

SC REVENUE RULING #09-4

SUBJECT: Internal Revenue Code §338(h)(10) Election
(All Taxes)

EFFECTIVE DATE: Applies to all periods open under the statute.

SUPERSEDES: All previous advisory opinions and any oral directives in conflict herewith.

AUTHORITY: S. C. Code Ann. Section 12-4-320 (Supp. 2008)
S. C. Code Ann. Section 1-23-10(4) (2008)
SC Revenue Procedure #09-3

SCOPE: The purpose of a Revenue Ruling is to provide guidance to the public and to Department personnel. It is an advisory opinion issued to apply principles of tax law to a set of facts or general category of taxpayers. It is the Department's position until superseded or modified by a change in statute, regulation, court decision, or another Departmental advisory opinion.

I. General Overview

A purchasing corporation¹ making a qualified stock purchase (*i.e.*, the purchase of at least 80% of the total voting power and value of the stock of a corporation during a 12 month acquisition period) of a target corporation² may make a joint election under Internal Revenue Code §338, "Certain Stock Purchases Treated as Asset Acquisitions," to treat the stock purchase as an asset acquisition.

Internal Revenue Code §338(h)(10), "Elective Recognition of Gain or Loss by Target Corporation, Together with Nonrecognition of Gain or Loss on Stock Sold by Selling Consolidated Group," allows a target corporation that was a member of the selling consolidated group before the transaction to be treated as a member of the selling consolidated group with the stock sale transaction treated as if the target corporation had sold all of its assets at the close of the acquisition date at fair market value in a single, fully taxable transaction,

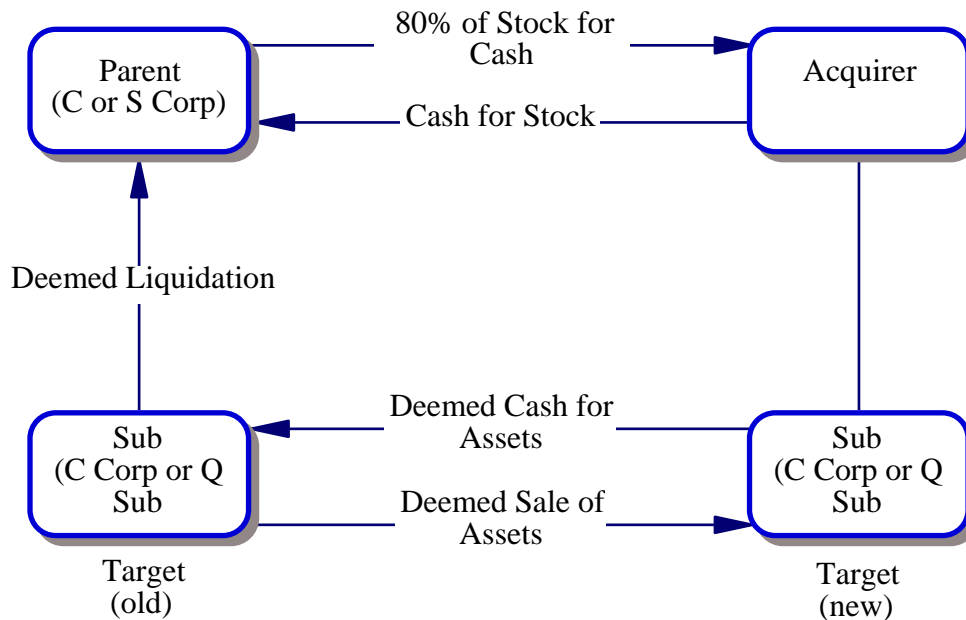
¹ The term "purchasing corporation" means any corporation which makes a qualified stock purchase of stock of another corporation.

