



# MULTISTATE TAX REPORT

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**Business/Nonbusiness Income**

State tax law on the treatment of deemed gain under I.R.C. § 338(h)(10) varies widely and, thus, presents both tax traps and tax planning opportunities. In the following article, authors Rachel A. Wilson and Karen H. Currie of Jones Day review and analyze various conflicting state authorities on I.R.C. § 338(h)(10) transactions, with a focus on recent decisions in Missouri and Utah.

## **State Tax Treatment of I.R.C. § 338(h)(10) Elections And the Business Versus Nonbusiness Income Debate**

By RACHEL A. WILSON  
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**A**lthough federal tax considerations often drive the form of acquisitions and reorganizations, state tax consequences may be quite important. In the context of I.R.C. § 338(h)(10) transactions, state law is far from settled and often inconsistent. Recent Missouri Supreme Court and Utah Tax Court decisions held that deemed gain from an I.R.C. § 338(h)(10) transaction is allocable nonbusiness income.

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While these decisions seem to be part of a larger trend, recent state legislative actions indicate another shift may be ahead. Inconsistent state tax treatment of deemed gain can lead to under- or over-taxation, meaning there are both tax traps and tax planning opportunities. This article contrasts authorities regarding I.R.C. § 338(h)(10) transactions from several states and discusses some consequences of the divergent state tax treatment.

### **DISTINCTION BETWEEN BUSINESS AND NONBUSINESS INCOME**

Before contrasting state law regarding the treatment of I.R.C. § 338(h)(10) deemed gain, a brief summary of the purposes of an I.R.C. § 338(h)(10) election and the general state rules for classifying deemed gain as business or nonbusiness income may be helpful.

## Making an I.R.C. § 338(h)(10) Election

A company planning to sell a corporate subsidiary has several options in structuring the sale. The primary decision is whether to sell the stock or underlying assets held by the subsidiary. Although both actions would result in the sale of the subsidiary business, the tax consequences could be vastly different.

If stock is sold, the selling company will recognize gain for federal income tax purposes to the extent consideration received exceeds the basis in the subsidiary stock. The target subsidiary will owe no tax and the target will have carryover basis in its assets after the sale. If the subsidiary's assets are sold, the subsidiary as seller will recognize gain for federal income tax purposes to the extent the consideration received exceeds the subsidiary's basis in the assets. Because gain is recognized on the sale of assets, the purchaser is entitled to a step-up in the basis of the assets and additional depreciation expense over time.

I.R.C. § 338(h)(10) provides an opportunity for a company selling stock to elect to have the target subsidiary recognize gain or loss as if the subsidiary had sold all of its assets. Such an election is commonly made for federal income tax purposes when the purchaser desires a step-up in the basis of the subsidiary's assets. The varying state income tax rules governing an I.R.C. § 338(h)(10) election can cause a great deal of confusion.<sup>1</sup> Although most states will respect the federal treatment of an I.R.C. § 338(h)(10) election, the billion-dollar question is: How many states get to tax the gain from the deemed sale of its assets (and is this additional exposure of the buyer or seller)?

## State Allocation and Apportionment Of Deemed Gain

The determination of which state may tax the gain from an I.R.C. § 338(h)(10) transaction generally turns on whether the income is classified as business or non-business income. For states that have adopted the Uniform Division of Income for Tax Purposes Act (known as UDITPA),<sup>2</sup> business income is apportioned using a formula that calculates a percentage of a company's income attributable to the state based on the company's property, personnel, and sales in the state. Under a state's allocation rules, nonbusiness income is allocated to a particular state, typically the corporation's state of domicile or the state in which income-producing property is located.

If the gain recognized as a result of an I.R.C. § 338(h)(10) election is business income, the gain is apportioned among the states where the subsidiary has operations. If the gain is nonbusiness income, the entire gain is allocated to one state. Because the sale of a subsidiary often generates significant gain, the classifica-

tion of such income as business or nonbusiness income can be of great consequence.

