

# ARIZONA DEPARTMENT OF REVENUE

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## ARIZONA CORPORATE TAX RULING CTR 98-2

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### **ISSUE:**

What is the Arizona tax treatment of an Internal Revenue Code (I.R.C.) § 338(h)(10) election?

### **APPLICABLE LAW:**

Arizona Revised Statutes (A.R.S.) § 43-102.A.2 provides that the legislative intent is to adopt the provisions of the Internal Revenue Code relating to the measurement of taxable income by corporations, to the end that taxable income reported each taxable year by a corporation to the Internal Revenue Service shall be the identical sum reported to this state, subject only to modifications contained in Title 43 of the Arizona Revised Statutes.

A.R.S. § 43-102.A.3 provides that the legislative intent is to achieve the results in paragraph 2 of A.R.S. § 43-102.A by the application of the various provisions of the Internal Revenue Code relating to the definitions of income, exceptions, deductions, accounting methods, taxation of corporations, basis, and other pertinent provisions relating to gross income as defined, resulting in an amount called taxable income for corporations in the Internal Revenue Code.

A.R.S. § 43-1101.1 provides that "Arizona gross income" means the federal taxable income of a corporation for the taxable year.

A.R.S. § 43-1101.4 provides that "federal taxable income" means the taxable income of a corporation computed pursuant to the Internal Revenue Code.

Internal Revenue Code (I.R.C.) § 338 and the accompanying Treasury regulations provide elections that allow taxpayers to treat qualified stock purchases as asset purchases.

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### **DISCUSSION:**

I.R.C. § 338 and the accompanying Treasury regulations provide two elections relating to the treatment of a qualified stock purchase as an asset purchase. The first election available under I.R.C. § 338 is the step-up election. An I.R.C. § 338 election (or step-up election) allows the acquiring or purchasing corporation to treat the purchase of a controlling interest in the stock of another corporation (the target) as a purchase of the target's assets. As a result of this election, the target recognizes gain or loss on the deemed sale of its assets and adjusts the basis of its assets to reflect the price paid for its stock. The purchaser recognizes a stepped up basis in the target's assets for federal tax purposes.

The second election available under I.R.C. § 338 is the I.R.C. § 338(h)(10) election. The seller and the purchaser may make a joint election for the target under I.R.C. § 338(h)(10). If the I.R.C. § 338(h)(10) election is made for the target, it must be a simultaneous joint election by the seller and purchaser. If this election is made, the target is deemed to have sold all of its assets and then distributed the proceeds in complete liquidation. This election also allows the seller to avoid recognition of the gain on the sale of the target's stock.

An I.R.C. § 338(h)(10) election is irrevocable. If an I.R.C. § 338(h)(10) election is made for a target, a step-up election is deemed made for the target. If an I.R.C. § 338(h)(10) election for a target is not valid, the step-up election for a target is also not valid.

### **RULING:**

Arizona has no specific statutory provisions regarding an I.R.C. § 338(h)(10) election. Arizona's tax treatment of an I.R.C. § 338(h)(10) election is based on the legislative intent expressed in A.R.S. § 43-102.A and the provisions of A.R.S. § 43-1101.1. This ruling consists of the department's answers to questions which have been raised concerning the Arizona tax treatment of an I.R.C. § 338(h)(10) election.

1. Does the department recognize an I.R.C. § 338(h)(10) election for Arizona corporate income tax purposes?

Yes. The department will accept the federal election.

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2. May a corporation that makes an I.R.C. § 338(h)(10) election for federal tax purposes choose not to so elect for Arizona income tax purposes?

No. The taxpayer is bound by the election made for federal income tax purposes.

3. Is a separate Arizona election required in order to make an I.R.C. § 338(h)(10) election for Arizona income tax purposes?

No. A separate election is not required or allowed for Arizona income tax purposes.

4. Does the department recognize an I.R.C. § 338(h)(10) election made by S corporation shareholders for Arizona income tax purposes?

An I.R.C. § 338(h)(10) election made by S corporation shareholders for federal income tax purposes is binding for Arizona income tax purposes. A separate Arizona election is not required or allowed.

5. When an I.R.C. § 338(h)(10) election is made, do the Arizona filing periods follow those of federal?

Yes. The Arizona filing periods follow the federal filing periods.

6. Is the selling parent subject to tax on gain from sale of the subsidiary (target) stock?

No. The selling parent is not subject to tax on gain from the sale.

7. Is the subsidiary (target) subject to tax on the deemed sale of its assets?

Yes. If the target is an S corporation, the S corporation rules apply.

8. Is the target's gain resulting from an I.R.C. § 338(h)(10) election considered business income subject to apportionment or nonbusiness income allocable to a particular state?

The gain from the deemed sale of the target's assets is usually treated as business income subject to apportionment. If any portion of the gain is attributable to the sale of nonbusiness assets, that portion of the gain would be treated as nonbusiness income subject to allocation.

9. How is the apportionment formula determined for use in apportioning the target's business income?

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The gain will be apportioned under the provisions of chapter 11, article 4 of the Arizona Revised Statutes and the accompanying administrative rules.

Mark W. Killian, Director

Signed: July 23, 1998

Explanatory Notice

The purpose of a tax ruling is to provide interpretive guidance to the general public and to department personnel. A tax ruling is intended to encompass issues of law that are not adequately covered in statute, case law or administrative rules. A tax ruling is a position statement that provides interpretation, detail, or supplementary information concerning application of the law. Relevant statute, case law, or administrative rules, as well as a subsequent ruling, may modify or negate any or all of the provisions of any tax ruling. See GTP 96-1 for more detailed information regarding documents issued by the Department of Revenue.