

**TENNESSEE DEPARTMENT OF REVENUE  
LETTER RULING # 14-15**

**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 an S corporation that has 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**

[TAXPAYER] (the "Taxpayer") is incorporated in [STATE], conducts business in Tennessee, and files an annual Tennessee franchise and excise tax return. The Taxpayer has elected under Section 1362(a) of the Internal Revenue Code of 1986, as amended ("I.R.C."), to be taxed as an S corporation for federal income tax purposes. The Taxpayer's [REDACTED] shareholders (the

“Sellers”), each of whom is an individual [REDACTED], have received an offer to purchase the entirety of their stock in the Taxpayer (the “Proposed Sale”) from [BUYER] (the “Buyer”), [REDACTED].

The Sellers and the Buyer have agreed to structure the Proposed Sale under I.R.C. § 338(h)(10) and make the appropriate elections on the Buyer’s and the Taxpayer’s federal tax returns. The Buyer will pay the Sellers a portion of the purchase price on the transaction closing date. The Buyer will pay the Sellers the remainder of the purchase price as an “earn-out”<sup>1</sup> (the “Earn-Out Amount”) contingent on [EARN-OUT CONTINGENCY TERMS] during the [NUMBER - REDACTED] years following the sale and transfer of ownership of the Taxpayer to the Buyer. If the Taxpayer meets the earn-out contingencies, the Buyer will pay the Earn-Out Amount in full at the end of the [NUMBER] year following the Proposed Sale.

For federal income tax purposes, the I.R.C. § 338(h)(10) election causes the sale of stock to be treated as a deemed sale of the Taxpayer’s assets. Pursuant to the election, along with reporting under the I.R.C. § 453 installment method, the Taxpayer will report the Earn-Out Amount, if received, on its federal income tax return for the [NUMBER] year following the Proposed Sale.

## **RULING**

Is the Earn-Out Amount included in the Taxpayer’s net earnings for purposes of the Tennessee excise tax?

Ruling: Yes. Tennessee law neither adopts nor disallows the federal election under I.R.C. § 338(h)(10) or the use of the installment method under I.R.C. § 453. Any gain the Taxpayer recognizes on its actual or constructive receipt of the Earn-Out Amount will be reported as income on its federal form 1120S when received. Because such gain is attributable to the Taxpayer’s § 338(h)(10) election, it must be included in the Taxpayer’s Tennessee net earnings in the same taxable year it is reported for federal purposes.

## **ANALYSIS**

### Overview of I.R.C. § 338(h)(10)<sup>2</sup>

For federal income tax purposes, when a buyer acquires stock of a target corporation, the sale generally has no 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.

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<sup>1</sup> An “earn-out” is a payment structure utilized in mergers and acquisitions whereby the sellers must “earn” part of the purchase price based on the performance of the business following the acquisition. In an earn-out, part of the purchase price is paid after closing, based on the target company achieving certain financial goals.

<sup>2</sup> 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) (West 2014) or any other federal tax law to the Taxpayer or other parties to the Proposed Sale. If the Taxpayer’s federal tax treatment is not as described, the conclusions in this ruling are inapplicable to the transaction.

Alternatively, provided certain requirements are met, the buyer and the seller can make an election which must be joint under I.R.C. § 338(h)(10) to treat a stock sale as an asset sale for federal income tax purposes. Upon making this election, the target corporation (referred to here as the “old target”<sup>3</sup>) 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).<sup>4</sup>

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.<sup>5</sup> The seller recognizes no gain or loss on the sale or exchange of target stock included in the qualified stock purchase; however, the seller may recognize gain or loss on the target stock in the deemed liquidation.<sup>6</sup>

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.<sup>7</sup> 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.<sup>8</sup> 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.<sup>9</sup>

#### The I.R.C. § 338(h)(10) Election and the Tennessee Excise Tax

##### *a. Computation of Net Earnings for Tennessee Excise Tax Purposes*

The Taxpayer has elected to be taxed for federal income tax purposes as an S corporation.<sup>10</sup> Tennessee imposes an excise tax at the rate of 6.5% on the net earnings of all persons, including S

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<sup>3</sup> 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) (West 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.