## What Is Business Income?

The determination of what constitutes business income varies greatly from state to state. In some states, the definition of business income includes only certain items of income. In other states, business income includes all income permitted under the U.S. Constitution. Even more perplexing are the many ways states interpret the supposedly uniform UDITPA definition of business income.

UDITPA defines business income as:

income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.<sup>3</sup>

Nonbusiness income is defined as all income other than business income. Although these definitions have been widely adopted by states, the approaches used to interpret the statute seem endless.

State courts generally view the UDITPA definition as providing two tests for determining whether income is business income: the transactional test and the functional test. Under the transactional test, which is derived from the first clause of the business income definition, income is considered business income if it arises "from transactions and activity in the regular course of the taxpayer's trade or business." The transactional test is generally interpreted as focusing on the income-producing transaction. To create business income, the transaction and activity must occur in the "regular course of the taxpayer's trade or business."<sup>4</sup>

Under the functional test, which is derived from the second clause of the business income definition, corporate income is considered business income if the "acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." The interpretation of the functional test varies greatly between jurisdictions. In some jurisdictions, the focus is on the income-producing property and the relationship between the property and the taxpayer's business operations. In those states, the critical inquiry is whether the function of the property is integral to the taxpayer's regular business operations.<sup>5</sup> In other jurisdictions, the functional test is barely distinguishable from the transactional test, and the focus remains on the income-producing activity.<sup>6</sup>

<sup>3</sup> UDITPA § 1(a).

<sup>4</sup> *Ex parte Uniroyal Tire Co.*, 779 So. 2d 227, 236 (Ala. 2000).

<sup>5</sup> *Hoechst Celanese Corp. v. California Franch. Tax Bd.*, 22 P.3d 324 (Cal. 2001); see also *Laurel Pipe Line Co. v. Pennsylvania*, 642 A.2d 472, 475 (Pa. 1994) ("Income meets the functional test if the gain arises from the sale of an asset which produced business income while it was owned by the taxpayer").

<sup>6</sup> See, e.g., *ABB C-E Nuclear Power Inc. v. Missouri Dir. of Rev.*, Case No. SC 87811 (Mo. Jan. 30, 2007) (stating that "the 'functional test' determines whether the gain is attributable to an activity—namely the acquisition, management, and disposition of property—that constitutes an integral part of the taxpayer's regular business").

<sup>1</sup> For example, some states depart from the federal treatment of an I.R.C. § 338(h)(10) election under certain circumstances, while others, such as California, allow taxpayers to choose to depart from the federal treatment by requiring or permitting a separate state election.

<sup>2</sup> UDITPA is a model act drafted in 1957 to provide a method for dividing the income tax base between states. Many states have adopted UDITPA or similar provisions.

As discussed below, the application of these tests varies greatly from state to state. Some decisions are well reasoned, while others defy all logic. Companies should carefully chart their course before making an I.R.C. § 338(h)(10) election.

## RECENT STATE DECISIONS ON CLASSIFICATION OF DEEMED GAIN

Historically, a taxpayer faced with gain resulting from an I.R.C. § 338(h)(10) transaction was provided little state tax guidance for sourcing that gain. Over the years, rulings issued by taxing authorities and litigation on the issue have provided some guidance, but the guidance is often inconsistent and frequently changes. Most recently, the Missouri Supreme Court and the Utah Tax Court weighed in on the issue, both courts concluding that such gain is nonbusiness income.

### Missouri

In *ABB C-E Nuclear Power Inc.*, the Missouri Supreme Court upheld the Missouri Administrative Hearing Commission's (AHC) finding that the proceeds from the sale of ABB C-E Nuclear Power Inc. (ABB) did not constitute business income subject to Missouri corporate income tax.<sup>7</sup>

ABB, a Delaware corporation, was headquartered in Connecticut with operations in several states, including Missouri. ABB's parent company sold ABB's stock, electing to treat the sale as an asset sale under I.R.C. § 338(h)(10). Pursuant to the election, ABB was deemed to have sold its assets and distributed the proceeds to its parent in complete liquidation. On ABB's Missouri corporate income tax return, ABB treated the income as nonbusiness income and allocated the \$277 million gain to its state of commercial domicile, Delaware. After adjustments, no taxable income was apportioned to Missouri. The Missouri Department of Revenue rejected the characterization of the gain as nonbusiness income and issued a \$1.8 million assessment.

