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Georgia (and New York) Reexamine their IRC § 338(h)(10) Election for S Corporations

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The Georgia General Assembly recently passed House Bill 1138,¹ which legislatively overrules the Georgia Supreme Court's recent decision in *Trawick Construction Company, Inc. v. Georgia Department of Revenue*.² The legislation became effective when it was signed by the governor on June 3, 2010.³ The new law marks the final termination point of Trawick's long and tortuous journey through the Georgia court system.

In *Trawick*, the Georgia Supreme Court overruled an earlier court of appeals decision by holding that an IRC § 338(h)(10) election did not apply to Trawick Construction Company, Inc. ("Trawick") for Georgia income tax purposes.⁴ Trawick, a Florida corporation, was a Subchapter S corporation for federal income tax purposes.⁵ Under Georgia law, however, Trawick was considered for state income tax purposes to be a Subchapter C corporation.⁶ The court held that because the IRC § 338(h)(10) election was made by Trawick's shareholders rather than by Trawick itself, the election did not apply to the determination of Trawick's Georgia income tax.⁷ The Georgia Legislature responded by adopting HB 1138, which, among other things, makes all IRC § 338 elections applicable to calculating Georgia taxable income.⁸

¹ House Bill 1138 (as passed by House and Senate), 150th Gen. Assem. Reg. Sess. (Ga. 2009), available at http://www.legis.ga.gov/legis/2009_10/pdf/hb1138.pdf (all web sites herein last visited June 7, 2010).

² 286 Ga. 597, 597 (2010).

³ *Governor Signs Legislation to Improve Access to Home-based Care*, June 4, 2010, http://www.georgia.gov/00/press/detail/0,2668,78006749_78013037_160143973,00.html.

⁴ *Trawick*, 286 Ga. at 601.

⁵ *Id.* at 597.

⁶ *Id.*

⁷ *Id.* at 601.

⁸ House Bill 1138 (as passed by House and Senate), 150th Gen. Assem. Reg. Sess. (Ga. 2009).

Background

Prior to October 1, 1999, Trawick was a closely held Florida corporation.⁹ Pursuant to Section 1362 of the Internal Revenue Code, a small business corporation may elect to be a Subchapter S corporation.¹⁰ Having made this election, Trawick was treated as a Subchapter S corporation for federal income tax purposes,¹¹ and Trawick's shareholders were required to report their proportionate shares of the corporate income on their individual federal income tax returns.¹²

For Georgia state income tax purposes, however, Trawick was treated as a Subchapter C corporation.¹³ Trawick filed a Georgia corporate income tax return on which it reported its business income apportioned to the state.¹⁴ Trawick paid taxes directly to Georgia.

On October 1, 1999, Trawick shareholders sold all of their stock in Trawick to Quanta Services, Inc., for \$36,500,000.¹⁵ Pursuant to Section 338(h)(10) of the IRC, and as part of the stock purchase agreement, "an election was made to treat the transaction as a deemed sale of all corporate assets, the majority of which was goodwill."¹⁶ The "§ 338(h)(10) election allows a purchasing corporation to treat a purchase of the stock of a target corporation as if it was actually the purchase of the assets of the target corporation at fair market value."¹⁷ Moreover, "[t]he target corporation is treated as if it sold all assets in a single transaction and subsequently distributed the purchase proceeds to its shareholders."¹⁸

A 338(h)(10) election can have beneficial tax consequences for the purchasing corporation. For example, because the purchase is deemed to be a purchase of assets, the transaction results in a stepped-up basis for the target's assets.¹⁹ This stepped-up basis results in future amortization and depreciation deductions.²⁰

For the tax year ending on October 1, 1999, Trawick included the gain from the deemed sale of assets in its reported federal taxable income, a small fraction of which it apportioned to Georgia.²¹ Trawick's total reported federal taxable income for 1999 was \$35,961,518.²² Of this

⁹ *Trawick*, 286 Ga. at 597.

¹⁰ I.R.C. § 1362(a)(1).

¹¹ *Trawick*, 286 Ga. at 597.

¹² I.R.C. § 1366(a)(1).

