TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 14-06

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 availability of the Tennessee franchise and excise tax industrial machinery credit to an entity that has made an I.R.C. § 338(h)(10) election.

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

Prior to [TRANSACTION DATE], [TAXPAYER] (the "Taxpayer") was a subsidiary of [SELLER] (the "Seller"). On [TRANSACTION DATE], [BUYER] (the "Buyer") acquired 100% of the stock of the Taxpayer from the Seller (the "Sale"). At the time of the Sale, the Taxpayer possessed manufacturing assets (the "Manufacturing Assets") that qualified as

industrial machinery under TENN. CODE ANN. §§ 67-4-2009(3), -6-102 (2013). The Buyer and the Seller jointly elected to treat the stock sale as a sale of assets for federal income tax purposes under I.R.C. § 338(h)(10).

RULING

For tax periods following the Sale, is the Taxpayer eligible to claim the Tennessee franchise and excise tax industrial machinery credit under TENN. CODE ANN. § 67-4-2009(3)(A) (2013) with respect to the Manufacturing Assets that the Taxpayer was deemed to have acquired upon making the I.R.C. § 338(h)(10) election?

> Ruling: No. The Taxpayer is not eligible to claim the Tennessee franchise and excise tax industrial machinery credit under TENN. CODE ANN. § 67-4-2009(3)(A) with respect to the Manufacturing Assets that the Taxpayer was deemed for federal income tax purposes to have acquired as a result of the Sale.

ANALYSIS

I.R.C. § 338(h)(10) Election

Under federal law, I.R.C. § 338(h)(10) provides an elective, alternative federal income tax treatment for qualifying sales of corporate stock. When a buyer acquires corporate stock in a target corporation, the purchase generally has no federal income tax consequences for the target corporation. Instead, the target corporation's former shareholders recognize gain or loss on the sale or exchange of the target corporation's shares. Conversely, when a buyer acquires the assets of a corporation, the asset acquisition causes the target corporation to recognize gain or loss on the sold assets, but the transaction has no immediate federal income tax consequences on the target corporation's shareholders.

Provided certain requirements are met, the buyer and the target corporation's owners may jointly elect under I.R.C. § 338(h)(10) to treat a stock sale as an asset sale for federal income tax purposes. To facilitate the correct computation of federal income tax under an I.R.C. § 338(h)(10) election, Treas. Reg. § 1.338(h)(10)-1 instructs electing taxpayers to compute their respective federal tax liabilities as though a series of fictional transactions had occurred. In general, the buyer is deemed to have contributed the purchase money to a wholly owned subsidiary; the target corporation is deemed to have transferred all of its assets to the buyer's fictional subsidiary in exchange for the purchase money; and the target corporation's shareholders are deemed to have ultimately received the purchase money upon liquidating the target corporation.

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.[1] 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

[1] Treas. Reg. §§ 1.338-1(a) (as amended in 2013), 1.338(h)(10)-1(d)(2)-(3) (as amended in 2007).

to members of the selling consolidated group and ceased to exist. 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. 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.

Industrial Machinery Credit

Tennessee imposes on all persons doing business within Tennessee an excise tax at the rate of 6.5% on net earnings and a franchise tax at the rate of $0.25 per $100, or major fraction thereof, of net worth.

Taxpayers who purchase qualifying industrial machinery that will be located in Tennessee are entitled to take an industrial machinery credit against their combined Tennessee franchise and excise tax liability for the period in which the purchase occurs.[2] The industrial machinery credit is generally equal to 1% of the purchase price of the qualifying machinery.[3] For Tennessee franchise and excise tax purposes, qualifying industrial machinery includes "industrial machinery" as defined in TENN. CODE ANN. § 67-6-102,[4] as well as certain additional computer-related assets outlined in TENN. CODE ANN. § 67-4-2009(3)(A)(ii).

Thus, the following requirements must be met in order for the Taxpayer to qualify for the industrial machinery credit with respect to the Manufacturing Assets that the Taxpayer was deemed for federal income tax purposes to have acquired upon making the I.R.C. § 338(h)(10) election: 1) the Taxpayer must have purchased the Manufacturing Assets during the tax period in which the credit will be claimed; 2) the Manufacturing Assets must be industrial machinery; and 3) the Manufacturing Assets must be located in Tennessee.

The first requirement is not met because the Taxpayer did not, for Tennessee tax purposes, purchase the Manufacturing Assets as a result of the Sale.

Importantly, the Tennessee franchise and excise tax laws are not controlled by federal income tax laws, regulations, and elections.[5] For all provisions of franchise or excise tax law that are not

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[2] TENN. CODE ANN. § 67-4-2009(3)(A) (2013).