The Missouri Supreme Court agreed with the AHC's holding that the proceeds of the sale of ABB did not constitute business income under either the transactional test or the functional test set forth in the UDITPA definition adopted by Missouri. The sale of ABB's assets in a complete liquidation was not a type of business transaction in which ABB regularly engaged, nor did the liquidation activity constitute an integral part of ABB's ordinary business. Rather, the Missouri Supreme Court held that the sale and liquidation of ABB was a one-time, extraordinary event. As an extraordinary event, the gain from ABB's sale and liquidation was nonbusiness income.

Despite the taxpayer's favorable decision, Missouri's interpretation of the UDITPA definition of business income may be of concern to some. Like many states, Missouri has codified the UDITPA definition of business and nonbusiness income.<sup>8</sup> While the Missouri Supreme Court purports to consider both a transactional and functional test, the functional test described by the court is barely distinguishable from the transactional

test because the focus remains on the income-producing activity rather than on the property.<sup>9</sup>

Unlike many states, Missouri has adopted regulations that focus the business income classification solely on the business activity. Specifically, Missouri's regulations provide that:

Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is business income or non-business income is the identification of the transactions and activity which are the elements of a particular trade or business. In general all transactions and activities of the taxpayer which are dependent upon or contribute to the operations of the taxpayer's economic enterprise as a whole constitute the taxpayer's trade or business and will be transactions and activity arising in the regular course of, and will constitute integral parts of, a trade or business.<sup>10</sup>

Therefore, while it may appear that the Missouri Supreme Court glossed over the transactional and functional tests, the decision is consistent with Missouri's specific regulations interpreting business income.

### Utah

About the same time that the Missouri Supreme Court concluded I.R.C. § 338(h)(10) gain was nonbusiness income, the Utah Tax Court reached a similar conclusion in *Chambers v. Utah State Tax Comn.*<sup>11</sup>

The taxpayer in *Chambers* was incorporated and domiciled in Alabama. The parent sold the stock of the taxpayer, and an election was made to treat the sale as an asset sale pursuant to I.R.C. § 338(h)(10). On its return, the taxpayer treated the income as nonbusiness income and allocated the gain to its state of commercial domicile, Alabama. The state challenged this position and assessed tax based on the finding that the gain from the I.R.C. § 338(h)(10) transaction was business income.

Like the Missouri Supreme Court, the Utah Tax Court held that gain from the sale of the stock accompanied by an I.R.C. § 338(h)(10) election constituted nonbusiness income, allocable to the state of commercial domicile. The Utah Tax Court judge noted that the UDITPA definition of business income, adopted by Utah, consists of two tests that must be satisfied for income to constitute business income. The court concluded that because there was a complete cessation of the business, neither the transactional test nor the functional test had been met, and thus, the income was appropriately classified as nonbusiness income.

Notably, in addition to the UDITPA definitions of business and nonbusiness income, Utah has adopted a statute specifically relating to I.R.C. § 338 elections. This statute, entitled "Section 338, Internal Revenue Code –

<sup>9</sup> See *ABB C-E Nuclear Power* (stating that "the 'functional test' determines whether the gain is attributable to an activity—namely the acquisition, management, and disposition of property—that constitutes an integral part of the taxpayer's regular business" (emphasis added)).

<sup>10</sup> Mo. Code. Regs. tit. 12, § 10-2.075(4).

<sup>11</sup> *Chambers v. Utah State Tax Comn.*, Case No. 050402915 TX (Utah Tax Ct. Jan. 25, 2007).

