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07.11.19

Chief Counsel Ruling 2019 - 02

RE: Chief Counsel Ruling Request for *****

Dear *****,

This letter is in response to your Chief Counsel Ruling ("CCR") request dated ***** and supplemented on *****. In the request, you ask for the Franchise Tax Board's ("FTB") guidance as to California apportionment of gain resulting from ***** ("Taxpayer") making an Internal Revenue Code ("IRC") section 338(g) election.

FACTS

Taxpayer is a global media and technology company that provides media, entertainment, and telecommunication services. ***** ("Buyer") is Taxpayer's lower-tier, wholly-owned company incorporated in the ***** and registered in ***** and *****. For California tax purposes, Taxpayer files its California franchise and income tax returns on a worldwide basis.

***** ("Target") is a top-tier parent company that is incorporated in the ***** and registered in ***** and *****. Target is publicly traded on the *****. Target is also in the media and telecommunications business, providing services similar to Taxpayer's, throughout the *****. In addition to owning numerous subsidiaries operating internationally, Target owns ***** also a foreign company but with operations in the *****. ***** has filed an IRS 1120-F for federal purposes and on a Water's-Edge basis for California purposes.

From ***** through ***** Buyer purchased Target's stock in separate transactions, or tranches. On ***** Buyer completed its first purchase of 29 percent of Target's stock. Buyer continued purchasing tranches of Target's stock and by

***** ** ****, Buyer effectively owned more than 50 percent of Target's stock, and on that date was instantly unitary with Target.¹

Buyer continued purchasing additional tranches of Target's stock and by ***** ** ****, Buyer effectively owned more than 80 percent of Target's stock. Pursuant to federal rules, Taxpayer became eligible, as of ***** ** ****, to make an IRC section 338(g) election and to treat its purchase of Target's stock as a purchase of Target's assets.² On ***** ** ****, Buyer acquired the remainder of Target's stock, thereby becoming Target's sole owner.³ Taxpayer has not yet made the election, and has until the fifteenth day of the ninth month beginning after the month in which Taxpayer became eligible to make the election.⁴

ISSUE

Whether gain realized from Taxpayer making an IRC section 338(g) election must be apportioned using Target's apportionment formula.

HOLDING

Pursuant to federal and California authorities, as discussed below, any gain on the deemed asset sale pursuant to the election must be apportioned using Target's adjusted apportionment formula as provided by California Code of Regulations, title 18, section 25106.5-9(a).

LAW AND ANALYSIS

On May 5, 2006, FTB issued Legal Ruling 2006-03 which addressed the apportionment of gains resulting from an IRC section 338 election. However, Legal Ruling 2006-03 did not address how gains from an IRC section 338 election are apportioned for a transaction involving a group of foreign corporations. Also, Legal Ruling 2006-03 is only applicable to taxpayers that had been members of the seller's federal consolidated return group.⁵ IRC section 1501 provides that "a consolidated return [requires] all corporations [to be] members of the affiliated group." IRC section 1504(a)(1)(A) states "[an] 'affiliated group' [is] 1 or more chains of includable corporations connected through stock ownership with a common parent corporation which is an includable corporation." Pursuant to IRC section 1504(b)(3), a foreign corporation is not an "includable corporation." As Target is a foreign

¹ California Revenue and Taxation Code section 25105.

² IRC section 338(a) and (d)(3); IRC section 1504(a)(2).

³ Specifically, in ***** ** ****, Buyer acquired Target's stock in more than ten separate purchases. In ***** ** ****, Buyer acquired more of Target's stock in another five separate purchases. Finally, in ***** ** ****, Buyer acquired the remainder of Target's stock in three additional purchases.

⁴ IRC section 338(g)(1).

⁵ See United States Treasury Regulation section 1.1502-0 et seq.

corporation that does not own a U.S. corporation, neither Target nor its subsidiaries are eligible to file a federal consolidated return.

California Revenue & Taxation Code ("CRTC") section 24451 conforms to IRC section 338 by reference.⁶ IRC section 338(g) allows the acquiring corporation to make an election to treat its acquisition of a target's stock as a purchase of the target's assets.⁷ When the election is made, the acquired corporation ("Old Target") is deemed to have sold all of its assets at the close of the acquisition date.⁸ Thereafter, Old Target is treated as a new corporation ("New Corporation") that owns Old Target's assets.⁹

In this case, Taxpayer making an IRC section 338(g) election will result in Target's deemed sale of its assets at the close of ***** ***, the date Taxpayer became eligible to make the election.

