

New York State Department of Taxation and Finance
Taxpayer Services Division
Technical Services Bureau

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Corporation Tax
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New York State Treatment of an Election
Under Section (338)(h)(10) of the Internal Revenue Code

General

A purchase or sale of assets occurs where a corporation acquires another business by a direct purchase of assets or where stock is purchased (80% or more) and a section 338 election is made to treat the stock purchase as an asset acquisition. In the event a corporation is acquired in a qualified stock purchase (the "target") from a selling consolidated group the selling consolidated group may make a section 338(h)(10) election. Under such an election, and in accordance with regulations prescribed by the Secretary of the Treasury, recognition may be made by the selling consolidated group of the deemed sale gain or loss on the target corporation's assets.

For Federal purposes, where the old target's final tax year was otherwise included in a consolidated return of the selling group and the purchaser makes a valid Code section 338 election, the old target is disaffiliated from that group immediately before its deemed sale of assets under Code section 338. It must file a deemed sale return (a final one-transaction return that includes only the items from the deemed sale and certain carryover items). Any transactions of the old target occurring on the acquisition date before the deemed sale, which is considered the last transaction of the old target, are reported in the selling group's consolidated return. The deemed sale of the old target reported in the deemed sale return is treated as a separate tax year, except for purposes of determining the number of years in a carryover or carryback period.

Code Section 338(h)(10) Election

Code section 338(h)(10) provides that an election may be made by the selling consolidated group whereby the target corporation is still treated as a member of the selling consolidated group. However, in order to make the Code section 338(h)(10) election, there are two major requirements. The target corporation must have been, before such transaction, a member of the selling consolidated group. Also, the target corporation must recognize gain or loss with respect to the transaction as if it sold all of its assets in a single transaction. With respect to such sale, and to the extent provided in regulations, no gain or loss will be recognized on stock sold or exchanged in the transaction by members of the selling consolidated group.

New York State Treatment

Article 9-A of the Tax Law imposes a franchise tax on general business corporations. One of the measures of the tax is entire net income which is presumably the same as the Federal taxable income which the taxpayer is required to report to the United States Treasury Department, with certain modifications. Therefore, the Federal treatment accorded in an IRC section 338(h) (10) election will be followed where the Federal selling consolidated group is the

same as the Article 9-A combined group. However, where the Federal selling consolidated group is not the same as the Article 9-A combined group or where there is no Article 9-A combined group, the Federal treatment accorded to an IRC section 338(h)(10) election is inconsistent for Article 9-A purposes. A prerequisite of a section 338(h) (10) election is a section 338(a) election. There is no inconsistency problem vis-a-vis Federal consolidated groups and Article 9-A combined groups were only section 338(a), and not also section 338(h) (10), elected. See, TSB-M-86(3) (C) (April 3, 1986). Therefore, since a section 338(a) election is necessarily made at the Federal level, for purposes of Article 9-A the entire transaction will be treated as if only a section 338(a) election were made.

Federal Group, New York Group Same

Where the Federal selling consolidated group is the same as the New York State combined group taxpayers in the selling consolidated group, the purchaser and the old and new targets are accorded the Federal treatment in a Code Section 338(h)(10) election, except that the one day report required of the old target for Federal purposes is not required for New York State purposes. The old target must file a cessation report through the date of the deemed sale. It is required to report all transactions, including the gain or loss from the deemed sale, as well as recapture of any unused investment tax credit and depreciation. It then files subsequent reports as if it were a new corporation. Property would then have a stepped up basis.

Federal Group, New York Group Not Same

Where the Federal selling consolidated group is not the same as the New York State combined group, or where all or some the members of the selling consolidated group file on a separate basis in New York State, different treatment applies. Seller will recognize the gain from its sale of Target's stock. Without the aid of section 338(h) (10), such gain would be recognized at the Federal level and, thus, at the New York State level under Tax Law section 208.9. Since New York State will, in essence, decouple from the effects of section 338(h) (10), including the nonrecognition treatment accorded to gain on the stock sold by Seller, such gain will be recognized under Article 9-A. However, by virtue of Tax Law section 208.9(a) (1) entire net income does not include gains and losses from subsidiary capital.

Pursuant to the section 338(a) election which is deemed to have been made for purposes of Article 9-A, Target will recognize gain from the deemed sale of its assets and it will achieve the gross-up in the basis of those assets. The Article 9-A franchise tax liability for the deemed sale will be the responsibility of Target corporation which is treated as having made the deemed sale and deemed purchase. Although section 338(a) (as well as section 338(h) (10)) treats Target as an old corporation (the deemed sale) and then as a new corporation (the deemed purchase), for purposes of Article 9-A Target never truly ceases its corporate existence which continues throughout. Therefore, the franchise tax liabilities of "old" Target, including any liabilities resulting from section 338(a), remain the tax liabilities of "new" Target.

Target will be required to file three separate New York State franchise tax reports. One will be a "cessation" report covering the activities of "old" Target up to the deemed sale transaction. This report will be due two and one-half months following the "cessation" date. The second report will be a "one-day report" reflecting only the section 338(a) deemed sale and deemed purchase. This report will be due two and one-half months following the date of the deemed sale. The third report will cover activities of "new" Target through the end of its taxable year. This report will be due two and one-half months following the close of Target's taxable year.