<sup>7</sup> *Id.*

<sup>8</sup> Mo. Rev. Stat. § 32.200, art. IV, 1(1), (5).

elections,” provides a rebuttable presumption that the gain or loss on the deemed sale of assets constitutes business income.<sup>12</sup> The *Chambers* court acknowledged this statute and concluded that because the statute is in direct conflict with the statute setting forth the UDITPA definition of business income, the definition of business income controls. The court further noted that even if that were not the case, the plaintiff successfully rebutted the presumption. Because an election under I.R.C. §338 will always involve a complete cessation of the business and should always result in nonbusiness income pursuant to *Chambers*, the court effectively nullified the statutory rebuttable presumption.

## STATES ARE SPLIT ON BUSINESS/NONBUSINESS ISSUE

In the I.R.C. §338(h)(10) context, several states in addition to Missouri and Utah treat gain from an I.R.C. §338(h)(10) transaction as nonbusiness income, while other states have guidance indicating that such gain is business income. A few states have varied<sup>13</sup> and sometimes inconsistent<sup>14</sup> guidance on the treatment of an I.R.C. §338(h)(10) election that may be a trap for the unwary.

Courts in a number of jurisdictions adopting UDITPA have classified gains from the cessation of business as nonbusiness income.<sup>15</sup> Following these decisions, some states such as Pennsylvania have held that I.R.C. §338(h)(10) deemed gain is nonbusiness income. A number of other jurisdictions adopting UDITPA have classified gain in the context of an I.R.C. §338(h)(10) election to be business income. Two of the most recent business income rulings come from California and Indiana.

### Pennsylvania

In *Canteen Corp. v. Pennsylvania*,<sup>16</sup> the Pennsylvania Commonwealth Court concluded that the taxpayer's deemed gain must be treated as nonbusiness income. In reaching its decision, the court relied on a prior Pennsylvania Supreme Court decision, *Laurel Pipe Line Co. v. Pennsylvania*.<sup>17</sup>

In *Laurel Pipe Line Co.*, Laurel liquidated a pipeline division and distributed the proceeds to the shareholders. While the Pennsylvania Supreme Court stated that the functional test focuses on the property being dis-

posed,<sup>18</sup> the court held that the gain from sale of Laurel's division was nonbusiness income because “the pipeline was not disposed of as an integral part of Laurel's regular trade or business.”<sup>19</sup> The Pennsylvania Supreme Court was swayed by the fact that Laurel distributed the sale proceeds, rather than reinvesting them in the business, and that the partial liquidation changed the character of Laurel's business going forward. In so holding, the Pennsylvania Supreme Court appears to recognize a partial liquidation exception to the functional test.

In *Canteen Corp.*, the court reiterated that the critical act of distributing the proceeds from the asset liquidation to shareholders, rather than reinvesting the proceeds in the business, made the gain nonbusiness income based on *Laurel Pipe Line*. Since in an I.R.C. §338(h)(10) transaction the deemed asset sale is followed by a deemed liquidation, the fiction must hold for both the gain and the liquidation. Because the deemed proceeds are distributed, the deemed gain is nonbusiness income under the holding of *Laurel Pipe Line*.

The court's decision in *Canteen Corp.* was not swayed by a regulation, 61 Pa. Code §153.81(d)(1), which provides that taxable income generated as a result of an I.R.C. §338 election is treated as business income. Rather, the court held that the regulation conflicts with the Pennsylvania Supreme Court's interpretation of the underlying statute in *Laurel Pipe Line*.<sup>20</sup> Because the regulation is inconsistent with the statute under which it was promulgated, the court in *Canteen Corp.* held that it was not lawfully applied to the taxpayer's case. Despite the court's rejection of the regulation in 2004, however, the relevant regulation has remained unchanged and may be confusing to taxpayers following the *Canteen Corp.* decision.

