built-in gains tax), as discussed later in this section.

16.7.4 Selling Shareholders

The S corporation shareholders, whether or not they sell their stock, report their pro rata share of the deemed sale consequences under IRC Section 1366 and increase or decrease their basis in the Target stock under IRC Section 1367. (Treas. Reg. Section 1.338(h)(10)-1(d)(5)(i)) This occurs because the S corporation Target will report the deemed gain on its final S corporation tax return. (Treas. Reg. Section 1.338(h)(10)-1(d)(3)(i)) The selling S corporation shareholders treat the transaction as if (after the deemed sale and before the close of the acquisition date) Old Target transferred the assets (the sales proceeds) to the shareholders. In most cases, the transfer of the assets (the sales proceeds) will be treated as a distribution in complete liquidation to which IRC Section 331 or IRC Section 332 applies. (Treas. Reg. Section 1.338(h)(10)-1(d)(5)(i)) Therefore, shareholders realize capital gain or loss on the exchange. The amount realized is the stock price, and the adjusted basis is the shareholders' basis in the stock, after taking into account the flow-through income or loss items.

In computing the gain/loss, the shareholders' basis in the stock should be increased/decreased by the flow-through gain/loss recognized on the deemed sale of assets by the corporation, pursuant to IRC Section 1367(a). Most often there will be an increase in stock basis which will cause there to be little or no gain or loss recognized by the shareholders on the deemed liquidation.

As mentioned before, an IRC Section 338(h)(10) election is irrevocable. If an IRC Section 338(h)(10) election is made, then an IRC Section 338 election is deemed made. If a stock transaction does not qualify for the IRC Section 338(h)(10) election (an invalid election is made), it cannot qualify for the regular IRC Section 338 election. Therefore, the deemed IRC Section 338 election is invalid as well. If an invalid election is made, the transaction is treated as a simple stock transfer. Therefore, the New Target does not receive basis step up, and the selling shareholders compute gain/loss pursuant to IRC Section 1001(a).

S corporation shareholders who do not sell their stock in Target are treated as acquiring the retained stock on the day after the acquisition date for its FMV. (Treas. Reg. Section 1.338(h)(10)-1(d)(5)(ii)) The holding period for the stock starts on the acquisition date. The FMV of the Target stock equals the grossed-up amount realized on the sale to the Purchaser of recently purchased Target stock. The S corporation shareholders recognize no gain or loss on the sale of Target stock, although gain or loss may be recognized in the deemed transfer. (Treas. Reg. Section 1.338(h)(10)-1(d)(5)(iii))

Gain or loss on the actual sale of Target stock is ignored in an IRC Section 338(h)(10) transaction. (IRC Section 338(h)(10)(A) and Treas. Reg. Section 1.338(h)(10)-1(d)(5)(iii))

Example D

Using the facts in Examples A, B, and C, Susan sold all of her issued and outstanding S-Mart stock to P-Mart for $1 million. A valid, joint IRC Section 338(h)(10) election was made regarding to the stock sale. Old S-Mart recognized $640,000 gain (no built-in gains) on deemed sale of assets and passed through the gain (along with other flow-through items) to Susan.

Susan's stock basis was $330,000, excluding effects of the IRC Section 338(h)(10) elections, but including all other flow-through items. Susan must recognize the $640,000 flow-through gain and increase her stock basis in Old S-Mart to $970,000 ($330,000+$640,000).

Under IRC Section 331(a), Susan computes her gain on deemed liquidation of S-Mart as follows:

Amount Realized (Stock Price)	$1,000,000
Adjusted Basis (Stock Basis)	(970,000)
Capital Gain on Sale of Stock	$30,000

If Susan was a California resident, her total gain recognized from the IRC Section 338(h)(10) election should be $670,000 ($640,000 flow-through gain and $30,000 capital gain under IRC Section 331(a)).