Pursuant to the IRC section 338(g) election, the old target, not the electing acquirer, recognizes the gain on the deemed sale of its assets.¹⁰ United States Treasury Regulation ("Treasury Regulation") section 1.338-10(a)(1) sets forth, in relevant parts, a general rule that any tax consequences from the IRC section 338(g) deemed asset sale must be reported on the old target's final return for the taxable year ending at the close of the acquisition date. The exception to this rule set forth in paragraph (a)(2) of Treasury Regulation section 1.338-10 is not relevant in this case because Target and ***** are foreign corporations ineligible to file a federal consolidated return.

Pursuant to paragraph (a)(5) of Treasury Regulation section 1.338-10, "[o]ld target may not be considered a member of any affiliated group that includes the purchasing corporation with respect to the deemed asset sale." This paragraph disallows inclusion of the old target and its deemed asset sale in a consolidated return which also includes the buyer making the election. As such, paragraphs (a)(1) and (a)(5) work in harmony, both directing the old target to report the deemed asset sale gain on its own return.

IRC section 338(h)(9) also provides that the target corporation will not be treated as a member of an affiliated group with respect to the sale described in subsection (a)(1).¹¹

FTB Legal Ruling 2006-03 addressed the apportionment of gains resulting from an IRC section 338(g) election by providing three scenarios and the associated tax outcomes for

⁶ The FTB has not issued any regulations pertaining to CRTC section 24451. Consequently, as there are no conflicting regulations issued by the FTB, pursuant to CRTC section 23051.5, subdivision (d), the federal regulations pertaining to IRC section 338 apply for California purposes.

⁷ IRC section 338(b)(3).

⁸ IRC section 338(a)(1).

⁹ IRC section 338(a)(2).

¹⁰ Treasury Regulation section 1.338-10.

¹¹ IRC section 338(h)(9).

each.¹² While all three fact patterns involved a seller that filed a federal consolidated income tax return, which is not the case in the situation presented, the ruling provides support for a conclusion that the target must report gains on the deemed asset sale separately from the buyer even if the buyer and the target were instantly unitary as a result of the acquisition. More specifically, while considering a situation in which "Old Target is a member of a federal consolidated return group, but not the common parent," FTB provided:

For California franchise and income tax purposes, the gain from the deemed sale of assets is treated as having arisen after Old Target's stock was sold. (See *Appeals of S.C.V. Realty & Development Co., Ltd., et al.*, 94-SBE-015, December 14, 1994.) ... Because the gain is inherent in Old Target's assets when they are acquired by New Target, the gain does not relate to the unitary business of the acquiring corporation, even if instantly unitary. Therefore, the gain should not be included in the acquiring corporation's combined report, but should be reported on New Target's single day return.¹³

Under the facts presented in this ruling, Target was already unitary with Taxpayer at the time of the acquisition. Therefore, the apportionment factors shall be determined pursuant to the regulations under CRTC section 25106.5. Accordingly, when Taxpayer makes the IRC section 338(g) election (effective ***** ** ** **), any gain realized on Target's deemed asset sale as a result of the election would be apportioned using California Code of Regulations, title 18, section 25106.5-9, which relates to partial combined reporting periods when a member is included in an existing combined reporting group. Utilizing the pro-rata method based on the number of days addressed in California Code of Regulations, title 18, section 25106.5-9(a), Target's apportionment factor percentage that will be utilized to source the gain on the deemed sale of the assets will be its intrastate apportionment percentage¹⁴ from **** ** **** through ***** ** **** combined on a pro rata basis with its intrastate apportionment percentage taking into account the apportionment factor denominators of the combined reporting group that it became a member of during ***** ** **** through ***** ** ****.

CONCLUSION

Gain realized as a consequence of Taxpayer making an IRC section 338(g) election must be reported by Target on Target's return and apportioned to California using Target's adjusted apportionment formula.

Please be advised that the tax consequences expressed in this CCR are applicable only to the named taxpayer and are based upon and limited to the facts you have submitted. In the event of a change in relevant legislation, or judicial or administrative case law, a change in federal interpretation of federal law in cases where our opinion is based upon such an interpretation, or a change in the material facts or circumstances relating to your request

¹² FTB Legal Ruling 2006-03 (May 5, 2006), pp. 3-6.

¹³ FTB Legal Ruling 2006-03 (May 5, 2006), p. 5.

¹⁴ California Code of Regulations, title 18, section 25106.5(b)(22).

upon which this opinion is based, this opinion may no longer be applicable. It is your responsibility to be aware of these changes, should they occur.

This letter is a legal ruling by the FTB's Chief Counsel within the meaning of paragraph (1) of subdivision (a) of section 21012 of the CRTC. Please attach a copy of this letter and your request to the appropriate return(s) (if any) when filed or in response to any notices or inquiries which might be issued.

Very truly yours,

Laura Taing
Tax Counsel