<sup>4</sup> Treas. Reg. § 1.338(h)(10)-1(d)(3).

<sup>5</sup> *Id.*

<sup>6</sup> Treas. Reg. § 1.338(h)(10)-1(d)(5)(iii).

<sup>7</sup> Treas. Reg. § 1.338(h)(10)-1(d)(5).

<sup>8</sup> Treas. Reg. § 1.338(h)(10)-1(d)(4).

<sup>9</sup> *Id.*

<sup>10</sup> See TENN. CODE ANN. § 67-4-2006(a)(2) (2013) (defining an S corporation as a corporation electing S corporation status for federal income tax purposes under 26 U.S.C. §§ 1361-1363).

corporations,<sup>11</sup> doing business within Tennessee.<sup>12</sup> TENN. CODE ANN. § 67-4-2006(a)(2) defines “net earnings” of S corporations as “federal taxable income calculated as if the corporation had not elected S status, taken before the operating loss deduction and special deductions provided for in 26 U.S.C. §§ 241, 242 [repealed], 243-247, and 249-250” as adjusted by TENN. CODE ANN. §§ 67-4-2006(b)-(c).<sup>13</sup>

*b. Effect of § 338(h)(10) on Net Earnings of an S Corporation*

Tennessee law neither adopts nor disallows the election under I.R.C. § 338(h)(10) and the accompanying federal regulations.<sup>14</sup> 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.

As described above, although the Taxpayer has elected to be treated as an S corporation under federal law, it must determine its net earnings for Tennessee excise tax purposes as if it had not made such election.<sup>15</sup> In other words, in order to determine its Tennessee net earnings, the Taxpayer must first compute its federal taxable income as if it were a C corporation. To do this, the Taxpayer will prepare a pro forma federal Form 1120 (U.S. Corporation Income Tax Return).<sup>16</sup>

The § 338(h)(10) election is available to a target C corporation only if it is affiliated with the corporation selling its stock, or is part of a consolidated group with the corporation or corporations selling its stock.<sup>17</sup> The Taxpayer is owned by [REDACTED] individuals instead of one or more corporations with which it is affiliated or consolidated. Therefore, were the Taxpayer a C

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<sup>11</sup> TENN. CODE ANN. § 67-4-2004(38) (2013) (defining S corporations as “persons” for purposes of the Tennessee excise tax).

<sup>12</sup> 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).

<sup>13</sup> 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.

<sup>14</sup> 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).

<sup>15</sup> TENN. CODE ANN. § 67-4-2006(a)(2).

<sup>16</sup> All domestic corporations must file a Form 1120 for federal tax purposes, unless they are required, or elect to file a special return. S corporations are required to file a Form 1120S (U.S. Income Tax Return for an S Corporation).

<sup>17</sup> I.R.C. § 338(h)(10). A consolidated group is a group of corporations filing a consolidated return. *Id.* at § 338(h)(10)(B); Treas. Reg. § 1.1502-1(h) (generally defining a consolidated group). An affiliated group is one that does not file consolidated returns, but meets certain thresholds representing significant common ownership and control. Treas. Reg. § 1.338(h)(10)-1(b)(3); see also I.R.C. § 1504(a)(2) (establishing these standards).

corporation, it would be precluded from making the I.R.C. § 338(h)(10) election.<sup>18</sup> Consequently, the Taxpayer's federal taxable income as shown on its pro forma Form 1120 will not include any gain or loss attributable to the I.R.C. § 338(h)(10) election, even though the Taxpayer recognizes gain attributable to the election and reports that gain on its federal income tax return.

