PUBLICATION

Spotlight on Tennessee: Letter Ruling Addresses Treatment of a Section 338(h)(10) Election

Authors: Carl E. Hartley
July 10, 2014

Tennessee does not expressly conform to most provisions in Subchapter C of the Internal Revenue Code. Instead, Tennessee's federal corporate income tax conformity is determined based on the "starting point" that Tennessee uses to determine net earnings – that is, federal corporate taxable income before special and net operating loss deductions. In Letter Ruling No. 14-01 dated June 24, 2014, the Department of Revenue (Department) addressed how Tennessee conforms to an Internal Revenue Code Section 338(h)(10) election under specific circumstances, including a distribution of assets to the selling corporate shareholder that preceded the sale of stock.

For federal corporate income tax purposes, when a C or S corporation makes a "qualified stock purchase" (generally, a purchase of at least 80 percent of the stock) of a "Target" U.S. corporation (either a C or S corporation) and Target's "selling shareholder(s)" is/are a C corporation (and files a consolidated federal tax return or is affiliated with Target) or S corporation shareholders, the buyer and seller of the stock may jointly elect under Section 338(h)(10) to treat the sale of stock as a deemed sale of assets. The selling shareholder's sale of Target stock is ignored and Target is treated as selling its assets to "new Target" and then liquidating. As long as the selling shareholder and Target are tax indifferent as to stock or asset sale gain or loss, the primary advantage of such an election is to allow the buyer to obtain a "stepped-up" basis in the assets of the Target.

While a basis step-up in the Target's assets is a primary advantage and reason for making the joint Section 338(h)(10) election, such an election is conducive to the business or economic reasons underlying the type of transaction addressed in Letter Ruling No. 14-01 – namely, when Target has appreciated assets that are unwanted by the buyer.

Implicit in this Letter Ruling were circumstances where either the Target had a separate business division or assets that were appreciated, but that were not wanted by the buyer (the "unwanted assets"), or the selling shareholder insisted upon retaining these particular assets as part of the deal. For business, legal or other reasons not mentioned in the Letter Ruling, the buyer only wanted to purchase Target stock. Prior to the stock sale, the unwanted assets were distributed in kind to the selling shareholder. Normally, such a distribution would result in taxable gain to the Target under Internal Revenue Code Section 311(b) (alternatively, if the assets are loss assets, Section 311(b) disallows the deduction of any loss). However, by making the Section 338(h)(10) election, Target is also deemed to have adopted a plan of complete liquidation and could distribute the unwanted assets to the selling shareholder prior to the stock sale, while the selling shareholder and buyer elected to treat the stock sale as an asset sale for tax purposes. Because the selling shareholder was a C corporation, the pre-sale distribution was treated as part of a tax-free complete liquidation of the Target under Sections 332 and 337. The buyer got the assets it wanted with a stepped up fair market value basis, and the selling shareholder avoided the undesirable tax consequences of a Section 311(b) gain in its federal consolidated group and/or assets that it insisted upon retaining.

The "starting point" for determining Tennessee net earnings for excise tax purposes is federal taxable income to which there are statutorily applied certain addition and subtraction adjustments with respect to specific

income, gain, loss or deduction items to arrive at Tennessee net earnings. Although Tennessee neither adopts nor disallows the federal election under Section 338(h)(10), the Department stated in this Letter Ruling that, because no gain from the stock sale was included in the selling shareholder's federal taxable income and such gain was not added to net earnings under Tennessee excise tax law, no gain from the stock sale was included in the selling shareholder's net earnings for Tennessee excise tax purposes. Similarly, since no gain from the pre-sale asset distribution was included in the Target's federal taxable income and there is no Tennessee statutory adjustment to add any such gain to net earnings, no gain from the pre-sale asset distribution was included in the Target's net earnings for Tennessee excise tax purposes.

Please note that, pursuant to T.C.A. Section 67-1-109, Letter Rulings interpret and apply the Tennessee tax law to a specific set of existing facts furnished by a particular taxpayer, and such Letter Rulings are binding upon the Department but are applicable only to the taxpayer being addressed.

If you would like to discuss Letter Ruling No. 14-01 or similar corporate transactions, please contact any one of the attorneys in the Firm's Tax Group.