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Georgia Court Ruling Spotlights Significant Complexities of 338(h)(10) Elections for State Income Tax Purposes

Kirk Kringelis
Atlanta
(404) 581-8565

In most instances, Georgia conforms to elections made by corporate taxpayers under the Internal Revenue Code.[1] However, Georgia provides special rules that apply to federal elections involving consolidated corporate returns under I.R.C. §§ 1501–1504 and Subchapter S elections under I.R.C. §§ 1361–1379.[2] These special rules create complexities under Georgia income tax laws where a taxpayer has made a federal income tax election involving a consolidated corporate return or "pass-through" entity treatment under Subchapter S along with another seemingly unrelated federal election. A recent decision by the Georgia Court of Appeals illustrates some of these complexities.

In *Trawick*,[3] the Georgia Court of Appeals considered whether a corporation was subject to tax on the gain from a deemed asset sale under I.R.C. § 338(h)(10) in a situation where the corporation was treated as an S corporation for federal income tax purposes, but as a C corporation for Georgia income tax purposes. *Trawick* held that the taxpayer was subject to tax on the gain from a deemed asset sale under I.R.C. § 338(h)(10) even though the taxpayer was treated as an S corporation for federal income tax purposes, since it was treated as a C corporation for Georgia income tax purposes.

As further discussed in this article, the *Trawick* decision had a couple of interesting aspects. The first is that the decision seemed to be a "results"-oriented decision that prevented Trawick from receiving a double Georgia income tax benefit. The second is that the decision highlights the complexities that can arise for Georgia income tax purposes with respect to I.R.C. § 338(h)(10) elections.

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[1] O.C.G.A. § 48-7-21(b)(7).

[2] *Id.*

[3] *Dep't of Revenue v. Trawick Construction Co.*, 674 S.E.2d 350 (Ga. Ct. App. 2009), *cert. granted* (Ga. Mar. 16, 2009) (No. S09C1045).

Georgia Law Regarding Subchapter "S" Elections

Georgia automatically conforms to most elections made by corporate taxpayers under the Internal Revenue Code.[4] However, Georgia does not automatically conform to Subchapter S elections. By statute, Georgia provides that:

> All elections made by corporate taxpayers under the Internal Revenue Code of 1954 or the Internal Revenue Code of 1986 shall also apply under this article except elections involving consolidated corporate returns and Subchapter "S" elections which shall be treated as follows:
>
> …
>
> Subchapter "S" elections apply only if all stockholders are subject to tax in this state on their portion of the corporate income. If all nonresident stockholders pay the Georgia income tax on their portion of the corporate income, the election shall be allowed.[5]

Another Georgia statute provides that:

> Nonresident shareholders of a Georgia Subchapter "S" corporation shall execute a consent agreement to pay Georgia income tax on their portion of the corporate income in order for such Subchapter "S" corporation to be recognized for Georgia purposes.[6]

Background

Trawick Construction Company, Inc. ("Trawick"), a Florida corporation, performed contracting work in the telecommunications industry. Trawick's principal place of business was located in Florida, but Trawick also transacted business in Georgia (and several other states). All of Trawick's shareholders (the "Shareholders") were Florida residents.

For federal income tax purposes, Trawick elected to be taxed as an S corporation.[7] However, for Georgia income tax purposes, Trawick was taxed as a C corporation (presumably because Trawick's nonresident Shareholders did not execute consent agreements to pay Georgia income tax on their portion of Trawick's income).[8]

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[4] O.C.G.A. § 48-7-21(b)(7).

[5] O.C.G.A. § 48-7-21(b)(7)(B).

[6] O.C.G.A. § 48-7-27(d)(2).

[7] *See* I.R.C. § 1362(a).

[8] *See* O.C.G.A. § 48-7-27(d)(2).

On October 1, 1999, Trawick's shareholders sold all of their stock in Trawick to Quanta Services, Inc. ("Quanta"), for $36.5 million under a stock purchase agreement ("Agreement"). The Agreement provided that Trawick and its shareholders would join with Quanta in making an I.R.C. § 338(h)(10) election.

