

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 14-01**

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This ruling is based on the particular facts and circumstances presented, and is an interpretation of the law at a specific point in time. The law may have changed since this ruling was issued, possibly rendering it obsolete. The presentation of this ruling in a redacted form is provided solely for informational purposes, and is not intended as a statement of Departmental policy. Taxpayers should consult with a tax professional before relying on any aspect of this ruling.

SUBJECT

The computation of net earnings for Tennessee excise tax purposes by taxpayers who have made an election under I.R.C. § 338(h)(10).

SCOPE

This letter ruling is an interpretation and application of the tax law as it relates to a specific set of existing facts furnished to the Department by the taxpayer. The rulings herein are binding upon the Department, and are applicable only to the individual taxpayer being addressed.

This letter ruling may be revoked or modified by the Commissioner at any time. Such revocation or modification shall be effective retroactively unless the following conditions are met, in which case the revocation shall be prospective only:

- (A) The taxpayer must not have misstated or omitted material facts involved in the transaction;
- (B) Facts that develop later must not be materially different from the facts upon which the ruling was based;
- (C) The applicable law must not have been changed or amended;
- (D) The ruling must have been issued originally with respect to a prospective or proposed transaction; and
- (E) The taxpayer directly involved must have acted in good faith in relying upon the ruling; and a retroactive revocation of the ruling must inure to the taxpayer's detriment.

FACTS

1. Corporate Structure

[SELLER'S PARENT] ("Seller's Parent"), a [REDACTED] corporation, owns all of the issued and outstanding stock of [SELLER] ("Seller"), a [REDACTED] corporation. Seller owns all of the issued and outstanding stock of [TARGET] (the "Target"), a [REDACTED] corporation.

2. Proposed Transaction

An unrelated corporation (“Buyer”) has offered to buy the Target from Seller. The following steps, collectively referred to as the “Proposed Transaction,” will occur to effectuate the proposed sale of Target stock to Buyer within a single taxable year of the Target:

Step 1: Seller’s Parent, Seller, the Target, and Buyer agree to undertake the transaction described in Steps 2 and 3 (in that order), and, following Step 3, to make the election described in Step 4.

Step 2: The Target will distribute more than fifty percent of its retained assets and certain liabilities (the “Distribution Assets”) to Seller (the “Distribution”).

Step 3: A subsidiary of Buyer will merge with and into the Target, with the Target surviving as Buyer’s subsidiary, or Buyer will purchase all of the issued and outstanding stock of the Target (the “Sale”). Seller will receive only cash in exchange for the Sale, and Buyer will acquire all of the issued and outstanding stock of the Target.

Step 4: Buyer and Seller will make a joint election under I.R.C. § 338(h)(10) with respect to the Sale (the “I.R.C. § 338(h)(10) Election”).

RULINGS

1. Will the gain on the Sale that the Target recognizes for federal income tax purposes as a result of the I.R.C. § 338(h)(10) Election be included in the Target’s net earnings for Tennessee excise tax purposes?

Ruling: Yes. Tennessee law neither adopts nor disallows the federal election under I.R.C. § 338(h)(10). Because the gain that the Target recognizes on the Sale pursuant to the I.R.C. § 338(h)(10) Election is included in the Target’s federal taxable income, and because such gain is not subtracted in the computation of the Target’s net earnings, such gain will be included in Target’s net earnings for Tennessee excise tax purposes.

2. For Tennessee excise tax purposes, will Seller be required to recognize any net earnings as a result of the Sale made pursuant to the I.R.C. § 338(h)(10) Election?

Ruling: No. Tennessee law neither adopts nor disallows the federal election under I.R.C. § 338(h)(10). Because no gain on the Seller’s sale of the Target’s stock is included in Seller’s federal taxable income pursuant to the I.R.C. § 338(h)(10) Election, and because such gain is not added to net earnings under Tennessee excise tax law, no gain arising from the Sale will be included in Seller’s net earnings for Tennessee excise tax purposes.

3. Assuming that the Distribution is treated for federal income tax purposes as part of a tax-exempt liquidating distribution pursuant to I.R.C. §§ 332 and 337, will the Target or

Seller be required to recognize any net earnings for Tennessee excise tax purposes as a result of the Distribution?

Ruling: No. Tennessee law neither adopts nor disallows the federal treatment of liquidating distributions provided for by I.R.C. §§ 332 and 337. Because no gain on the Distribution is included in the Target's federal taxable income, such gain will be excluded from the Target's net earnings for Tennessee excise tax purposes. Similarly, because no gain on the Distribution is included in Seller's federal taxable income, such gain will be excluded from Seller's net earnings for Tennessee excise tax purposes.

ANALYSIS

Overview of applicable federal income tax law¹

a. Overview of I.R.C. § 338(h)(10)

For federal income tax purposes, when a buyer acquires stock of a target corporation, the sale generally has no federal income tax consequences for the target. Instead, the target's former shareholders recognize gain or loss on the sale or exchange of the target corporation's shares.

