New York State Department of Taxation and Finance
Office of Tax Policy Analysis
Technical Services Division

TSB-A-02(1)C
Corporation Tax
April 2, 2002

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. C010202B

On February 2, 2001, a Petition for Advisory Opinion was received from McDermott, Will & Emery, 50 Rockefeller Plaza, New York, New York 10020.

The issue raised by Petitioner, McDermott, Will & Emery, is whether an actual distribution of assets by a subsidiary corporation to its parent in a transaction for which an election has been made under section 338(h)(10) of the Internal Revenue Code ("IRC"), will be treated as part of a complete liquidation of the subsidiary into its parent for purposes of the tax measured by entire net income under Article 9-A of the Tax Law.

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

Parent ("Seller"), a company incorporated in Delaware, owns 100 percent of the stock of Target, a New York corporation. For purposes of this Advisory Opinion, it is assumed that Seller is a taxpayer under Article 9-A of the Tax Law. Seller proposes to sell 100 percent of Target's stock to Buyer, an unrelated corporation. Target owns certain assets that Buyer is not interested in acquiring (collectively, the Unwanted Assets"). Therefore, in connection with the transaction, Buyer and Seller agree that Target will distribute the Unwanted Assets to Seller. Buyer will purchase the stock of Target, and Seller and Buyer will join in an election pursuant to section 338(h)(10) of the IRC ("section 338(h)(10) election"), whereby the transactions will be treated for federal income tax purposes as if Target had sold its assets to an unrelated person and distributed the sale proceeds to Seller in complete liquidation.

Petitioner states that the proposed transaction will satisfy all of the requirements for the section 338(h)(10) election. A formal plan of liquidation by Target will be adopted; such adoption will occur before the distribution; and Buyer will be required to purchase the stock of Target. The distribution of the Unwanted Assets will be made in connection with the section 338(h)(10) transaction.

Discussion

Section 208.9 of the Tax law defines entire net income as "total net income from all sources, which shall be presumably the same as the entire taxable income ... which the taxpayer is required to report to the United States treasury department ... except as hereinafter provided...." Therefore, the taxable income reported for federal income tax purposes is the starting point for computing entire net income. After determining federal taxable income, it must be adjusted as required by section 208.9 and section 210.3(d) and (e) of the Tax Law.

Under section 338 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 (the target corporation) within a 12 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." 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 in the hands of new target is increased or decreased to recognize the gain or loss (stepped up or down), as the case may be.

Under section 338(h)(10) of the IRC, and section 1.338(h)(10)-1(c) of the Treasury Regulations, adopted February 12, 2001, the seller and purchaser of target stock may make an election whereby the old target generally is deemed to sell all of its assets and distribute the proceeds in complete liquidation, and the sale of target stock included in the qualified stock purchase generally is ignored. This election may be made for the target corporation only if it is (1) a member of a selling consolidated group, (2) a member of a selling affiliated group filing separate returns, or (3) a federal S corporation. The gain or loss on the deemed asset sale is included in the tax return of old target, but no gain or loss is recognized on the sale of target stock by members of the consolidated group, the selling affiliate or the S corporation shareholders. Where the election under section 338(h)(10) is deemed made for the target, a section 338 election is deemed made for the target.

Section 1.338(h)(10)-1(d)(4) of the Treasury Regulations, adopted February 12, 2001, provides the tax characterization of the deemed liquidation with respect to old target and the selling consolidated group or the selling affiliate as follows:

> (i) *In general*. Old T [target] is treated as if, before the close of the acquisition date, after the deemed asset sale in paragraph (d)(3) of this section, and while old T is a member of the selling consolidated group (or owned by the selling affiliate ...), it transferred all of its assets to members of the selling consolidated group, the selling affiliate ... and ceased to exist. The transfer from old T is characterized for Federal income tax purposes in the same manner as if the parties had actually engaged in the transactions deemed to occur because of this section and taking into account other transactions that actually occurred or are deemed to occur. For example, the transfer may be treated as a distribution in pursuance of a plan of reorganization, a distribution in complete cancellation or redemption of all its stock, one of a series of distributions in complete cancellation or redemption of all its stock in accordance with a plan of liquidation, or part of a circular flow of cash. In most cases, the transfer will be treated as a distribution in complete liquidation to which section 336 or 337 applies.

