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Whether a Corporation Acquired Under Section 338 of the Internal Revenue Code is Treated as a "New Business" for the Purposes of Claiming a Refundable Investment Tax Credit

Reproduced below is an official Opinion of Counsel, issued on January 28, 2003. The Opinion concludes that a corporation acquired in a qualified stock purchase under section 338 of the Internal Revenue Code (IRC), where the purchaser makes an election under section 338 (h)(10) of the IRC to treat that stock purchase as an asset purchase, is not treated as a "new business" under Tax Law section 210.12 (j)(3) for purposes of claiming a refundable investment tax credit. This opinion is applicable to IRC Section 338 elections made on or after January 1, 2003.

Opinion of Counsel Issued by Barbara G. Billet, Deputy Commissioner and Counsel, on January 28, 2003

This Opinion of Counsel will discuss whether a corporation that is acquired in a qualified stock purchase under §338 of the Internal Revenue Code is treated as a "new business" under Tax Law § 210.12(j)(3), for purposes of claiming a refundable investment tax credit ("ITC") under Tax Law § 210.12(j), by reason of the purchaser's IRC § 338 election to treat that stock purchase as an asset purchase.

Tax Law § 210.12 allows a business corporation to claim an ITC against its corporate franchise tax for investments in qualified tangible personal property and real property. The ITC is a percentage of the cost, or other federal income tax basis, of such qualifying property less the amount of certain non-qualified nonrecourse financing of the property. Property qualifies for the ITC if it: (1) is tangible property, including buildings and their structural components; (2) is depreciable under IRC § 167; (3) has a useful life of four or more years; (4) is acquired by the taxpayer by purchase as defined in IRC § 179(d); (5) has a situs in New York; and (6) is principally used by the taxpayer in the production of goods by manufacturing . . . (Tax Law § 210.12(b)).

The ITC may not reduce a taxpayer's tax liability to less than the greater of its tax computed on the minimum taxable income base or its fixed dollar minimum tax. However, any ITC that cannot be used to reduce a taxpayer's current year's tax liability may be carried over and claimed in future taxable years.

In lieu of a credit carryover, a corporation which qualifies as a "new business" may elect to treat an ITC carryover as a refundable overpayment. A "new business" is defined as any corporation, except a corporation: (1) of which over fifty percent of the number of shares of voting stock is owned or controlled either directly or indirectly by a corporation subject to taxation under Article 9-A, Article 32, Article 33 or §§ 183, 184 or 185 of Article 9; or (2) which is substantially

similar in operation and in ownership to a business entity or entities taxable or previously taxable under Article 9-A, Article 32, Article 33, §§ 183, 184, 185 or 186 of Article 9, Article 22, or Article 23; or (3) which has been subject to tax under Article 9-A for more than four taxable years (excluding short taxable years) prior to the taxable year when the taxpayer first became eligible for the ITC (Tax Law §§ 210.12(e),(j)). For purposes of the analysis in this opinion, it is assumed that the provisions of Tax Law § 210.12(j)(1) & (2) are not applicable. Accordingly, the only issue to be decided is whether the provision under Tax Law § 210.12(j)(3), which excludes from the definition of a new business any corporation which has been subject to tax under Article 9-A for more than four taxable years, applies to a corporation that is acquired in a qualified stock purchase under IRC § 338, as discussed below.

Section 338 elections

Elections are available under IRC § 338 when a corporation acquires the stock of another corporation (the target) in a qualified stock purchase. A qualified stock purchase occurs on the first day that the acquiring corporation has purchased, in one or more transactions during a 12-month acquisition period, at least 80 percent (by voting power and total value) of a target's stock.[1] One type of election, under IRC § 338(g) is available to a purchasing corporation. Another type of election, under IRC § 338(h)(10) is, in more limited circumstances, available jointly to a purchasing corporation and the sellers of the stock.[2]

If a purchasing corporation makes an IRC § 338 election, the target corporation is treated as having sold all of its assets for fair market value at the close of the first day that the purchaser has acquired 80 percent of the target's stock. At this point, the target corporation may be referenced as "old target". Old target is deemed to have sold all of its assets to an unrelated person in exchange for consideration that includes the discharge of its liabilities. This sale amount is referred to as the aggregate deemed sales price and generally takes into account tax credit recapture liabilities arising from the deemed asset sale and the federal income tax liability arising from the transfer of a particular asset in a deemed asset sale (i.e., IRC § 1245 gain).[3] The target corporation is then treated as a new corporation, which may be referenced as "new target", which is deemed to have acquired, on the day after the acquisition date, all of its assets from an unrelated party in exchange for consideration that includes the assumption of those liabilities.[4] The effect of this deemed asset sale is usually a step-up in the basis of the corporation's assets in accordance with what the purchasing corporation paid for the stock of the target corporation, plus assumed liabilities.

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[1] IRC § 338(d)(3).

[2] Treas. Reg. § 1.338-1(a).

[3] Chudy, Spector, and McGill, 788 T.M., Stock Purchases Treated as Asset Acquisitions – Section 338., section III-E - Calculation and Allocation of Aggregate Deemed Sale Price.., Tax Management, Inc., 2002.

[4] Treas. Reg. § 1.338-1(a).

Generally, if an election is made under IRC § 338(g), there will be two levels of federal income tax.[5] The seller of the shares of the target corporation's stock will recognize gain or loss on the sale of those shares of stock in an amount equal to the difference between the amount realized and seller's basis in the shares sold. Secondly, the target corporation itself will recognize gain or loss on the deemed sale of its assets, as described above.

