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Technical Services Bureau

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Corporation Tax
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Revisions to New York State's Treatment of Elections Under Section 338(h)(10) of the Internal Revenue Code

In 1987 the Department of Taxation and Finance issued Technical Services Bureau Memorandum TSB-M-87(4)C, which set forth the treatment of elections made under § 338(h)(10) of the Internal Revenue Code for purposes of Article 9-A of the Tax Law. As a result of recent reconsideration, it has been determined that it is appropriate to revise the treatment of such transactions. This revision, set forth below, makes technical corrections to existing treatment and simplifies filing requirements.

Federal Election

For Federal purposes, an election may be made under § 338(a) of the Internal Revenue Code by the purchaser in a qualified stock purchase, which generally speaking is one involving the purchase of 80% or more of the stock of a corporation (in terms of both voting power and value) within a twelve month period. 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." IRC § 338(a). The result of the election is that the difference between the fair market value of the assets and their basis 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 § 338(a), a further election may be made under IRC § 338(h)(10) by the seller and purchaser of target stock. Under the § 338 (h)(10) election, the gain or loss on the deemed asset sale is included in the consolidated tax return of the selling group, but no gain or loss is recognized on the sale of target stock by members of that group.

Deemed Sale of Assets

If only the election under IRC § 338(a) is made, IRC § 338(h)(9) would apply, prohibiting old target from filing on a consolidated return as a member of an affiliated group with respect to the deemed sale of assets. Thus, if target filed on a consolidated basis with seller, target's inclusion on such return would terminate immediately prior to the deemed sale of assets, and a "deemed sale return" would be filed with respect to the gain or loss from the deemed sale of assets. However, where a joint election by seller and purchaser is made under § 338(h)(10), the disaffiliation rule contained in § 338(h)(9) is overcome, and the need for the "deemed sale return" is eliminated. Rather, the target corporation would file on a consolidated return as part of the selling consolidated group (i,e., a group including both seller and target), such return covering the transaction date and including the gain or loss from the deemed sale.

For federal purposes, then, as a result of the § 338(h)(10) election (1) the "deemed sale" return is eliminated, (2) recognition of the deemed sale is fixed in the final short taxable year of old target and (3) target's inclusion on the respective consolidated returns (assuming it is also included on a consolidated return with the buyer) effects the § 338(a) consequence of two short taxable years - a final short year of target as old target and the first short year as new target.

While the short years of target are included in consolidated returns for federal purposes, for New York purposes a target subject to tax under Article 9-A of the Tax Law files either on a separate or a combined basis. Regardless of target's New York filing status, however, the federal short years created by the § 338(a) election are also reflected for New York purposes, since the franchise tax report periods are required to match the periods covered by a taxpayer's federal returns. 20 NYCRR § 2-1.1(a). Assuming target files separately for New York purposes, target accordingly will file two franchise tax reports matching the two short taxable years which result from the § 338(a) election. For example, if target were to file separately for New York for calendar 1991, with a sale date of October 19, 1991, it would be required to file two CT-3 reports, one for each of the periods matching the periods covered by its federal returns (that is, 1/110/19/91 and 10/20-12/31/91).

For each such period, target will take as its starting point for computing its entire net income bases under Article 9-A its federal taxable income for the comparable period. Tax Law § 208.9. Since, under this hypothetical, target is included on consolidated returns for federal purposes but files separately for New York purposes, it would be required to determine its federal taxable income for each period <u>as if</u> it had filed <u>separately</u> for federal purposes, on a pro forma 1120 for each period. See 1965 NYTB v.3, p. 6; TSB-A-84(2)C.

If a target were to file separately for federal purposes, gain on the deemed sale of target's assets under a § 338(a) election would be included in old target's final return. 26 CFR § 1.338-iT(f)(2). Accordingly, the § 338(a) election would require recognition of this gain on the pro forma 1120 of target for the period 1/1-10/19/91. Thus, the gain from the deemed sale of assets would also be included on the CT-3 report of target covering that period.

The result is the same for New York purposes, with respect to recognition of the gain from the deemed sale of assets, where target files on a combined basis with the seller. This is because each taxpayer included on a combined report on form CT-3-A is required to first complete a separate CT-3 report as if it were filing on a separate basis for New York purposes. 20 NYCRR § 62.1(b). The separate CT-3 reports are thereafter merged to produce a CT-3-A. As indicated above, a taxpayer filing separately under Article 9-A commences its computation with the preparation of a pro forma 1120, completed as if filing separately for federal purposes, in which case the election made under § 338(a) would require inclusion of the gain on the deemed sale of assets in its final "old target" return for the period 1/110/19/91. Inasmuch as the gain from the deemed sale is thus included on target's separate CT-3 covering the short period 1/1 to 10/19/91, the gain is included in the computation of the entire net income of the combined group. Likewise, target's separately computed federal taxable income for the short taxable year 10/20/91-12/31/91 would be reported for that short taxable year for New York purposes.