² The term "target corporation" means any corporation the stock of which is acquired by another corporation in a qualified stock purchase.

distributed the proceeds of the sale to the seller³ (the corporation that owns the target, *e.g.*, another member, parent, or Q Sub) in tax free deemed liquidation under Internal Revenue Code §332, and treated as a new corporation which purchased all the assets as of the beginning of the day after the acquisition date (*i.e.*, repurchased its own assets in a hypothetical sale). As a result, the purchasing corporation receives a stepped up (or stepped down) basis in the assets acquired from the target corporation and a gain or loss on the deemed sale of assets is recognized by the target on its old consolidated return if the target is a member of the selling consolidated group, or the old target's separate return if the target was a member of an affiliated group filing separate returns or an S corporation.

An Internal Revenue Code §338(h)(10) election can be made until the 15th day of the 9th month after the month in which the acquisition date occurs. The election must be made jointly by both the seller and the purchaser.

The practical effect of an Internal Revenue Code §338(h)(10) election is summarized as follows:



1. The target is treated as if it had sold all of its assets in a single, fully taxable transaction and recognizes gain or loss on the deemed sale of the assets (*i.e.*, there is an asset sale for income tax purposes; the form of the transaction is a stock sale).

³ An Internal Revenue Code §338(H)(10) election cannot be made for a target corporation unless it is acquired from a selling consolidated group, a selling affiliate, or an S corporation shareholder(s).

2. The target is generally treated as making the deemed sale and then distributing all of its assets in a complete liquidation. The target's tax year ends on the date of acquisition. Generally, for federal income tax purposes, the target corporation's short period return is included in the selling parent's federal consolidated return.
3. Any gain or loss on the actual sale of the stock in the target is not recognized by the selling group.
4. A purchasing corporation (sometimes referred to as the "new target"), using the same employer identification number of the target corporation, is treated as if it had purchased all the assets of the target corporation (sometimes referred to as the "old target"), and begins business the following day. The purchasing corporation ("new target") receives a stepped up (or down) basis in the assets acquired from the (old) target.

The purpose of this advisory opinion is to provide guidance concerning South Carolina income tax, sales tax, deed recording fee, and personal property tax consequences of an Internal Revenue Code §338(h)(10) election.

II. Income Tax Consequences

A. Conformity to Federal Election

Code Section 12-6-40, "Application of Federal Internal Revenue Code to State Tax Laws", provides that all elections made for federal income tax purposes in connection with Internal Revenue Code Sections adopted by South Carolina automatically apply for South Carolina income tax purposes unless otherwise provided. Code Section 12-6-40 and Code Section 12-6-50, "Internal Revenue Code Sections Specifically not Adopted by State," provide that South Carolina has adopted Internal Revenue Code §338 and related regulations.⁴

Accordingly, an Internal Revenue Code §338(h)(10) election made by a C corporation or an S corporation for federal income tax purposes automatically applies for South Carolina income tax purposes (*i.e.*, a separate South Carolina election is not made). Further, the election may not be made solely for federal income tax purposes or solely for South Carolina income tax purposes.

B. Treatment of Gain from Sales of Assets

In an Internal Revenue Code §338(h)(10) transaction, the target is treated as if it had sold all of its assets in a single, fully taxable transaction and recognizes gain or loss on the deemed sale of the assets (*i.e.*, there is an asset sale for income tax purposes; the form of the transaction is a stock sale). This results in sourcing issues and making a determination as to whether the gain from the deemed sale of assets recognized by the target subsidiary is apportionable business income, allocable nonbusiness income, or a combination.

⁴ Note that South Carolina has not, however, adopted Internal Revenue Code §§1501 - 1505 relating to consolidated tax returns.

Code Section 12-6-2220 specifically lists items of income that must be directly allocated. This statute is generally applicable to nonbusiness items of net income. Code Section 12-6-2240 provides that all income remaining after allocation is apportioned. Accordingly, the proper sourcing and the amounts used in the apportionment factors depend on the facts and circumstances.

