New York State Department of Taxation and Finance
Taxpayer Services Division
Technical Services Bureau

TSB-A-97(5)C
Corporation Tax
TSB-A-97(2)I
Income Tax

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. Z960430A

On April 30, 1996, a Petition for Advisory Opinion was received from Arnold Haskell, CPA, Holtz Rubenstein & Co., LLP, 125 Baylis Road, Suite 300, Melville, New York 11747.

The issue raised by Petitioner, Arnold Haskell, CPA, concerns the New York State tax treatment of a transaction where an election under section 338(h)(10) of the Internal Revenue Code ("IRC") is made by the shareholders of a corporation that has elected to be taxed under Subchapter S of the IRC ("S corporation") when (1) the corporation is a non-electing S corporation for New York tax purposes, and (2) the corporation is a New York electing S corporation.

Petitioner submits the following facts as the basis for this Advisory Opinion.

X corporation is a New York State corporation, whose shareholders have elected to be taxed as an S corporation for federal income tax purposes. At the present time, an S election has not been made for New York State tax purposes, although such election is being considered.

X has four equal (25%) shareholders. Three are residents of New York State.

Although at this time no transaction has actually occurred, X is the possible target for acquisition by an unrelated party. The transaction will potentially be structured as an acquisition of the stock of X coupled with an election under section 338(h)(10) of the IRC. This election under section 338(h)(10) of the IRC would treat the qualifying stock acquisition as a deemed asset sale by X followed by an immediate deemed liquidation of X. It is anticipated that the shareholders of X would be disposing their entire interest in X to a single unrelated party.

Petitioner states that if the shareholders of X and the acquiring party jointly make the election under section 338(h)(10) of the IRC and the Treasury Regulations thereunder, the result would be as follows:

1. X would be treated as if it had sold all of its assets at their fair market value to the acquiror in a single transaction at the close of the acquisition date, but prior to the deemed liquidation. Any gain on the deemed sale would be recognized by X which, as an S corporation, would be passed through to the selling shareholders who would be taxed on the gain at the individual level. No gain would be recognized or tax would be borne by the acquiror.

2. Immediately following the deemed asset sale, X would be deemed to have distributed all its assets in complete liquidation to the selling shareholders. The selling stockholders will be entitled to increase the basis of their stock under section 1367(a)(1) of the IRC as a result of the recognition of the gain on the deemed asset sale.

3. No gain or loss would be recognized by the selling shareholders on the actual sale of their stock to the acquiror.

4. The acquiror receives a step up in the basis of the assets to their respective fair market values deemed to be acquired, based upon the arm's length consideration paid to acquire the stock of X.

Under section 338(a) of the IRC an election may be made by the purchaser in a qualified stock purchase, which generally is one involving the purchase of 80 percent or more of the stock of a corporation within a 12 month period. However, if the target corporation is an S corporation, the acquiring corporation must acquire its qualifying interest on the acquisition date. Pursuant to this election, the target corporation (old target) is "treated as having sold all of its assets at the close of the acquisition date" (the date of the qualified stock purchase) "at fair market value in a single transaction" and is then "treated as a new corporation" (new target) "which purchased all of the assets ... as of the beginning of the day after the acquisition date." The result of the election is that the difference between the fair market value of the assets and the adjusted basis of the assets is recognized as gain or loss to old target, and the basis of the assets is stepped up or down, as the case may be.

If the election is made under section 338(a) of the IRC, a further election may be made under section 338(h)(10) of the IRC by the seller and purchaser of target stock. Under this election, target is deemed to sell all of its assets and distribute the proceeds in complete liquidation. Thus, the sale of target stock included in the qualified stock purchase generally is ignored. This election may be made for target only if it is a member of a selling consolidated group, a member of a selling affiliated group filing separate returns or an S corporation. The gain or loss on the deemed asset sale is included in the tax return of the selling consolidated group, the selling affiliated group or the S corporation shareholders, but no gain or loss is recognized on the sale of target stock by members of the consolidated group, members of the affiliated group or the S corporation shareholders.

Where a section 338(h)(10) of the IRC election is made for a target corporation that is an S corporation, the S corporation is treated as if it distributed the proceeds immediately after the deemed sale of assets in complete liquidation. The S shareholders take into account the gain or loss on the deemed asset sale that is passed through to them on a prorata basis pursuant to section 1366 of the IRC, and adjust their bases in the stock in accordance with section 1367 of the IRC. The S shareholders also take into account the gain or loss on the deemed liquidation, pursuant to section 331 of the IRC, but they do not recognize gain or loss on the actual sale of their S corporation stock.

Tax Treatment Under Article 9-A of the Tax Law

Section 208.1-A of the Tax Law provides that the term "New York S corporation" means, with respect to any taxable year, a corporation subject to tax under Article 9-A of the Tax Law for which an election is in effect pursuant to section 660(a) of the Tax Law for the year. The term "New York C corporation" means with respect to any taxable year, a corporation subject to tax under Article 9-A of the Tax Law which is not a New York S corporation.

Section 208.9(ii) of the Tax Law provides that the term "entire net income" means total net income from all sources, which shall be presumably the same as the entire taxable income (but not alternative minimum taxable income) which the taxpayer would have been required to report to the United States Treasury Department if it had not made an election under Subchapter S of Chapter one of the IRC, except as modified as required by section 208.9 and section 210.3(d) and (e) of the Tax Law.

Section 2-1.1(a) of the Business Corporation Franchise Tax Regulations (the "Article 9-A Regulations") provides that, in most cases, the taxable year for which a franchise tax report is to be filed is the same as the taxpayer's taxable year for federal income tax purposes, or that portion of the federal taxable year for which the taxpayer is subject to tax under Article 9-A of the Tax Law.