If a target corporation's stock is purchased from a group filing consolidated returns, or from an affiliated group filing separate returns, or if the target corporation is an S corporation, a purchaser and the seller of stock may make a further election known as an IRC § 338(h)(10) election. If this election is made, the target corporation is deemed to have sold its assets in a taxable transaction and then distributed the proceeds in a deemed liquidation while it was a member of the selling consolidated group, or while it was owned by the selling affiliates or S corporation shareholders. The effect is that there will only be one level of federal income tax on the transaction, which will be imposed on the target corporation on the deemed sale of its assets. The sale of the stock in the target corporation is ignored.[6]

Treatment of old target and new target

Although the target corporation is a single corporation under corporate law, if an IRC § 338 election is made, then two separate corporations, old target and new target, generally are considered to exist for purposes of IRC, Subtitle A - Income Tax provisions. (Treas. Reg § 1.338-1). Therefore, new target may adopt any method of accounting allowed under IRC § 446, and any tax year permitted by IRC § 441. Also, new target is treated as having purchased its assets in a deemed sale from an unrelated person. Therefore, new target can make new depreciation elections without taking into account elections made by old target.

However, the regulations contained under IRC § 338 provide exceptions to treating new target as a separate corporation and old and new target will be treated as the same corporation for the rules relating to: 1) employee benefit plans, 2) qualified retirement plans and self employment plans, 3) incentive stock options and employee stock purchase plans, 4) welfare benefit funds and voluntary employee benefit associations, 5) limitation period mitigation provisions, 6) provisions relating to the reduction of purchase money debt, 7) the Indian employment work opportunity and welfare to work credits, 8) the Empowerment Zone Act, 9) medical benefits for retirees, 10) certain definition and special rules under IRC § 414, and 11) any other income tax provisions to be identified by IRC reg. 1.338-a(b)(2). Also, for purposes other than those of IRC, Subtitle A (unless IRC § 338 regulations make an exception), new target is treated as a continuation of old target. Accordingly, new target is liable for old target's Federal income tax liabilities, old target and new target must use the same employer identification number, and wages earned from old target are considered earned from new target for purposes of the Federal Insurance Contributions Act and

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[5]Chudy, Spector, supra., section III-A.

[6]IRC section 338(h)(10); Reg. 1.338(h)(10)-1.

Federal Unemployment Tax Act. (Treas. Reg. § 1.338-1(b)(3)).

"New business" provision

As stated above, the issue to be determined in this request is whether a taxpayer meets the definition of a "new business" under Tax Law § 210.12(j)(3) because of an IRC § 338 election. Tax Law § 210.12(j)(3) defines a "new business" as any corporation except a corporation, among other things, that has been subject to tax for more than four taxable years prior to the taxable year when the taxpayer first became eligible for the ITC. Therefore, in those cases where a taxpayer has been subject to tax for more than four taxable years, and is a corporation subject to an IRC § 338 election, it must be determined whether such target corporation becomes a new corporation as a result of this election and therefore a "new business" for purposes of the ITC refundable provisions. Based on the legislative history of Tax Law § 210.12(j), it is my opinion that such target corporation will not be considered a "new business".

As determined in the Matter of Arthur Andersen LLP, TSB-A-98(20)C, November 3, 1998, where a corporation has elected under IRC § 338(a) to treat the sale of its stock in a qualified stock purchase as an asset sale, such election will also be recognized under the Tax Law. As such, the assets of the old target are deemed sold at the close of the acquisition date at fair market value in a single transaction, and new target is deemed to have acquired the assets by purchase with the basis of the assets stepped up or down, as the case may be. This deemed asset sale requires old target to recapture the investment tax credit claimed for its assets against its New York Corporation Franchise Tax and new target may be allowed to claim a new ITC with respect to such assets if the property otherwise qualifies under Tax Law § 210.12.

Notwithstanding the fact that the new target's assets may qualify for a new ITC, the taxpayer will not qualify as a "new business" and be eligible for a refund of any ITC carryover. The legislative history contained in Tax Law § 210.12(e) indicates that the "new business" provisions were added to the Tax Law to expand and enrich various investment incentives to assure continued economic growth in New York by providing for a refund of the ITC to *new firms*. The history indicates that such provisions were aimed at increasing new business formation, increasing the survival rate of such new enterprises and aiding new businesses during their crucial start-up periods by enhancing the cash flows of such businesses.[7]

The "new business" provisions implemented to assist *new firms* during their *start-up* periods of existence, were not enacted to aid a business that has been in existence, possibly for a number of years, that may have already claimed and received ITC refunds for its qualified property. Such a business is not an unestablished entity commencing its corporate existence with little cash flow and/or reserves to enhance its survival rate, but remains the same corporation with new owners where an IRC § 338 election has been made to deem its stock purchase an asset sale. As noted

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[7]See Governor's Approval Memorandum, New York State Legislative Annual - 1981 pages 81 - 82; Office of Counsel files for chapter 103 of the laws of 1981 - Memo to John G. McGoldrick, Counsel to the Governor from Howard F. Miller, Director of Budget, dated 1/30/81.

above, where an election is made, the IRC treats the target corporation as a new corporation only for purposes of subtitle A, provided that treatment is not excluded by the numerous exceptions contained within IRC § 338. Like the IRC, the Tax Law also treats such a corporation as a new corporation for purposes of depreciation and claiming an ITC based on any stepped up basis "new target" would have. However, new target should not be entitled to a refund of its ITC as a result of its IRC § 338 election.

This Opinion of Counsel will be applicable to elections made under Internal Revenue Code §338 on or after January 1, 2003.

/s/
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