Provided certain requirements are met, the buyer and the seller may jointly elect under I.R.C. § 338(h)(10)² to treat a stock sale as an asset sale for federal income tax purposes. Upon making an I.R.C. § 338(h)(10) election, the target corporation (referred to here as the "old target"³) is treated as transferring all of its assets to an unrelated person in exchange for consideration in a single transaction at the close of the acquisition date (but before the deemed liquidation, described below).⁴

For federal income tax purposes, the old target generally recognizes the gain realized on the deemed transfer of its assets; the realization event is deemed to occur prior to the close of the acquisition date.⁵ The seller recognizes no gain or loss on the sale or exchange of target stock

¹ The Department does not issue rulings on federal tax matters. This ruling is not an opinion regarding the applicability of I.R.C. §§ 338(h)(10), 332, and 337 to the taxpayers. If the taxpayers' federal tax treatment is not as described, the conclusions in this ruling are inapplicable to the transaction.

² I.R.C. § 338(h)(10) (LexisNexis 2014).

³ For federal income tax purposes, if an election under I.R.C. § 338(h)(10) is made, the target corporation is treated as though it were two separate corporations, Old Target and New Target. I.R.C. § 338(a). Old Target is treated as if, before the close of the acquisition date, after the deemed asset sale, and while Old Target is a member of the selling consolidated group, it transferred all of its assets to members of the selling consolidated group and ceased to exist. Treas. Reg. § 1.338(h)(10)-1(d)(4) (LexisNexis 2014). Members of the selling consolidated group are treated as if, after the deemed asset sale and before the close of the acquisition date, they received the assets transferred by Old Target. Treas. Reg. § 1.338(h)(10)-1(d)(5)(i). In other words, immediately after the deemed asset sale, Old Target is treated as having liquidated into its parent company or companies. New Target is treated as a separate corporation that acquired the assets of Old Target.

⁴ Treas. Reg. § 1.338(h)(10)-1(d)(3).

⁵ *Id.*

included in the qualified stock purchase; however, the seller may recognize gain or loss on the target stock in the deemed liquidation.⁶

The seller is treated as if, after the deemed asset sale and before the close of the acquisition date, it received the assets transferred by the old target.⁷ The old target is treated as if, before the close of the acquisition date but after the deemed asset sale, it transferred all of its assets to the seller and ceased to exist.⁸ 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.⁹

b. Overview of I.R.C. §§ 332, 337

Under I.R.C. §§ 332 and 337,¹⁰ no gain or loss is recognized for federal income tax purposes when property is distributed by a subsidiary to the owner pursuant to the subsidiary's complete liquidation. Without these provisions, such liquidating distributions would be treated for federal income tax purposes as amounts received by the owners in exchange for the subsidiary's shares, and both the subsidiary and its owners could recognize gain or loss on the distribution.¹¹

In conjunction with an effective I.R.C. § 338(h)(10) election, the assets and liabilities that a target distributes to its shareholders prior to being sold may be treated for federal tax purposes as having been made pursuant to a plan of reorganization, a distribution in complete cancellation or redemption of all its stock, or similar transaction.¹² When these distributions meet all the necessary requirements for tax-exempt treatment under I.R.C. §§ 332 and 337, the seller and the target do not recognize gain or loss for federal income tax purposes on the assets and liabilities transferred from the target to the seller prior to the sale.

Computation of net earnings for Tennessee excise tax purposes

Tennessee imposes an excise tax at the rate of 6.5% on the net earnings of all persons, as defined under TENN. CODE ANN. § 67-4-2004(38) (2013), doing business within Tennessee.¹³

⁶ Treas. Reg. § 1.338(h)(10)-1(d)(5)(iii).

⁷ Treas. Reg. § 1.338(h)(10)-1(d)(5).

⁸ Treas. Reg. § 1.338(h)(10)-1(d)(4).

⁹ *Id.*

¹⁰ I.R.C. §§ 332, 337 (LexisNexis 2014).

¹¹ I.R.C. § 331 (LexisNexis 2014); Treas. Reg. § 1.332-1 (1960); I.R.C. § 336(a) (LexisNexis 2014).

¹² Treas. Reg. 1.338(h)(10)-1(d)(4) to (5) (as amended in 2007).

¹³ TENN. CODE ANN. § 67-4-2007(a) (2013). Tennessee also imposes a franchise tax at the rate of \$0.25 per \$100, or major fraction thereof, on the net worth of a person doing business in Tennessee, pursuant to TENN. CODE ANN. §§ 67-4-2105(a) and 2106(a) (2013).