Prior to 2007, this incompatibility between Tennessee and federal law yielded results divergent from the Legislature's intent to calculate the net earnings of S corporations in a like manner as C corporations under TENN. CODE ANN. § 67-4-2006(a)(2). The outcome was that gains or losses from the sale remained fictitiously absent from the net earnings calculation for Tennessee excise tax. Despite this, a target S corporation nevertheless received a stepped-up basis in its assets for purposes of the Tennessee franchise tax and for calculating gain or loss on any future disposition.

In 2007, the General Assembly addressed this anomalous result by amending the excise tax law to require that an S corporation include in net earnings any gain or loss attributable to an I.R.C. § 338(h)(10) election.<sup>19</sup> Thus, if any gain realized pursuant to this election is recognized and reported on an S corporation's federal Form 1120S, but not included on the S corporation's pro forma federal Form 1120 for the reasons outlined above, such gain must be added to the taxpayer's pro forma federal taxable income to arrive at net earnings for Tennessee excise tax purposes.<sup>20</sup> This gain must be added to the taxpayer's pro forma federal taxable income in the same tax year in which it is reported for federal tax purposes.<sup>21</sup>

Because the Taxpayer is an S corporation whose shareholders will sell its stock and make a § 338(h)(10) election, it must follow the mandate of TENN. CODE ANN. § 67-4-2006(b)(1)(M). Thus, in the computation of its net earnings, the Taxpayer must add any gain that it recognizes that is attributable to the § 338(h)(10) election in the same year such gain is reported on the Taxpayer's form 1120S for federal purposes.

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<sup>18</sup> S corporations are qualified to make the § 338(h)(10) election pursuant to Treas. Reg. §§ 1.338(h)(10)-1(b) and (c), without meeting the same requirements as C corporations.

<sup>19</sup> 2007 Tenn. Pub. Acts, Ch. 602 §§ 15, 16. These amendments became effective on October 1, 2007, and apply to all transactions occurring on or after that date. *Id.* TENN. CODE ANN. § 67-4-2006(b)(1)(M) now states that an S corporation must add to its net earnings or loss "any gain that is not included in net earnings or loss and that is attributable to an election under 26 U.S.C. § 338(h)(10)." Similarly, TENN. CODE ANN. § 67-4-2006(b)(2)(Q) requires S corporations to include "any loss that is not included in net earnings or loss and that is attributable to an election under 26 U.S.C. § 338(h)(10)."

<sup>20</sup> TENN. CODE ANN. § 67-4-2006(b)(1)(M). Because the Taxpayer anticipates recognizing gain from the Proposed Sale, the analysis will focus particularly on TENN. CODE ANN. § 67-4-2006(b)(1)(M) and its impact on the Proposed Sale. Of course, the ultimate conclusion would remain unchanged if a target S corporation were to recognize loss pursuant to a § 338(h)(10) election. In that instance, the loss would similarly be reported on the S corporation's federal form 1120S, and, consequently, would have to be included in the S corporation's computation of net earnings or loss for Tennessee excise tax purposes in the same year. TENN. CODE ANN. § 67-4-2006(b)(2)(Q).

<sup>21</sup> Note that, in this situation, a taxpayer will still receive a stepped-up basis in its assets for calculating depreciation and gain or loss on any subsequent disposition of the assets consistent with treatment at the federal level. TENN. CODE ANN. § 67-4-2006(a)(2).

*c. The I.R.C. § 453 Installment Method*

The Proposed Sale involves two distinct forms of consideration payable by the Buyer: (1) the lump-sum payment due at the time of the deemed asset sale, and (2) the Earn-Out Amount due at the end of the [NUMBER] year following the sale, provided the Taxpayer meets certain performance requirements. Pursuant to TENN. CODE ANN. § 67-4-2006(b)(1)(M), the Taxpayer must include all such gain resulting from the Proposed Sale in net earnings for the same tax period in which it recognizes and reports such gain for federal income tax purposes on its federal Form 1120S.<sup>22</sup>

The Taxpayer has indicated that the Proposed Sale will be characterized as an installment sale<sup>23</sup> for federal tax purposes; this is because the Taxpayer may receive at least one payment after the close of the year in which the sale occurs. Pursuant to I.R.C. § 453, unless a taxpayer elects otherwise,<sup>24</sup> all income from an installment sale is taken into account under the installment method. The Taxpayer will not elect out of the installment method and will, therefore, report any gain from the sale for federal purposes under I.R.C. § 453.