Each of Trawick's shareholders (including Ms. Floyd) signed a consent form whereby they consented to an I.R.C. § 338(h)(10) election between Quanta and Trawick. In addition, Ms. Floyd made the election by signing a second document, Federal Form 8023, and indicated her title as Trawick's "Vice President-Finance." Federal Form 8023 was for the use of entities termed a "common parent," a "selling affiliate," or an "S corporation shareholder" in making elections under I.R.C. § 338(h)(10). The consents executed by the other shareholders were attached to the Federal Form 8023.

On its Georgia income tax return for the period ending October 1, 1999, Trawick reported the gain from the deemed asset sale as part of its federal taxable income, made no subtractions on the schedule provided for adjustments to federal taxable income allowed by O.C.G.A. § 48-7-21(b), but treated the gain as income allocable outside Georgia. On its Georgia income tax return for the period ending December 31, 1999, Trawick claimed an amortization deduction of Trawick's goodwill due to a stepped-up basis in its assets resulting from the I.R.C. § 338(h)(10) election.

The *Trawick* Appellate History

Upon audit of Trawick's return for the period ending October 1, 1999, the Georgia Department of Revenue ("Department") issued an assessment against Trawick based on the Department's determination that a portion of the gain from the deemed asset sale was apportionable to Georgia and therefore subject to Georgia income tax. Trawick appealed the decision under the Georgia Administrative Procedures Act ("APA"). After holding a hearing in which testimony was given, the administrative law judge ("ALJ") issued an initial decision that ruled in favor of Trawick. However, the final APA decision issued by the Revenue Commissioner ("Commissioner") upheld the Department's assessment.

Upon appeal, the Georgia Superior Court reversed the APA decision and ruled in favor of Trawick. The Department then appealed to the Georgia Court of Appeals, which reversed the superior court's decision and ruled in favor of the Department.

As an initial matter, the Department contended that the Georgia Superior Court erred in rejecting the Commissioner's factual determination that Trawick had joined with its shareholders and Quanta in making the I.R.C. § 338(h)(10) election. During the APA proceeding, the ALJ made a factual finding that Ms. Floyd signed the Federal Form 8023 in her individual capacity as a shareholder and not for Trawick as its Vice President-Finance. The Commissioner rejected the ALJ's factual finding and determined that Ms. Floyd signed the Federal Form 8023 on behalf of Trawick as its Vice President-Finance.

The superior court reversed the Commissioner's factual determination and held that, absent reopening the record and taking additional testimony, the Commissioner was

bound by the ALJ's finding of fact that Floyd signed Federal Form 8023 in her individual capacity as a shareholder and not for Trawick.

Court of Appeals Findings

The court of appeals reversed the superior court's determination and concluded that the Commissioner, as the ultimate factfinder, was not bound by the ALJ's finding of fact. The court of appeals then determined that the Commissioner's factual finding that Ms. Floyd signed the Federal Form 8023 as Trawick's Vice President-Finance was supported by some evidence. As a result, the Georgia Court of Appeals upheld the Commissioner's factual finding that Trawick joined in making the I.R.C. § 338(h)(10) election.

The Georgia Court of Appeals addressed several issues related to whether the I.R.C. § 338(h)(10) election was recognized by O.C.G.A. § 48-7-21(b)(7) even though Trawick was treated as an S corporation for federal income tax purposes but as a C corporation for Georgia income tax purposes; and, if not, whether an "imaginary" federal taxable income that treated the I.R.C. § 338(h)(10) election as if it had not been made should be calculated to determine Trawick's Georgia taxable net income.

Taxable Income?

To resolve those issues, the Georgia Court of Appeals first considered whether the superior court erred when it held that Trawick had no Georgia taxable income from the deemed sale because Trawick received nothing of economic value as a result of the transaction. The court determined that Trawick "recognized its gain on the deemed sale of its assets on its 1999 federal tax return and on its Georgia return filed that year as required by OCGA §48-7-21(a)." It was undisputed by the parties that, for tax periods subsequent to the sale, Trawick received the tax benefit of a stepped-up basis in its assets, thereby allowing it to claim increased amortization and depreciation deductions for Georgia income tax purposes. Because Trawick received a stepped-up basis in its assets as a result of the deemed asset sale, the Georgia Court of Appeals held that Trawick benefited economically from the transaction. Accordingly, the court ruled that the superior court erred when it held that Trawick had no taxable income from the deemed asset sale.