Based on the above statute, the target subsidiary's gain from the deemed sale of assets used in the business is generally apportionable business income. However, the target subsidiary's gains and losses from the sale of real property less all related expenses are allocable income and are allocated to the state in which the real property is located except to the extent that gain represents the return of amounts deducted as depreciation. The amount of gain which represents the return of amounts deducted as depreciation is allocated to South Carolina to the extent of depreciation previously deducted in computing South Carolina taxable income. Gain in excess of recaptured depreciation is allocated to the state where the real property is located whether or not the real property was used in or connected with the taxpayer's trade or business. The target subsidiary's gain from the deemed sale of assets not used in the business is allocable income.

C. Apportionment Factors

The single sales factor apportionment method is provided in Code Section 12-6-2252. Code Section 12-6-2295 provides a list of items included and excluded from the term "sales." Accordingly, the following provides guidance concerning the apportionment of income in an Internal Revenue Code §338(h)(10) election:

1. Net gains (not the selling price) from the sale of tangible and intangible personal property used in the business (other than inventory and other property sold in the ordinary course of business) from the deemed sale are included in the target subsidiary's sales factor.
2. The gross proceeds from the sale of inventory and other property sold in the ordinary course of business, for example, from the deemed sale is included in the target subsidiary's sales factor.
3. The sales factor does not include gain which is allocated pursuant to Code Section 12-6-2220, such as a gain from the sale of real property (see discussion above.)
4. The gain and short period income is apportioned based on apportionment factors for the short period.

Note: The above guidance may be different if the statutory apportionment formula does not fairly represent the extent of the taxpayer's business within South Carolina. Code Section 12-6-2320 provides that such taxpayer may petition for, or the Department may require, an alternative method. See SC Revenue Procedure #09-1 for application procedures.

D. Filing Obligations

Code Section 12-6-4410(A) provides that a taxpayer's taxable year must be the same as the taxpayer's taxable year for federal income tax purposes. However, Code Section 12-6-50 provides that South Carolina has not adopted Internal Revenue Code §§1501 - 1505 relating to consolidated tax return rules. With respect to taxpayers filing consolidated federal returns, the short-period return for the target subsidiary is not due until the extended due date of the selling parent's return (in many cases, this is more than one year from the close of the target's short period). Since, as a practical matter, South Carolina's filing requirements follow the federal rules, the taxpayer's South Carolina income tax return cannot be prepared and filed before the federal income tax return. As a result, a penalty and interest imposed due to the federal filing situation will be waived.⁵

E. Income Tax Credits and Recapture

When making an Internal Revenue Code §338(h)(10) election, a taxpayer transferring unused credits should carefully examine the particular South Carolina credit statute to determine if the unused credits can be transferred or sold, whether there are any recapture provisions, and review the requirements for eligibility of new credits. Several examples of the income tax credit consequences of an Internal Revenue Code §338(h)(10) election are provided below.

Job Tax Credit. Code Section 12-6-3360(I) provides that a taxpayer may assign its rights to its job tax credit to another taxpayer if it transfers all, or substantially all, of the assets of a trade or business or operating division of a taxpayer related to the generation of the jobs tax credits to that taxpayer if the required number of new jobs is maintained for that amount of credit.

Unused tax credits may be transferred and continued by the succeeding taxpayer subject to the limitations of Section 12-6-3320.⁶ Code Section 12-6-3360(A) and (F) sets forth the requirements for creating a new job tax credit for qualifying new jobs. In other words, if the target corporation created 100 new, full time jobs in the past and has \$500,000 of unused job tax credits and carryovers, the purchasing corporation is eligible to use the unused credits and carryovers subject to any restrictions. The purchasing corporation is not, however, considered to have created the 100 new jobs and is not eligible to claim the credit for a new, five year credit period.

⁵ The Department is authorized to waive, dismiss, or reduce penalties under Code Section 12-54-160. There is no authority granting the Department the right to waive interest (see Code Section 12-4-320(3)), but on occasions interest has been deemed to be in the nature of a penalty and waived. See *Colonial Life & Accident Insurance Company v. South Carolina Tax Commission*, 248 S.C. 334 (1966), and *Texaco, Inc., v. Robert C. Wasson*, 269 S.C. 255 (1977). See also SC Revenue Ruling #89-10 addressing the return due date for a South Carolina subsidiary involved in a Internal Revenue Code Section 338(h)(10) transaction and the waiver of certain penalties.