### California

In California FTB Legal Ruling 2006-03 (May 5, 2006), the California Franchise Tax Board held that an I.R.C. §338(h)(10) deemed sale of assets will be treated as an actual sale of assets for apportionment purposes. “If the gain from the sale constitutes apportionable business income pursuant to section 25120, subdivision (a), the gain must be apportioned to the states where Old Target did business prior to the sale.” Section 25120 is the statute in which California codified the UDITPA definition of business income.<sup>21</sup> The legal ruling is consistent with a California Supreme Court deci-

<sup>18</sup> *Id.* at 475 (“Income meets the functional test if the gain arises from the sale of an asset which produced business income while it was owned by the taxpayer”).

<sup>19</sup> *Id.*

<sup>20</sup> Pennsylvania's definition of business income generally follows the UDITPA language. See Pa. Cons. Stat. §7401(3)2(a)(1)(A) (“‘Business income’ means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if either the acquisition, the management or the disposition of the property constitutes an integral part of the taxpayer's regular trade or business operations. The term includes all income which is apportionable under the Constitution of the United States”) (emphasis added). In 2006, the phrase “the acquisition, the management and the disposition” was changed to “the acquisition, the management or the disposition” in Pennsylvania's definition statute.

<sup>21</sup> Cal. Rev. & Tax. Code §25120(a).

<sup>12</sup> Utah Code Ann. §59-7-114(4).

<sup>13</sup> See, e.g., the discussions of Illinois and North Carolina, below.

<sup>14</sup> See, e.g., the discussions of Pennsylvania and Indiana, below.

<sup>15</sup> See, e.g., *Ex parte Uniroyal*, 779 So. 2d 227; *Kemppel v. Zaino*, 746 N.E.2d 1073, 1076 (Ohio 2001); *Federated Stores Realty Inc. v. Huddleston*, 852 S.W.2d 206, 211 (Tenn. 1992); *Western Natural Gas Co. v. McDonald*, 446 P.2d 781, 784 (Kan. 1968); *McVean & Barlow Inc. v. New Mexico Bureau of Rev.*, 543 P.2d 489 (N.M. Ct. App. 1975); *May Dept. Stores Co. v. Indiana Dept. of Rev.*, 749 N.E.2d 651, 663-65 (Ind. Tax Ct. 2001). *Western Natural Gas Co.* and *McVean & Barlow* have since been effectively superseded by statute.

<sup>16</sup> *Canteen Corp. v. Pennsylvania*, 818 A.2d 594 (Pa. Commw. Ct. 2003), *aff'd* by 854 A.2d 440 (Pa. 2004).

<sup>17</sup> *Laurel Pipe Line*, 642 A.2d 472.

sion holding that gains from the cessation of business are business income.<sup>22</sup>

## Indiana

In 2006, Indiana issued several Letters of Findings concluding that gain from an I.R.C. § 338(h)(10) transaction is business income. In Letter of Findings No. 03-0166 (July 1, 2006), the Indiana Department of Revenue held that income derived from a taxpayer's I.R.C. § 338(h)(10) deemed asset sale was business income. The department based its finding on the fact that the parent corporation used the tax attributes (basis adjustment) associated with the disposition to reduce the taxpayer's apportionable business income subject to Indiana income tax. The department maintained that "using an analysis similar to the *May* court, the disposition benefited the taxpayer and not the purchaser; and therefore, the disposition of the property constituted an integral part of the taxpayer's business operations."<sup>23</sup>

Similarly, in Letter of Findings No. 98-0523 (April 1, 2006), the department concluded that gain from an I.R.C. § 338(h)(10) transaction is business income based on the fact that the taxpayer utilized the proceeds of the asset disposition to further the parent corporation's ongoing business operations. Because the taxpayer's decision to sell its stock and make an I.R.C. § 338(h)(10) election were volitional, rather than something the taxpayer was legally compelled to do, the disposition was an integral part of the taxpayer's regular trade or business operations as required by the functional test.<sup>24</sup>