Election Under 338(h)(10)?

Next, the Georgia Court of Appeals considered whether the superior court erred by relying upon O.C.G.A. § 48-7-21 in holding that "Trawick's Georgia taxable net income ... must be determined as if no such [I.R.C. § 338(h)(10)] election exists" because such an election is made by the shareholders of an S corporation, not a corporate taxpayer. For federal income tax purposes, Treas. Reg. § 1.338(h)(10)-1(c)(3) provided that an I.R.C. § 338(h)(10) election must be made jointly by the purchaser and by either: (1) the selling consolidated group, (2) the selling affiliate, or (3) the S corporation shareholders. The superior court determined that Trawick had no legal ability to make the election because it was not the parent of a selling consolidated group or a selling affiliate. The superior court further determined that because Trawick was an S corporation, the I.R.C. § 338(h)(10) election was an election by its shareholders as to

how they would be taxed on the sale of their stock and not an election by Trawick to be taxed on the deemed sale of its assets.

The Georgia Court of Appeals rejected the superior court's conclusions and determined that the I.R.C. § 338(h)(10) election applied for Georgia income tax purposes. The applicable statute, O.C.G.A. § 48-7-21(b)(7), provided that "[a]ll elections made by corporate taxpayers under the Internal Revenue Code … of 1986 shall also apply under this article except elections involving consolidated corporate returns and Subchapter 'S' elections." The court determined that "[w]hile only Trawick's shareholders and Quanta could make the election as a matter of law (Treas. Reg. § 1.338-1(a)), it is undisputed that Trawick joined in making the election as a matter of fact and received beneficial treatment for federal tax purposes." The court then concluded that the I.R.C. § 338(h)(10) election applied for Georgia income tax purposes because the election did not involve a consolidated corporate return and did not involve a Subchapter S election.

After concluding that Trawick made the I.R.C. § 338(h)(10) election and that the election applied for Georgia income tax purposes, the Georgia Court of Appeals held that Trawick was taxable on the gain it realized as a result of the deemed sale of its assets. The court rejected the superior court's holding that Trawick's status as a C corporation for Georgia income tax purposes foreclosed its Georgia tax liability as to the deemed sale of its assets. The superior court had determined that the I.R.C. § 338(h)(10) election did not apply for Georgia income tax purposes because Trawick had no legal ability to make the election and that Trawick's Georgia taxable net income must therefore be determined as if no I.R.C. § 338(h)(10) election existed.

Apportionable Income?

The Georgia Court of Appeals then addressed the superior court's holding that even if Trawick's gain on the deemed sale of its assets was deemed taxable to Trawick for Georgia income tax purposes, the gain was not unitary business income apportionable under O.C.G.A. § 48-7-31(d). The superior court focused on the legal form of the transaction, which was the sale of Trawick's stock by its shareholders, who were Florida residents. The superior court had determined that "[a]lthough Trawick may have sufficient nexus to Georgia to allow Georgia to impose a corporate income tax on the [sic] Trawick's yearly revenue attributable to property or business done in Georgia, the stock transfer was not part of the day-to-day proceeds of Trawick, not even Trawick proceeds generally." Therefore, the superior court concluded that "[t]he fictional sale of assets pursuant to I.R.C. § 338(h)(10) does not confer jurisdiction to tax where none otherwise exists."