⁶ Code Section 12-6-3320 provides that the provisions of Internal Revenue Code §383 (Special Limitations on Certain Excess Credits) are applicable to all income tax credits available to a corporation for South Carolina income tax purposes.

Economic Impact Zone Credit and Recapture. Code Section 12-14-60 provides that “economic impact zone qualified manufacturing and productive equipment property” eligible for the credit includes property acquired by the taxpayer if the original use commences with the taxpayer inside the economic impact zone. If an Internal Revenue Code §338(h)(10) election is made, the assets acquired by the purchasing corporation, even assets less than one year old, are not eligible for the investment tax credit since the original use of the property did not begin with the taxpayer inside the economic impact zone.

Further, Code Section 12-14-60(E) provides that if the taxpayer disposes of the qualified manufacturing and productive equipment property before the end of the applicable recovery period, then the unearned portion of the credit must be recaptured. Subsection (F) further provides that if the credit is recaptured, then the basis of the property must be increased in the year of recapture. As a result, if an Internal Revenue Code §338(h)(10) election is made, the deemed sale of the assets is treated as a disposal of the assets and may trigger recapture of the economic impact zone credit claimed by the (old) target corporation.

III. Sales Tax Consequences

A taxpayer making an Internal Revenue Code §338(h)(10) election is making an election to treat a stock purchase as an asset acquisition (*i.e.* a deemed asset sale) for income tax purposes only. For sales tax purposes, there is no asset sale. Accordingly, there is no South Carolina sales or use tax consequences from an Internal Revenue Code §338(h)(10) election.

IV. Deed Recording Fee Consequences

The deed recording fee in Chapter 24 of Title 12 is imposed for the privilege of recording a deed in each county (*i.e.*, recorded with the clerk of court or register of deeds) with respect to any deed whereby any lands, tenements or other realty is transferred to another person. Code Section 12-24-40 lists transfers exempt from the deed recording fee.

For deed recording fee purposes, a “transfer” of realty to another person has not taken place under Code Section 12-24-10. Accordingly, there is no South Carolina deed recording fee consequence from an Internal Revenue Code §338(h)(10) election.

V. Personal Property Tax Consequences

Manufacturers. Code Section 12-37-930 provides for the depreciation allowances for manufacturer’s machinery and equipment. For personal property tax purposes, the original cost of the property is reduced by an annual depreciation percentage. “Original cost” is defined as gross capitalized cost, including property on which the taxpayer made the election allowed pursuant to §179 of the Internal Revenue Code, as shown by the taxpayer’s records for income tax purposes. In the year of acquisition, depreciation is allowed as if the property were owned for the full year. Therefore, if an Internal Revenue Code §338(h)(10) election is made, the

federal income tax basis of the deemed assets acquired by the purchasing corporation (stepped up or stepped down basis), excluding adjustments for Internal Revenue Code §179 and other Internal Revenue Code sections concerning depreciation not adopted by South Carolina (see Code Section 12-6-50), is used for South Carolina personal property tax purposes.

Merchants. Regulation 117-1840.1 provides that the fair market value of merchants' furniture, fixtures, and equipment shall be the depreciated value as shown by the merchants records for income tax purposes, provided however, that in no event is the original cost of the property to be reduced by more than 90% of the original capitalized cost. Therefore, if an Internal Revenue Code §338(h)(10) election is made, the federal income tax basis of the assets acquired by the purchasing corporation (stepped up or stepped down basis), excluding adjustments for Internal Revenue Code §179 and other Internal Revenue Code sections concerning depreciation not adopted by South Carolina (see Code Section 12-6-50), is used for South Carolina personal property tax purposes.

SOUTH CAROLINA DEPARTMENT OF REVENUE

s/Ray N. Stevens

Ray N. Stevens, Director

March 31 _____, 2009
Columbia, South Carolina