Corporations, such as the Target and Seller, are included among the types of entities defined as “persons” for purposes of the Tennessee excise tax.¹⁴ For corporations, TENN. CODE ANN. § 67-4-2006(a)(1) (2013) defines “net earnings” as “federal taxable income or loss before the operating loss deduction and special deductions provided for in 26 U.S.C. §§ 241, 242 [repealed], 243-247,” as adjusted by TENN. CODE ANN. § 67-4-2006(b)-(c).¹⁵

1-2. *The I.R.C. § 338(h)(10) election and the Tennessee excise tax*

Tennessee law neither adopts nor disallows the election under I.R.C. § 338(h)(10) and the accompanying federal regulations.¹⁶ Additionally, the Tennessee franchise and excise tax laws do not provide for a comparable election to treat a stock sale as a deemed asset sale.

Nonetheless, gain that the Target recognizes for federal tax purposes pursuant to the I.R.C. § 338(h)(10) Election is included in the Target’s net earnings for Tennessee excise tax purposes. If the I.R.C. § 338(h)(10) Election is properly made, then for federal income tax purposes the Target will recognize gain arising from the Sale. As an item comprising part of the Target’s federal taxable income before the net operating loss deduction and special deductions provided for in 26 U.S.C. §§ 241, 242 [repealed], 243-247, such gain or loss is included in the starting point for the computation of the Target’s Tennessee net earnings under TENN. CODE ANN. § 67-4-2006(a)(1). Furthermore, TENN. CODE ANN. § 67-4-2006(b)(2) does not provide for a subtraction adjustment to federal taxable income that would require gain or loss arising from the Sale to be excluded in the computation of Tennessee net earnings.

Accordingly, because the gain that the Target recognizes on the Sale pursuant to the I.R.C. § 338(h)(10) Election is included in the Target’s federal taxable income, and because such gain is not subtracted in the computation of the Target’s net earnings, such gain will be included in Target’s net earnings for Tennessee excise tax purposes.

Gain that Seller does not recognize for federal income tax purposes on the Sale pursuant to the I.R.C. § 338(h)(10) Election is excluded from Seller’s net earnings for Tennessee excise tax purposes. If the I.R.C. § 338(h)(10) Election is properly made, then for federal income tax purposes Seller will not recognize any gain or loss on the Sale. Because such gain or loss does not comprise part of Seller’s federal taxable income before the net operating loss deduction and special deductions provided for in 26 U.S.C. §§ 241, 242 [repealed], 243-247, such gain or loss is not included in the starting point for the computation of Seller’s net earnings under TENN. CODE ANN. § 67-4-2006(a)(1). Furthermore, TENN. CODE ANN. § 67-4-2006(b)(1) does not provide for an adjustment to federal taxable income that would require gain or loss unrecognized

¹⁴ TENN. CODE ANN. § 67-4-2004(38).

¹⁵ TENN. CODE ANN. § 67-4-2006(b) requires specific addition and subtraction adjustments to federal taxable income to arrive at Tennessee net earnings. TENN. CODE ANN. § 67-4-2006(c) relates to the deduction of net operating losses.

¹⁶ Note that the Tennessee Court of Appeals has stated that “rulings of the federal courts in regard to federal tax laws are not binding on Tennessee courts when they are called upon to interpret Tennessee tax laws.” *Little Six Corp. v. Johnson*, 1999 WL 336308 at *3 (Tenn. Ct. App. May 28, 1999); see also *Tidwell v. Berke*, 532 S.W.2d 254 (Tenn. 1975).

pursuant to the I.R.C. § 338(h)(10) Election to be included in the computation of Tennessee net earnings.

Because no gain on the Seller's sale of the Target's stock is included in Seller's federal taxable income pursuant to the I.R.C. § 338(h)(10) Election, and because such gain is not added to net earnings under Tennessee excise tax law, no gain arising from the Sale will be included in Seller's net earnings for Tennessee excise tax purposes.

3. *I.R.C. §§ 332, 337 and the Tennessee excise tax*

Tennessee law neither adopts nor disallows I.R.C. §§ 332 and 337 and the accompanying federal regulations for purposes of the Tennessee excise tax.

If the Distribution is treated for federal income tax purposes as part of a tax-exempt liquidating distribution pursuant to I.R.C. §§ 332 or 337, the Target will not recognize any gain on the Distribution for federal income tax purposes. Because gain on the Distribution does not comprise part of the Target's federal taxable income, such gain is not included in the starting point for the computation of the Target's Tennessee net earnings under TENN. CODE ANN. § 67-4-2006(a)(1). Furthermore, TENN. CODE ANN. § 67-4-2006(b)(1) does not provide for an adjustment to federal taxable income that would require such gain to be added in the computation of Tennessee net earnings.

Because no gain on the Distribution is included in the Target's federal taxable income, such gain will be excluded from the Target's net earnings for Tennessee excise tax purposes. Similarly, because no gain on the Distribution is included in Seller's federal taxable income, such gain will be excluded from Seller's net earnings for Tennessee excise tax purposes.

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