The Georgia Court of Appeals rejected the superior court's holding and determined that the gain on the deemed sale of Trawick's assets, which was primarily attributable to goodwill, was apportionable income under O.C.G.A. § 48-7-31(d). In making its determination, the court relied on the functional test,[9] which provides that income is apportionable if the taxpayer's acquisition, control, and use of the property contribute

[9] *See Hoechst Celanese Corp. v. Franchise Tax Bd.*, 22 P.3d 324 (Cal. 2001), *cert. denied*, 534 U.S. 1040 (2001).

materially to the taxpayer's production of business income. The Georgia Court of Appeals determined that Trawick's goodwill was " 'key' to Trawick's long-time operational business success in Georgia" and that Trawick's gain on the deemed sale of the goodwill was therefore apportionable income under O.C.G.A. § 48-7-31(d).

Taxable Nexus?

Finally, the Georgia Court of Appeals rejected the superior court's holding that Georgia was constitutionally barred from taxing any portion of Trawick's gain from the deemed asset sale because doing so would violate the nexus requirements of the Due Process and Commerce Clauses of the United States Constitution. Without addressing the unitary business concept, the court took a broad view of nexus with respect to the stock sale, basing its holding on two factors. First, it determined that "[i]nasmuch as it is undisputed that Trawick took advantage of the privilege of doing business in Georgia in a manner which added value to the company's assets and the value of its shareholder's stock, this claim also lacks merit." Second, the court concluded that

> [e]ven if it were otherwise, Trawick joined with its shareholders and Quanta in making the instant Section 338 election and in structuring the transaction in such manner…. Consequently, it cannot now complain that Georgia's tax laws treat the sale of the company's stock as a sale of its assets upon the Section 338 election.

Analysis of the *Trawick* Decision

The Georgia Court of Appeals held that Trawick was subject to tax on the gain from a deemed asset sale under I.R.C. § 338(h)(10) even though Trawick was treated as an S corporation for federal income tax purposes but as a C corporation for Georgia income tax purposes. One interesting aspect of the *Trawick* decision is that it seemed to be a "results"-oriented decision. The court's holding that Trawick was subject to tax on the gain from a deemed asset sale under I.R.C. § 338(h)(10) seemed to turn on one particular document and the court's decision to uphold the Commissioner's determination that Ms. Floyd signed that document, the Federal Form 8023, on behalf of Trawick as its Vice President-Finance. If the Georgia Court of Appeals had not upheld this determination, it seems questionable whether the court would have been able to conclude that Trawick was subject to tax on the gain from the deemed asset sale under I.R.C. § 338(h)(10).

For example, if Ms. Floyd had not indicated her title as Trawick's Vice President-Finance when she signed the Federal Form 8023, would the Georgia Court of Appeals (and the Commissioner) have been able to find another way to conclude that she signed the form on behalf of Trawick (as its Vice President-Finance or otherwise)? If not, would the court have been able to conclude that Trawick made the I.R.C. § 338(h)(10) election and that it was therefore subject to tax on the gain from the deemed asset sale? In other words, did the result of the case turn on the fact that Ms. Floyd happened to indicate her title on the Federal Form 8023? Furthermore, was it even relevant for Ms. Floyd to indicate a title on the Federal Form 8023? If Ms. Floyd had not indicated her title with Trawick on the Federal Form 8023, it is unclear whether the Georgia Court of Appeals

would have been able to conclude that she signed the form on behalf of Trawick and that Trawick was therefore subject to tax on the deemed asset sale because it made the I.R.C. § 338(h)(10) election.

In light of the particular facts of the case, it is questionable whether the *Trawick* decision should be broadly construed to stand for the proposition that an I.R.C. § 338(h)(10) election applies for Georgia income tax purposes in all situations where the election is made with respect to a corporation that is treated as an S corporation for federal income tax purposes but as a C corporation for Georgia income tax purposes. Perhaps a narrower reading of the case would be more appropriate.

As discussed above, the court determined that "[w]hile only Trawick's shareholders and Quanta could make the election as a matter of law [under Treas. Reg. § 1.338-1(a)], it is undisputed that Trawick joined in making the election as a matter of fact and received beneficial treatment for federal tax purposes." The court's conclusion that Trawick joined in making the I.R.C. § 338(h)(10) election is perplexing because it implies that Trawick was able to make the election even though it had no legal capacity to do so.