Sale of Target Stock

With regard to seller, typically the parent of the target subsidiary, the same income recognition rules apply as pertain to target. Whether the parent files separately or on a combined basis for New York purposes, the starting point for computing its entire net income bases under Article 9-A is its federal taxable income computed as if it had filed separately for federal purposes.

If the parent had filed separately for federal purposes the § 338(h)(10) election excluding the gain or loss from the stock sale would not be available, because at present that election is available only where seller and target file on a consolidated federal basis. See IRC §338(h)(10)(B)(ii). Therefore, where parent and target file on a consolidated basis and the §338(h)(10) election is made, the gain or loss on the stock sale would not be included on the federal consolidated return, but would be included on the parent's pro forma 1120, which is used as the starting point in preparing either its separate or combined New York report.

Thus, any gain or loss from the parent's sale of stock would be included in the starting point.for the computation of its entire net income base for Article 9-A purposes, whether filing on a separate or a combined basis. Likewise, gain or loss of other members of the selling consolidated group from sale of target stock, excluded for federal purposes by reason of the § 338(h)(10) election, would be included for New York purposes. In the case of target's parent, however, such gain or loss, subject to initial inclusion in the entire net income base, would be eligible for exclusion as "gain or loss from subsidiary capital" under § 208.9(a)(1) of the Tax Law. Ultimately, then, parent's gain would not be taxable under Article 9-A.

The previous M memorandum enunciated a rule to the effect that where the Federal consolidated group and the Article 9-A combined group were identical, § 338(h)(10) treatment would be followed, but that where the two groups were not identical the transaction would be treated as if only a § 338(a) election were made. As indicated above, the new approach announced in this memorandum effectively ignores the § 338(h)(10) election in all cases and arrives at a result based on recognition of the § 338(a) election only, determined as if seller and target filed separately for federal purposes.

Under the 1987 M memorandum, where the federal consolidated group and the New York combined group were not the same, the target corporation was required to file three separate Article 9-A reports, including a one-day, deemed.sale report. Under the new approach the target will, in the typical situation, be filing only two reports, irrespective of whether the federal and state groups are the same. Of course, if at the federal level only a § 338(a) election is made, and the target is consequently required to file a deemed sale return for federal purposes, then the target would be required to file such a one-day report for Article 9-A purposes. In either event, the New York short period reports would be due two and one-half months after the close of the period, subject to the usual opportunities for extensions of time to file.

The treatment provided in this memorandum applies to qualified stock purchases the acquisition date of which occurs after the date of this memorandum. However, in the case of qualified stock purchases occurring during the period commencing on October 30, 1990 and ending on the date of this memorandum, the treatment provided in this memorandum shall apply if all parties to the qualified stock purchase irrevocably elect such treatment. For purposes of this paragraph, the parties to the qualified stock purchase are (1) the purchasing corporation, (2) the target corporation and (3) any members of the selling consolidated group which sold or exchanged stock in the qualified stock purchase, but not including any of the aforesaid which are not required to file reports or returns under Article 9-A, 32 or 33 of the Tax Law. Such election shall be made by the filing of a statement of election executed by all of the parties to the qualified stock purchase, listing the name and federal employer identification number of each. Such statement must be filed within 90 days of the date of this memorandum. Such statement may be in the form of a letter, and should be mailed to Corporation Tax Bureau, Desk Audit, Building 9, State Campus, Albany, NY 12227. A copy of such statement should be attached to the report or return (or amended report or return, where applicable) of each party described in clause (2) or (3), supra, with respect to the period which includes the qualified stock purchase.

As indicated above, where the seller is an Article 9-A taxpayer the gain from the stock sale will generally be fully excluded from the entire net income base as gain from subsidiary capital, pursuant to Tax law § 208.9(a)(1). However, in certain unusual cases where a given sale of stock does not constitute a sale of subsidiary capital by a corporate parent, and in all cases where the parent is a banking corporation subject to Article 32 of the Tax Law, such exclusion will not apply. The reason that it will not apply in the latter case is that under Article 32 of the Tax Law only 60% of gain from subsidiary capital is excluded. Tax Law § 1453(e)(11)(ii). While the foregoing results derive from and are mandated by the provisions of current regulations, requests have been made for such a revision of the applicable regulations as would have the effect of fully excluding the gain (or loss) in the case of sales of either type, and for reconsideration of the due dates for short period reports. The Commissioner is presently studying the desirability of such actions.