Section 1.338(h)(10)-1(e), Example 2 of the Treasury Regulations, adopted February 12, 2001, provides as follows:

> (i) S [seller] and T [target] are solvent corporations. S owns all of the outstanding stock of T. S and P [purchaser] agree to undertake the following transaction: T will distribute half its assets to S, and S will assume half of T's liabilities. Then, P will purchase the stock of T from S. S and P will jointly make a section 338(h)(10) election with respect to the sale of T. The corporations then complete the transaction as agreed.
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> (ii) Under section 338(a), the assets present in T at the close of the acquisition date are deemed sold by old T to new T. Under paragraph (d)(4) of this section, the transactions described in paragraph (d) of this section are treated in the same manner as if they had actually occurred. Because S and P had agreed that, after T's actual distribution to S of part of its assets, S would sell T to P pursuant to an election under section 338(h)(10), and because paragraph (d)(4) of this section deems T subsequently to have transferred all its assets to its shareholder, T is deemed to have adopted a plan of complete liquidation under section 332. T's actual transfer of assets to S is treated as a distribution pursuant to that plan of complete liquidation.

Technical Services Bureau Memorandum TSB-M-91(4)C, April 17, 1991, revised the New York treatment of elections made under section 338(h)(10) of the IRC set forth in Technical Services Bureau Memorandum TSB-M-87(4)C, April 10, 1987, by making technical corrections to the treatment of the elections and simplifying the filing requirements. However, subsequent to the issuance of TSB-M-91(4)C, section 1.338(h)(10)-1 of the Treasury Regulations, relating to the stock and asset consistency rules under section 338 of the IRC was adopted on January 12, 1994. This regulation extended section 338(h)(10) of the IRC treatment to nonconsolidated affiliates. Section 1.338(h)(10)-1(b)(3) of the Treasury Regulations, adopted February 12, 2001, defines a "selling affiliate" as "a domestic corporation that owns on the acquisition date an amount of stock in a domestic target, which amount of stock is described in section 1504(a)(2) [of the IRC], and does not join in filing a consolidated return with the target". Thus, on the acquisition date, the selling affiliate and the target corporation are affiliated (within the meaning of section 1504 of the IRC) but do not join in filing a federal consolidated return.

For purposes of computing the entire net income base under Article 9-A of the Tax Law, where a parent corporation and a target corporation file a federal consolidated return, the starting point for each corporation is its federal taxable income computed as if it had filed separately for federal income tax purposes (pro forma federal return). Accordingly, as provided in Roger Cukras, Hutton Ingram Yuzek Gainen Caroll & Bertiolotti, Adv Op Comm T&F, September 14, 1999, TSB-A-99(22)C, assuming that the parent corporation is a selling affiliate pursuant to section 1.338(h)(10)-1(b)(3) of the Treasury Regulations, adopted February 12, 2001, the election made

under section 338(h)(10) of the IRC to exclude the gain or loss on the sale of the target's stock would be available on the parent's pro forma federal return computed as if it had filed separately. Therefore, when the parent sells the target's stock, any gain or loss on the sale of the stock would not be recognized on the parent's pro forma federal return, or in the starting point for computing the parent's entire net income base under section 208.9 of the Tax Law. There is no modification under section 208.9 or section 210.3(d) and (e) of the Tax Law that would require the parent to recognize any gain or loss on the sale of the target's stock.

In this case, Petitioner states that the proposed transaction will satisfy all of the requirements of the section 338(h)(10) election. Therefore, Target will either be a member of a selling consolidated group or a member of a selling affiliated group filing separate returns for federal income tax purposes. When Seller and Target each compute its entire net income base, the starting point will be its federal taxable income (if members of an affiliated group filing separate federal returns) or its federal pro forma taxable income computed as if each had filed separately (if members of a federal consolidated group). In either case, the starting point will reflect the provisions of the section 338(h)(10) election and section 1-338(h)(10)-1 of the Treasury Regulations, adopted February 12, 2001, and the actual distribution of the Unwanted Assets by Target to Seller will be treated as part of a complete liquidation of Target under section 332 of the IRC. Under section 332, no gain or loss will be recognized by Seller on such distribution, and under section 334(b)(1) of the IRC and section 1.334-1(b) of the Treasury Regulations, the Unwanted Assets will have the same basis in the hands of Seller as the adjusted basis in the hands of Target. There is no modification under section 208.9 or section 210.3(d) and (e) of the Tax Law that would modify such treatment to require Seller to recognize any gain or loss on the actual distribution of the Unwanted Assets or on the sale of Target's stock.

Accordingly, where section 1.338(h)(10)-1(e), Example 2 of the Treasury Regulations, adopted February 12, 2001, applies, an actual distribution of the Unwanted Assets by Target to Seller in a transaction that is treated as part of a complete liquidation of Target into Seller under a section 338(h)(10) election made by Seller and Buyer, will be treated for purposes of Article 9-A of the Tax Law the same as it is treated for federal income tax purposes.

DATED: April 2, 2002

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