SPECIAL CAPITAL GAINS FOR FEDERAL § 338 ELECTION

Issues:

1. The shareholders of a corporation have decided to sell all the stock of the corporation to another corporation. They have elected to treat the sale of stock under Internal Revenue Code (IRC) § 338(h)(10) as though it was the sale of assets. Some of the shareholders hold shares of stock that would qualify for Nebraska’s special capital gains exclusion (Exclusion). Does the IRC § 338(h)(10) election disqualify the transaction from the Exclusion?

2. If the sale is not disqualified, what portion of the capital gains from the sale of the capital stock can be excluded?

Conclusions:

1. The election under IRC § 338(h)(10) to treat the sale as the sale of assets does not disqualify the sale from the Exclusion.

2. The capital gains determined on the deemed sale of assets under IRC §§ 1231, 1245, or 1250 do not qualify for the Exclusion, but any capital gains from the sale of capital stock attributed to redemption of capital stock in the deemed liquidation do qualify.

Definition:

Special Capital Gains Exclusion. A special capital gains exclusion is an exclusion provided in Neb. Rev. Stat. § 77-2715.09 that reduces Nebraska taxable income by the amount of the capital gains from the sale or exchange of capital stock of one corporation selected by a shareholder who received the stock while employed by the corporation, or on account of employment with the corporation, when the corporation meets certain other criteria (see Neb. Rev. Stat. § 77-2715.08).

Analysis:

The ownership of a business operated by a corporation is normally transferred either by the shareholders selling the stock of the corporation or by the corporation selling its capital assets. There are significant tax and nontax business reasons for using each of the two methods. In addition to the federal tax differences which are recognized by Nebraska, the Revenue Act of 1967, as amended, provides for an additional difference between the two methods. The Exclusion applies to the capital gains from the sale or exchange of capital stock, but does not apply to the capital gains related to the sale of the assets of a corporation.

In order to minimize the tax differences between the two types of transactions, the IRC provides an election under § 338(h)(10). This particular election is an election to treat the sale of stock as the deemed sale of assets. The transaction is taxed as if there were two separate corporations, “Old Target” and “New Target.” Old Target is deemed to sell all of its assets to New Target at fair market value. New Target has a new depreciation basis for the assets, and Old Target recognizes gain on
the assets as though the assets were sold at fair market value. The shareholder’s basis of the stock in Old Target is adjusted, and then Old Target is deemed to make a distribution in liquidation which may create additional capital gains for the shareholders.

The actual transaction is the sale of stock that would qualify for the Exclusion. The making of the election does not disqualify the transaction. For Nebraska purposes, the federal election to treat the sale of the stock as the deemed sale of assets and liquidation is binding. The seller will have income for Nebraska in the same amount and of the same character as on the federal return.

Any ordinary income recognized, such as a recapture of accelerated depreciation, or gains on the sale of capital assets used in a trade or business under IRC §§ 1231, 1245, and 1250, recognized by Old Target, whether or not the gains flow through to, and are reported on, the shareholder’s return are not allowable under the Exclusion. These items are deemed to arise from the sale of the assets.

Only the capital gains relating to the sale of stock recognized by the selling shareholder are eligible for the Exclusion. In the deemed transaction, the capital gains that arise from the deemed liquidation of the corporation are considered to be capital gains from the sale or exchange of capital stock. These capital gains on the deemed liquidation can be excluded from income subject to tax in Nebraska as indicated in Neb. Rev. Stat. § 77-2715.09 below (emphasis added):

77-2715.09 Capital stock; sale or exchange; extraordinary dividend and capital gains treatment.

(1) Every resident individual may elect under this section to subtract from federal adjusted gross income, or for trusts qualifying under subdivision (2)(c) of this section from taxable income, the extraordinary dividends paid on and the capital gain from the sale or exchange of capital stock of a corporation acquired by the individual (a) on account of employment by such corporation or (b) while employed by such corporation.

APPROVED:

Douglas A. Ewald
Tax Commissioner
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