A federal S corporation making the election under section 338(h)(10) of the IRC will have two short taxable years for federal income tax purposes created by the election under section 338(a) of the IRC. A final short taxable year of the target corporation as old target and the first short taxable year as new target. Therefore, pursuant to section 2-1.1 of the Article 9-A Regulations, the federal short taxable years created by the election under section 338(a) of the IRC are similarly treated as short taxable years for purposes of Article 9-A of the Tax Law.

X is subject to tax under Article 9-A of the Tax Law regardless of whether it is a New York C corporation or a New York S corporation. However, section 210.1(g) of the Tax Law provides that a New York S corporation is not subject to the alternative minimum tax or the capital base tax. It is only subject to the tax on entire net income at a rate reduced to the differential rate or the fixed dollar minimum tax. The differential rate is the difference between the corporate rate under Article 9-A and the Article 22 equivalent rate.

Pursuant to section 208.9(ii) of the Tax Law, X's starting point for computing entire net income, whether a New York C corporation or a New York S corporation, is X's federal taxable income computed as if X had not made the election to be treated as a federal S corporation.

Pursuant to the tax treatment under section 338(a) of the IRC determined as if X had not made the election to be treated as a federal S corporation, X is treated as having sold all of its assets at the close of the acquisition date at fair market value in a single transaction. The difference between the fair market value of the assets and the adjusted basis of the assets is recognized as

gain or loss to X on its pro forma final federal return for the taxable year that ends at the close of the acquisition date. The same treatment will apply to X for purposes of Article 9-A of the Tax Law, regardless of whether it is a New York S corporation or a New York C corporation. That is, X must file a short taxable year report for the period that ends at the close of the acquisition date and its starting point for computing entire net income will be its federal taxable income as computed on its pro forma final federal return for that short taxable year. X must also file a short taxable year report under Article 9-A for the period that coincides with the federal first short taxable year as the new target. Its starting point for computing entire net income will be its federal taxable income as computed on its pro forma federal return for that short taxable year. (See, New York State Department of Taxation and Finance Publication 35 (2/96) New York Tax Treatment of S Corporations and their Shareholders, and Technical Services Bureau Memorandum TSB-M-91(4)C, April 17,1991.)

Tax Treatment Under Article 22 of the Tax Law

The personal income tax treatment for S corporation shareholders is explained in the New York State Department of Taxation and Finance Publication 35 (2/96) New York Tax Treatment of S Corporations and their Shareholders in Parts VII and VIII.

Deemed Asset Sale

X would be deemed to have sold all of its assets at their fair market value to the acquiror in a single transaction prior to the deemed liquidation. The gain on the deemed sale would be recognized by X, which would be passed through to its shareholders and included in the shareholders' federal adjusted gross incomes under section 1366 of the IRC.

Where X is a New York C corporation, a resident shareholder must subtract from the shareholder's federal adjusted gross income, pursuant to section 612(c)(22) of the Tax Law, the gain on the deemed sale of its assets that is recognized by X and passed-through to the shareholder under section 1366 of the IRC.

With respect to the nonresident shareholder of X where it is a New York C corporation, the mere ownership of the corporation's stock does not create tax jurisdiction under the New York Personal income tax, unless the X stock is employed in another trade or business carried on in New York State by the shareholder.

Where X is a New York S corporation, a resident shareholder includes in the shareholder's New York adjusted gross income the same gain on the deemed sale of X's assets that is recognized by X and passed-through to the shareholder under section 1366 of the IRC and included in the shareholder's federal adjusted gross income.

Where X is a New York S corporation, the nonresident shareholder is taxed on the X pass-through item of gain on the deemed sale of X's assets that is

recognized by X and passed-through to the shareholder under section 1366 of the IRC only to the extent the gain is derived from New York sources. The source of X's items of gain is determined at the corporate level, using the same allocation methods that apply to a corporation under Article 9-A of the Tax Law.

Deemed Liquidation

After the deemed asset sale, X would be deemed to have distributed all of its assets, to the shareholders, in complete liquidation. The shareholders would recognize gain on the deemed liquidation under section 331 of the IRC.

With respect to a resident shareholder, the shareholder includes in the shareholder's New York adjusted gross income the same gain on the deemed liquidation that is recognized under section 331 of the IRC and included in the shareholder's federal adjusted gross income, regardless of whether X is a New York C corporation or a New York S corporation.

With respect to the nonresident shareholder of X where X is a New York S corporation, the gain on the deemed liquidation would not ordinarily be New York source income, and the gain would not be included in the numerator of the New York source fraction unless the nonresident shareholder's X stock is employed in another trade or business carried on in New York State by the shareholder. As stated above, where X is a New York C corporation, a nonresident shareholder of X is not subject to tax under Article 22 of the Tax Law unless the X stock is employed in another trade or business carried on in New York State by the nonresident shareholder.

When computing the gain on the deemed liquidation where X did not elect to be a New York S corporation for all taxable years beginning after 1980, the federal and New York bases of the shareholders' stock would be different since the federal basis would have been adjusted for the S corporation income passed through each year. The shareholder's federal adjusted gross income must be modified, pursuant to section 612(n) of the Tax Law, to reflect the differences in the federal and New York bases.

Note that when a resident or nonresident shareholder of X actually disposes of the shareholder's X stock under the provisions of section 338(h)(10) of the IRC, any gain on the actual sale of X's stock is not recognized by the shareholder for federal or New York State personal income tax purposes.

/s/
DATED: February 6, 1997 John W. Bartlett
Deputy Director
Technical Services Bureau

NOTE: The opinions expressed in Advisory Opinions are limited to the facts set forth therein.