16.8 INSTALLMENT METHOD OF INCOME RECOGNITION

Treas. Reg. Section 1.338(h)(10)-1(d)(8) modifies the general rules for the tax consequences of IRC Section 338(h)(10) elections when applying the installment sales method and rules of IRC Section 453, IRC Section 453A and IRC Section 453B to Old Target in the deemed asset sale and to Old Target and its shareholders in the deemed liquidation (if applicable). Note that the regulations merely discuss the consequences of the application of the installment sales rules. The regulations do not override the requirements and limitations of the installment sales rules but merely describe the nature of the transactions when the installment sales rules apply in the context of an IRC Section 338(h)(10) transaction. California has generally conformed to the federal installment sales. The last conformity date was January 1, 2015.

In the case of an installment sale, Old Target is treated as receiving an installment obligation in exchange for its assets. Old Target is also treated as receiving in cash all other consideration in the deemed asset sale other than the assumption of, or taking subject to, Old Target liabilities.

If necessary, the amount realized for recently purchased stock and ADSP are redetermined to reflect amounts actually paid under an installment obligation for the stock when the total payments under the installment obligation are greater or less than the amount realized.

With respect to a deemed liquidation, Old Target is treated as distributing (in the deemed liquidation) the New Target installment obligations that it is treated as receiving in the deemed asset sale. The S corporation shareholders are treated as receiving (in the deemed liquidation) the installment obligations (that correspond to the Purchasing Corporation installment obligations they actually receive individually) in exchange for their recently sold stock.

See below for the mechanism of computing gain/loss by Old Target and the selling shareholders:

Example E

On 12/31/2016, a sole shareholder of Target sold Target stock to a qualified purchasing corporation for $75 and received a $40 installment note and $35 cash. Target's liabilities assumed by the purchasing corporation were $25. Total adjusted basis of assets deemed sold was $30. In year 2017 the shareholder collected $40 in full. Shareholders' basis in the stock was $20 immediately before the sale.

(a) Mechanics of an IRC Section 338(h)(10) with Installment Method of Income Recognition for Federal

1. Old Target reports $32.67 gain in 2016:

Amt. Realized	$100 (75 + 25 liabilities assumed)
A/B of Assets	30
Gross Profit	70
Profit %	93.34% (70 / 75)(i)
Cash Receipt	35
Gain	$32.67 (ii)

(i)The profit percentage should be computed by dividing the gross profit by the contract price pursuant to IRC Section 453.

(ii) Gain (attributable to deemed sale of assets) flows through to shareholder under IRC Section 1366(a) and increases shareholders' basis under IRC Section 1367(a)(1).

2. Selling Shareholder reports $10.42 gain in 2016:

Under IRC Section 453(h)(1)(A), when a shareholder receives an installment note in a liquidation of corporation during the 12-month winding-down period, the shareholder must treat installment payments as payments in exchange for stock. Therefore, a new profit percentage must be computed by the shareholder and applied to cash receipts to compute gain on installment payments.

Amt. Realized	$75 (stock price)
A/B stock	52.67 (20 plus 32.67 flow-through gain)
Gross Profit	22.33
Profit %	29.77% (22.33 / 75)
Cash Receipt	35
Rec. Gain	$10.42

3. Selling Shareholder receives $40 installment payment in 2018 and reports $11.91 gain in 2018:

Cash Receipt	$40
Profit %	29.77%
Rec. Gain	$11.91

California conforms to the federal provision of installment method of income recognition under IRC Section 453. However, for California Franchise Tax purposes, Target must report the unrecognized portion of the gain realized on a deemed sale of assets in 2016, pursuant to R&TC Section 24672(a) as follows. This acceleration of the gain is only applicable to the corporation for purposes of the 1.5% tax. See example below:

(b) Mechanics of an IRC Section 338(h)(10) with Installment Method Transaction for California

1. Old Target reports $70 gain in 2016:

Amt. Realized	$100 (75 stock price + 25 liabilities assumed)
A/B	30
Gross Profit	70
Profit %	93.34% (70/75)
Cash Receipt	35
Rec. Gain	32.67 -- flow-through gain
R&TC Section 24672(a) Gain	$37.33 (i)

(i) The gross profit is $70 and the gain reported in the current year is $32.67, thus the unrecognized portion of the gain is $37.33. The $37.33 gain does not flow-through to shareholders since we allow the installment method of income recognition.

