

PUBLICATION

Spotlight on Tennessee: Ruling Highlights Importance of State Income Tax Considerations for Section 338 Elections

Authors: Carl E. Hartley

October 23, 2014

In [Spotlight on Tennessee: Letter Ruling Addresses Treatment of a Section 338\(h\)\(10\) Election](#), dated July 10, 2014, we examined how Tennessee treats the federal election under Internal Revenue Code Section 338(h)(10) for franchise and excise tax purposes. Letter Ruling No. 14-01 provided that Tennessee neither follows nor rejects Section 338(h)(10). Further, the Department of Revenue concluded in such a Ruling that a pre-stock sale distribution of assets in connection with a qualified stock purchase for which the joint election under Section 338(h)(10) was made and that was treated as a "tax-free" subsidiary liquidation for federal purposes, would also under such Ruling's facts be "tax-free" for Tennessee excise tax purposes because (a) no gain or loss was recognized for federal tax purposes and (b), thus no gain or loss was included in the Tennessee federal taxable income "starting point" for determining Tennessee net earnings.

One state, Illinois, has used reasoning similar to Tennessee's in a recently-issued letter ruling regarding the same or similar qualified stock purchase in which a Section 338(h)(10) election was made. The Florida Department of Revenue also reached the same result, but because of Florida's specific conformity with Section 338(h)(10) and adoption of the underlying Treasury Regulations.

While the result in Letter Ruling No. 14-01 was welcome, the Department's Letter Ruling No. 14-06 (August 25, 2014) illustrates the downside to Tennessee's manner of conforming to federal tax law in general and Section 338(h)(10) elections specifically. In Letter Ruling No. 14-06, the stock of a subsidiary was in a qualified stock purchase transaction. The parent corporation selling shareholder and the buyer made a joint election under Section 338(h)(10) to treat the stock sale as a sale of the subsidiary's assets. Among the subsidiary's assets was equipment that qualified as industrial machinery and the industrial machinery credit under Tennessee franchise and excise tax laws. In general, that industrial machinery credit is equal to 1 percent of the purchase price of industrial machinery.

As a result of the Section 338(h)(10) election, this industrial machinery was among the assets deemed sold by the subsidiary of the parent corporation/selling shareholder, which resulted in the buyer receiving a "stepped-up" basis in the industrial machinery and the other assets which the buyer was treated, for federal purposes, as purchasing.

As in Letter Ruling No. 14-01, the Department noted that Tennessee neither follows nor rejects Section 338(h)(10) or the underlying Treasury Regulations. While the result in Letter Ruling 14-01 was taxpayer favorable, the result in Letter Ruling No. 14-06 was not. With no specific conformity, the stock sale was not converted to a deemed asset sale and the transactions deemed to have occurred for federal income tax purposes were not deemed to have occurred for Tennessee franchise and excise tax purposes. As a result, the Tennessee industrial machinery credit was determined in this Ruling to not be available to the subsidiary.

Letter Ruling No. 14-06 emphasizes the need to not only consider whether and how states follow the federal corporate income tax treatment of various forms of corporate transactions, but also the impact the transaction may have on existing state tax credits, incentive plans and other state tax attributes that may be a material component of how the parties value the deal. For example, and in addition to the primary determination in

Letter Ruling No. 14-06 that the industrial machinery credit would not be available to the subsidiary under the facts of the Ruling, the Ruling in a footnote also warned that if the subsidiary were deemed to have purchased the industrial machinery assets prior to the end of their useful life (i.e., the federal result under Section 338(h)(10)), then the subsidiary would have been subject to recapture of a portion of industrial machinery tax credits previously taken.

Planning for the state and local tax consequences in business transactions is critical. If you would like to discuss this Ruling or other important state tax considerations that must be evaluated in connection with any business transaction, please contact one of the attorneys in the Firm's Tax Group.