In the Letters of Findings, the department took inconsistent audit positions as to whether the gain was business or nonbusiness income. In Letter of Findings No. 98-0523, the department took the position that the gain from the out-of-state taxpayer's I.R.C. § 338(h)(10) transaction was business income and apportioned part of the income to Indiana, rather than allocating the income to the taxpayer's out-of-state commercial domicile in its entirety. This argument was upheld in the Letter of Findings. Faced with almost identical facts in Letter of Findings No. 03-0166, however, the department took the position that gain from the sale of a taxpayer domiciled in Indiana was nonbusiness income and should be allocated to Indiana in its entirety. In both Letters of Findings it was ultimately concluded that the gain was business income.

## TREND TOWARD STATES ABANDONING UDITPA

While many states have adopted the UDITPA definition of business income,<sup>22</sup> others have developed unique

<sup>22</sup> *Hoechst Celanese Corp.*, 22 P.3d 324.

<sup>23</sup> One may question whether the department in fact used an analysis similar to the *May* court. In *May Dept. Stores*, 749 N.E.2d 651, the Indiana Tax Court held that gains received by an out-of-state corporation from a court-ordered divestiture of an entire division were nonbusiness income, allocated to the taxpayer's out-of-state commercial domicile.

<sup>24</sup> Rather than making a conclusory statement that it relies on *May* with little explanation in this Letter of Findings, the department distinguishes the facts and concludes that the transaction is business income based on the fact that the I.R.C. § 338(h)(10) transaction was voluntary, rather than a court-ordered divestiture as was the case in *May*.

definitions. The unique definitions of business income were often developed to reverse court decisions that were adverse to the state. The statutory changes generally result in a broader definition classifying as much income as business income as is constitutionally possible. For many taxpayers, the adoption of these statutes may cause confusion because prior guidance is unreliable.

Illinois and North Carolina are two of the traditionally UDITPA states that have amended and broadened their statutory definition of business income.

## Illinois

Illinois' recent case law interpreted the prior statute. In *American States Ins. Co. v. Hamer*,<sup>25</sup> an Illinois appeals court held that gain from an I.R.C. § 338(h)(10) transaction is nonbusiness income. In reaching its decision, the court examined the application of both the transactional and functional tests to determine if the deemed gain was business income. The court relied in part on the decision of another Illinois appeals court, *Blessing/White Inc. v. Zehnder*,<sup>26</sup> which involved an actual liquidation. In *Blessing/White Inc.*, the court recognized that a liquidation resulting in a discontinuation of business activity is an exception to the functional test.

Near the time of the *American States Ins. Co.* decision, Illinois' definition of business income was changed. In 2004, the definition of business income was amended to read that "the term 'business income' means all income that may be treated as apportionable business income under the Constitution of the United States."<sup>27</sup> This statutory amendment eliminates the key language relied upon in *American States Ins. Co.* and *Blessing/White Inc.* Whether these courts would still hold that the gain from a liquidation, either actual or deemed, is business income under the new definition is unknown.

## North Carolina

Like Illinois, North Carolina historically adopted the UDITPA definition of business and nonbusiness income. In 2001, the North Carolina Supreme Court in *Lenox Inc. v. Tolson*, 548 S.E.2d 513, 516 (N.C. 2001), concluded that gain from the sale of assets in a liquidation was nonbusiness income if the liquidation resulted in the cessation of business and the company distributed all of the proceeds of the liquidation to its shareholders.

Subsequently, in 2002 the North Carolina Department of Revenue issued a directive indicating that the holding in *Lenox* would not apply to an I.R.C. § 338(h)(10) transaction.<sup>28</sup> The North Carolina Department of Revenue distinguished an I.R.C. § 338(h)(10) transaction from the transaction in *Lenox* because *Lenox* involved an actual liquidation, not a deemed liquidation. According to the department, in an I.R.C. § 338(h)(10) election "the target continues to operate the same assets and does not transfer title to any of its

<sup>25</sup> *American States Ins. Co. v. Hamer*, 816 N.E.2d 659 (Ill. App. Ct. 2004).