[3] *Id*. With certain exceptions, the credit shall not exceed fifty percent of the combined franchise and excise tax liability shown by the return before the credit is taken. TENN. CODE ANN. § 67-4-2009(3)(B). Any unused credit may be carried forward for a maximum of fifteen years. TENN. CODE ANN. § 67-4-2009(3)(C)(i). Note that industrial machinery credits of up to ten percent of the purchase price are available to qualifying taxpayers making certain levels of capital investments. *See, e.g.*, TENN. CODE ANN. § 67-4-2009(3)(I).

[4] *See* TENN. CODE ANN. § 67-6-102(44) (2013).

[5] *See Oak Ridge Land Co. v. Roberts*, No. E2012-00456-COA-R3-CV, 2012 WL 5962002, at *3 (Tenn. Ct. App. Nov. 29, 2012), *app. denied* (April 9, 2013); *Little Six Corp. v. Johnson*, No. 01-A-01-9806-CH00285, 1999 WL 336308, at *3 (Tenn. Ct. App. May 28, 1999).

directly and expressly tied to federal law, "[t]he omission of a reference to or reliance upon the federal code . . . should be construed as the legislature's intent to depart from the federal code."[6] The Tennessee franchise and excise tax laws neither adopt nor disallow the provisions of I.R.C. § 338(h)(10) and accompanying federal regulations, nor do they provide for a comparable election to treat a stock sale as a deemed asset sale. Accordingly, transactions deemed to have occurred for federal income tax purposes per Treas. Reg. § 1.338(h)(10)-1 are not deemed to have occurred for Tennessee franchise and excise tax purposes.[7]

The Taxpayer's deemed transfer of the Manufacturing Assets for federal income tax purposes pursuant to Treas. Reg. § 1.338(h)(10)-1 neither occurred in fact nor were deemed to have occurred for Tennessee franchise and excise tax purposes. Rather, the owners of the Taxpayer sold their stock in the Taxpayer, and the parties made a federal election to treat the stock sale as an asset sale for federal income tax purposes. Accordingly, the Sale did not involve the purchase by the Taxpayer of the Manufacturing Assets for purposes of qualifying for the industrial machinery credit.

As a result, the Taxpayer is not eligible to claim the Tennessee franchise and excise tax industrial machinery credit under TENN. CODE ANN. § 67-4-2009(3)(A) with respect to the Manufacturing Assets that it was deemed for federal income tax purposes to have acquired as a result of the Sale.[8]

Because the first requirement is not met, this ruling will not address the additional requirements under TENN. CODE ANN. § 67-4-2009(3).

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[6] *Oak Ridge Land Co.*, 2012 WL 5962002, at *3.

[7] Nevertheless, the effect on a taxpayer's federal taxable income from an I.R.C. § 338(h)(10) election is reflected in a taxpayer's Tennessee net earnings. As a general matter, capital gains and losses realized pursuant to an I.R.C. § 338(h)(10) election are incorporated into net earnings in the same manner as any other gains or losses. The Tennessee excise tax expressly uses specific elements of a taxpayer's federal taxable income in the computation of taxable net earnings. For example, corporations use "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 a starting point for computing their Tennessee net earnings. TENN. CODE ANN. § 67-4-2006(a)(1) (2013). While TENN. CODE ANN. § 67-4-2006(b) and (c) make several adjustments to a taxpayer's federal taxable income starting point, these adjustments do not alter the effects of an I.R.C. § 338(h)(10) election on a taxpayer's federal taxable income. Note that in the case of S corporations, TENN. CODE ANN. § 67-4-2006(b)(1)(M), (2)(Q) function to ensure that the gains or losses realized pursuant to an I.R.C. § 338(h)(10) election are reflected in net earnings.

[8] Note that if the Taxpayer were deemed for franchise and excise tax purposes to have purchased the Manufacturing Assets in conjunction with the Sale, the Taxpayer would be subject to recapture of industrial machinery credits previously claimed with respect to those same assets. TENN. CODE ANN. § 67-4-2009(3)(D) provides that if industrial machinery, for the purchase of which a tax credit has been allowed, is sold during its useful life, the Department shall be entitled to recapture a portion of the credit. The recapture is effected by increasing the taxpayer's franchise and/or excise tax liability for the taxable period during which the machinery was sold, in an amount equal to the percentage of useful life remaining on the industrial machinery at the time of sale times the total credit taken on the purchase of the machinery. *Id*.

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APPROVED: Richard H. Roberts
Commissioner of Revenue

DATE: August 25, 2014