16.9 AUDIT ISSUES

As explained in previous sections, the IRC Section 338(h)(10) election treats Target as if it had sold all assets and then ceased to exist. All tax provisions that are applicable to sale of assets and a corporate liquidation apply to Old Target and to the selling shareholders. Auditors should be aware of the following issues.

a. IRC Section 1245 Recapture

When a corporation sells IRC Section 1245 assets with accumulated depreciation and realizes gain, a portion of the gain must be classified as ordinary income instead of IRC Section 1231 gain. This is called IRC Section 1245 recapture. It is because the gain on sale of IRC Section 1245 assets is the result of the basis reduction by depreciation expenses (reducing ordinary income) and is not the result of appreciation. Therefore, it is fitting to characterize such gain as "ordinary" instead of "capital." The amount classified as ordinary income must be reported in the year realized and must not be deferred under the installment method pursuant to IRC Section 453(i)(1)(A).

Taxpayers tend to allocate more of ADSP to goodwill and less to Class III assets, to reduce the amount of possible IRC Section 1245 recapture. Therefore, it is imperative that auditors carefully analyze the FMV of each class/type of asset. Refer any issues relating to FMV to the valuation task force.

b. Built-In Gains

If the target corporation is an S corporation with unrealized built-in gain at the time of an S election, auditors should be concerned with the built-in gains issue. Although IRC Section 338(h)(10) triggers a deemed sale of assets by the target corporation, all tax provisions applicable in a true sale of assets applies to the deemed sale of assets, including the built-in gains tax provision. Please refer to S Corporation Manual Section 5.0 Built-in Gains for details.

c. Selling Shareholders' Flow-Through Gain or Loss

Under IRC Section 1366(b), the character of flow-through gain/loss that resulted from the deemed sale of assets is decided at the corporate level. If Target has California source income, the sourcing passes through to the shareholders. Even a non-California resident shareholder must report his/her share of flow-through gain/loss on a deemed sale of assets. (See California Court of Appeal, Fourth Appellate District, Division One, *Gene Valentino et al. v. Franchise Tax Board*) As in the case of *Valentino*, often California nonresident shareholders exclude their share of flow-through gain (on a deemed sale of assets) from California taxable income by classifying the income as income recognized on a sale of stock -- intangible asset. However, such treatment is erroneous. If a valid IRC Section 338 election is in place, the transaction is treated as a sale of assets by Target Corporation and not as sale of stock by the shareholders.

d. Selling Shareholders' Capital Gain/Loss on Target Liquidation

Under IRC Section 338(h)(10) and 331(a), shareholders compute gain/loss as if they had exchanged stock for deemed liquidating distributions. The shareholders' amount realized is the stock price; the adjusted basis is their basis in the stock sold.

As mentioned above, because the shareholders' stock basis received an increase when they reported flow-through gain on the deemed sale of assets by the corporation, the selling shareholders avoid double taxation on the gain by electing IRC Section 338(h)(10).

Unlike flow-through gain, the character of gain/loss realized on deemed liquidating distributions is decided at the shareholder level, following Personal Income Tax law. Therefore, California nonresident individual shareholders report the gain/loss on deemed liquidating distributions to their state of residency, not to California.

In a case where the selling shareholders are nonresidents and the installment method of income recognition was used to report income, the character of the gain/loss reported by the nonresident upon the receipt of the installment payments should be determined pursuant to IRC Section 453B(h)(1) and (2).

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