¹³ *Trawick*, 286 Ga. at 597.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.* at 602 (Melton, J., dissenting).

¹⁸ *Id.* (Melton, J., dissenting).

¹⁹ *Id.* (Melton, J., dissenting).

²⁰ *Id.* (Melton, J., dissenting).

²¹ *Trawick*, 286 Ga. at 597.

amount, Trawick allocated \$29,689,534 to Florida.²³ The remaining \$6,271,984 was apportioned as attributable to Georgia.²⁴ Trawick then applied the apportionment ratio of .127497 to arrive at a reported taxable business income in Georgia of \$799,659.²⁵ Thus, for the State of Georgia, the total tax due was only \$47,980 (6 percent of \$799,659).²⁶

Not surprisingly, the Georgia Revenue Commissioner disagreed with Trawick's calculations. In 2004, having determined that the income allocated to Florida by Trawick was apportionable, he assessed Trawick an additional \$224,820 in income tax, along with accrued interest.²⁷ The Commissioner determined that Trawick's actual business income subject to apportionment was \$35,661,031.²⁸ He then applied the same apportionment ratio used by Trawick (.127497) to determine taxable business income in Georgia of \$4,546,674.²⁹

Trawick protested the assessment, claiming that its 338(h)(10) election did not apply for Georgia state income tax purposes.³⁰ Rather, it argued, O.C.G.A. § 48-7-21 requires that elections made pursuant to the IRC be made *by corporate taxpayers* in order to apply for state income tax purposes in Georgia.³¹ But in the case of a Subchapter S corporation, according to federal regulations, a 338(h)(10) election is made jointly by the purchasing corporation and the Subchapter S corporation shareholders.³² Thus, the shareholders, and not the corporation, must make the election. Because Georgia recognized Trawick as a Subchapter C corporation in Georgia, Trawick was the taxpayer that was required to make any elections under the Internal Revenue Code.³³ The 338(h)(10) election therefore did not apply for Georgia income tax purposes because the election was not, as required by Georgia law, an election made *by the taxpayer* (i.e., by Trawick).³⁴ Rather, pursuant to federal regulations, the shareholders were the ones who made the election.³⁵

(continued...)

²² *Ga. Dept. of Revenue v. Trawick Const. Co., Inc.*, 269 Ga. App. 275, 275 (2009).

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Trawick*, 286 Ga. at 597.

²⁸ *Ga. Dept. of Revenue*, 269 Ga. App. at 278.

²⁹ *Id.*

³⁰ *Trawick*, 286 Ga. at 598.

³¹ *Id.*

³² 26 C.F.R. § 1.338(h)(10)-1(c)(1).

³³ *Trawick*, 286 Ga. at 598.

³⁴ *Id.* (citing O.C.G.A. § 48-7-21(b)(7)).

³⁵ 26 C.F.R. § 1.338(h)(10)-1(c)(1).

Over the next six years, the scenario's complexity confounded and confused Georgia's judicial system as it wound its way through the courts.

Georgia Law

In Georgia, “[a] corporation’s taxable income from property owned or from business done in [the state] consist[s] of the corporation’s taxable income as defined in the Internal Revenue Code of 1986, with the adjustments provided for [by O.C.G.A. § 48-7-21(b)] and allocated and apportioned as provided in [O.C.G.A. § 48-7-31].”³⁶ One such adjustment provided for by O.C.G.A. § 48-7-21(b) is that all elections made by corporate taxpayers under the IRC apply to the taxation of corporations for Georgia state income tax purposes, except elections involving consolidated corporate returns and Subchapter S elections.³⁷ Under Georgia law, Subchapter S elections apply only if all shareholders are subject to Georgia state income tax on their proportionate share of the corporate income.³⁸ Subchapter S elections are therefore allowed only if all nonresident shareholders consent to pay Georgia income tax on their proportionate share of the corporate income.³⁹ Trawick’s shareholders presumably had not so consented, and Trawick therefore had to be treated as a Subchapter C corporation in Georgia.