<sup>26</sup> *Blessing/White Inc. v. Zehnder*, 768 N.E.2d 332 (Ill. App. Ct. 2002).

<sup>27</sup> 35 ILCS 5/1501(a)(1).

<sup>28</sup> North Carolina Directive No. CD-02-3 (May 31, 2002).

property as a result of the transaction. Thus, the target is not liquidated and it continues its trade or business. As a result, the liquidation test created by the *Lenox* court is not satisfied when a §338(h)(10) election is made.”<sup>29</sup>

The problem with the department’s analysis is the inconsistency between distinguishing the fictional liquidation without distinguishing the fictional gain. An I.R.C. §338(h)(10) election creates *fictional* gain. If North Carolina is willing to recognize the fictional gain, it logically must also recognize the *fiction* that there was a liquidation. As the court in *Canteen Corp.* discussed, the fiction must hold for both the gain and the liquidation;<sup>30</sup> to do otherwise defies logic.

Nevertheless, the analysis applied by the department in North Carolina may be irrelevant. In 2003, a year after the department’s directive on I.R.C. §338(h)(10) transactions, the North Carolina statute was amended, eliminating the reference to business income and adopting an “apportionable income” approach to sourcing gain. Apportionable income is now defined as all income that may be apportioned under the U.S. Constitution.<sup>31</sup>

## PLANNING FOR STATE TAX TREATMENT OF I.R.C. §338(h)(10)

A goal of state tax planning is to allocate or apportion income in a manner yielding the least tax. For many taxpayers, classification of an I.R.C. §338(h)(10) deemed gain as nonbusiness income will further this goal. The facts, however, may dictate that the reverse is true for a given corporation.

The inconsistencies in the state tax treatment of I.R.C. §338(h)(10) transactions are often confusing and

troubling. This is an ever changing area of law. In some states, even with the most detailed analysis, uncertainty may remain as to the appropriate classification of gain. While state taxing authorities are becoming increasingly aggressive in classifying income as business income, the courts, at least recently, seem to be attempting to rein them in.

The state law inconsistencies may provide planning opportunities. The fact that some states classify I.R.C. §338(h)(10) income as business income while others classify the same income as nonbusiness income could be beneficial to taxpayers domiciled in tax-favorable jurisdictions. For example, a taxpayer that is headquartered in California but doing business in Missouri would have some “nowhere” income and, thus, will pay state tax on less than 100 percent of the I.R.C. §338(h)(10) gain. For Missouri purposes, the taxpayer would apportion none of its I.R.C. §338(h)(10) income because 100 percent of the income would be allocated to California. For California purposes, the taxpayer would be required to apportion its I.R.C. §338(h)(10) income among all the states in which it is doing business. Thus, the taxpayer would be subject to state income tax on less than 100 percent of the income. An even greater benefit may be achieved if the taxpayer is domiciled in a state that does not impose a tax on income (*e.g.*, Nevada).

Before getting too excited, remember the old adage, “excited fishermen are forgetful.”<sup>32</sup> Be sure to consider the state tax consequences, including whether the gain is reported by the buyer or seller, before deciding whether an I.R.C. §338(h)(10) election is advisable. Unfortunately, the business/nonbusiness income issue is only one of several unique state tax considerations that should be reviewed before making an I.R.C. §338(h)(10) election.

<sup>29</sup> *Id.* See also [Taxpayer] v. North Carolina Dept. of Rev., 2002-3, (Nov. 14, 2002).

<sup>30</sup> *Canteen Corp.*, 818 A.2d 594.

<sup>31</sup> N.C. Gen. Stat. §105-130.4(a)(1).

<sup>32</sup> For example, when a Nova Scotia fishing boat caught a record 30,000 pounds, the crew forgot that the vessel’s capacity was only 15,000 pounds, and the boat nearly sunk! See <http://www.redskyatnight.com/know.html>.