In the opinion, the Georgia Court of Appeals stated that it was undisputed by the parties that the gain recognized by Trawick entitled it to a stepped-up basis in its assets. Because this issue was not contested, it appears that neither the Georgia Court of Appeals nor the Georgia Superior Court addressed the issue of whether Trawick should be entitled to a stepped-up basis in its assets. Thus, the superior court's holding that Trawick was not subject to tax on the gain from the deemed asset sale under I.R.C. § 338(h)(10) meant that Trawick would receive a double tax benefit because it would incur no Georgia income tax liability on the gain from the deemed asset sale but would receive a Georgia income tax benefit in future tax years due to the increased amortization and depreciation deductions resulting from the stepped-up basis in its assets.

Although the issue was not clearly addressed in the opinion, the Georgia Court of Appeals seemed troubled by the end result of the superior court's holding. The court's effort to prevent Trawick from receiving a double tax benefit may explain why the court was willing to reach the strained conclusion that Trawick made the I.R.C. § 338(h)(10) election even though the court previously acknowledged that Trawick had no legal capacity to do so.[10] The end result of the Georgia Court of Appeals' decision was that Trawick was subject to Georgia income tax on the gain from the deemed asset sale but entitled to a future Georgia income tax benefit due to the increased amortization and depreciation deductions resulting from the stepped-up basis in its assets. Thus, it must be acknowledged that the court's decision was internally consistent for tax accounting and tax basis, even if one disagrees with the end result (*i.e.*, that Trawick was subject to tax on the gain from the deemed asset sale) and/or certain conclusions that the court made in reaching that result.

[10] If the Georgia Court of Appeals had determined that Trawick had no legal capacity to make the I.R.C. § 338(h)(10) election, then the court would have had to determine whether there was any other evidence that could support the Commissioner's determination that Trawick made the election.

If the issue of whether Trawick should be entitled to a stepped-up basis in its assets had been properly raised before the Georgia Superior Court, one can only wonder what the court would have concluded. To be internally consistent with the court's holding that Trawick did not make the I.R.C. § 338(h)(10) election, it seems that the court would have had to also conclude that Trawick was not entitled to a stepped-up basis in its assets and that, for purposes of determining its Georgia taxable net income for tax years ending after the transaction, Trawick would have had to compute an "imaginary" federal taxable income that treated the I.R.C. § 338(h)(10) election as if it had not been made. If the Georgia Superior Court had reached such an internally consistent decision under those hypothetical circumstances, then once again, one can only wonder what the Georgia Court of Appeals would have concluded upon appeal.

Regardless of the potential results that could have been reached under the various circumstances discussed above, the *Trawick* decision highlights the complexities that can arise for Georgia income tax purposes with respect to I.R.C. § 338(h)(10) elections. As previously discussed, the relevant Georgia statute, O.C.G.A. § 48-7-21(b)(7), provides that "[a]ll elections made by corporate taxpayers under the Internal Revenue Code of 1954 or the Internal Revenue Code of 1986 shall also apply under this article except elections involving consolidated corporate returns and Subchapter 'S' elections." On its face, the plain language of the statute could lead one to believe that Georgia would automatically conform to the effects of an I.R.C. § 338(h)(10) election because such an election does not (directly) involve a consolidated return or Subchapter S election. At first glance, the *Trawick* decision would appear to support such a conclusion.

Implications for the Future

A cursory review of the case could lead one to conclude that an I.R.C. § 338(h)(10) election applies for Georgia income tax purposes even where the election is made with respect to a corporation that is treated as an S corporation for federal income tax purposes but as a C corporation for Georgia income tax purposes. However, a closer analysis of the *Trawick* decision indicates that a narrow reading of the case may be more appropriate. If so, then an I.R.C. § 338(h)(10) election may not apply for Georgia income tax purposes in certain situations where the election is made with respect to a corporation that is treated as an S corporation for federal income tax purposes but as a C corporation for Georgia income tax purposes. This possibility highlights at least one Georgia complexity related to I.R.C. § 338(h)(10) elections.

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