The Georgia Supreme Court’s *Trawick* Decision

Reversing the court of appeals, the Georgia Supreme Court agreed with Trawick.⁴⁰ The court determined that the rules of construction for statutes require the court to read the requirements of O.C.G.A. § 48-7-21 literally.⁴¹ It held that because the 338(h)(10) election was not made “by a corporate taxpayer”—that is, Trawick—the election did not apply to the determination of Trawick’s Georgia income tax.⁴² Further, the court observed that Georgia had benefited for years by treating Trawick as a Subchapter C corporation.⁴³ It was therefore neither unfair nor unreasonable to require Georgia to forego a 338(h)(10) election made for a Subchapter S corporation when the state had refused to recognize the election that made Trawick a Subchapter S corporation in the first place.⁴⁴ Because the election did not apply, “the gain from the deemed sale of assets recognized by Trawick on its federal income tax return did not constitute Georgia taxable income”⁴⁵ because the sale of stock (as opposed to the sale of assets) was sourced for tax purposes to Florida.

³⁶ O.C.G.A. § 48-7-21(a).

³⁷ O.C.G.A. § 48-7-21(b)(7).

³⁸ O.C.G.A. § 48-7-21(b)(7)(B).

³⁹ *Id.*

⁴⁰ *Id.* at 601.

⁴¹ *Id.* at 598.

⁴² *Id.* at 601.

⁴³ *Id.*

⁴⁴ *Id.* at 600.

⁴⁵ *Trawick*, 286 Ga. at 601.

The Georgia Reexaminations

Each of the Trawick decisions raised the question of “whether the Section 338 election at issue relieve[d] Trawick of corporate tax liability under Georgia law as to the gain realized upon the proceeds from the deemed sale of its assets.”⁴⁶ This question was asked and answered no fewer than seven times. Not once did any of the answers agree with the one immediately preceding it. In the end, the legislature had the last word, answering the question by changing the law.

The Georgia Supreme Court had claimed that it was neither unfair nor “unreasonable to require the State of Georgia to forego a Section 338(h)(10) election made for a Subchapter S corporation, when the State has consistently refused to recognize that corporation’s original federal Subchapter S election.”⁴⁷ The Georgia General Assembly responded by enacting HB 1138, which reverses the result in *Trawick*. HB 1138, § 2, amends O.C.G.A. § 48-7-21(5)(b) by adding Subsection (5), which states, simply, that “[a]ll elections under Section 338 of the Internal Revenue Code of 1986 shall also apply under this article.”⁴⁸ The bill was passed by both the Georgia House of Representatives and the Georgia Senate; the legislation was recently signed by the governor.⁴⁹

The New York Reexaminations

It should also be noted that Georgia’s issues are not unique. In New York, for example, the State Tax Appeals Tribunal has held that a nonresident seller of S Corporation stock cannot be taxed on gain from the corporation’s deemed asset sale, because the corporate income should be computed as if there were no S election – in which case there would be no valid (h)(10) election.⁵⁰ The pending budget legislation proposed by Governor Paterson would reverse that outcome – which obviously is of concern on the buyers’ side of such transactions – and would do so retroactively for all open years.⁵¹ However, the retroactivity feature of the proposal has met with some resistance.⁵²

⁴⁶ *Ga. Dept. of Revenue*, 296 Ga. App. at 276.

⁴⁷ *Trawick*, 286 Ga. at 600.

⁴⁸ H.R. 1138, 150th Gen. Assem. Reg. Sess. (Ga. 2009).

⁴⁹ See Georgia General Assembly, H.B. 1138, http://www.legis.state.ga.us/legis/2009_10/sum/hb1138.htm; *Trawick Constr. Co., Inc. v. Ga. Dept. of Revenue*, 286 Ga. 597, 597 (2010).

⁵⁰ See *Matter of Gabriel S. and Frances B. Baum*, DTA Nos. 820837 *et al.*, December 20, 2007.

⁵¹ NYS Executive Budget Bill, released January 19, 2010, Part F.

⁵² See, e.g., New York State Bar Association Tax Section Letter No. 1206, February 22, 2010, supporting the application of federal section 338(h)(10) principles to S corporations, but expressing concern over the retroactive application of the budget proposal.



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