The installment method dictates that a taxpayer report income from a disposition of assets proportionally for each year in which it receives payments.<sup>25</sup> “Payments,” for this purpose, do not include the receipt of “installment obligations.”<sup>26</sup> Rather, only “amounts actually or constructively received in the taxable year under an installment obligation” are considered payments.<sup>27</sup>

*d. Application of TENN. CODE ANN. § 67-4-2006(b)(1)(M) to the Earn-Out Amount<sup>28</sup>*

As prescribed by I.R.C. § 453, the Taxpayer will not report any gain, for federal tax purposes, upon its receipt of the Buyer’s promise to pay the Earn-Out Amount, an installment obligation, unless and until it actually or constructively receives such payment. When the Earn-Out Amount is received by the Taxpayer, the Taxpayer will have recognized gain attributable to the

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<sup>22</sup> TENN. CODE ANN. § 67-4-2006(a)(2).

<sup>23</sup> An “installment sale” is the “disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs.” I.R.C. § 453(b)(1) (West 2014); *see also* Treas. Reg. § 15a.453-1(b)(1) (West 2014) (further defining an installment sale).

<sup>24</sup> I.R.C. § 453(d).

<sup>25</sup> I.R.C. § 453(c). “[T]he income recognized for any taxable year from a disposition is that proportion of the payments received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price.” *Id.*

<sup>26</sup> Installment obligations are defined as “evidences of indebtedness of the person acquiring the property.” I.R.C. § 453(f)(3); Treas. Reg. § 15a.453-1(b)(3)(i).

<sup>27</sup> Treas. Reg. § 15a.453-1(b)(3)(i).

<sup>28</sup> Under the terms of the Proposed Sale, the Taxpayer will receive a portion of the consideration in the year of the sale. The Taxpayer will recognize and report this amount as gain on its federal form 1120S for that year. Because the gain will be attributable to the Taxpayer’s § 338(h)(10) election, the Taxpayer must include the amount in net earnings for the same year for purposes of the Tennessee excise tax. *See* TENN. CODE ANN. §§ 67-4-2006(b)(1)(M).

§ 338(h)(10) election, and the Taxpayer will report such gain on its federal form 1120S. Consequently, the Taxpayer must add such gain to its pro forma federal taxable income in its Tennessee net earnings computation.

The Taxpayer has indicated that, if it satisfies the contingencies, the Earn-Out Amount will be paid in the [NUMBER] year following the Proposed Sale. Thus, assuming the Taxpayer actually or constructively receives the payment and reports the amount on its federal Form 1120S at that time, the Earn-Out Amount must be included in its Tennessee net earnings for the same tax year.<sup>29</sup>

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APPROVED: Richard H. Roberts  
Commissioner of Revenue

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<sup>29</sup> *See id.* By this point, the Sellers will no longer be in control of the Taxpayer and will no longer be filing the Taxpayer's returns. However, following the Proposed Sale, the Taxpayer will continue to exist and operate in its current form and will remain liable for any federal tax obligation resulting from the sale. *See* Treas. Reg. § 1.338(h)(10)-1(d)(2) (stating that "new T remains liable for the tax liabilities of old T (including the tax liability for the deemed sale tax consequences.)) Thus, the Taxpayer will necessarily be required to include any future income from the sale in net earnings for Tennessee excise tax purposes, notwithstanding the fact that any such income will actually flow to the subsequently unaffiliated Sellers. To the extent that the payment or non-payment of the Earn-Out Amount results in an adjustment to the Taxpayer's basis in its assets, the Taxpayer may need to file amended franchise and excise returns that reflect that adjustment.