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3

State and Local Income and Franchise Tax Aspects of Corporate Acquisitions (December 21, 2016)

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I. INTRODUCTION

A. State and local tax consequences are often ignored, or are addressed too late, in planning corporate acquisitions.

B. Form can be important in determining the state and local tax consequences of an acquisition. In many states, the principle that substance prevails over form is less well developed than it is under federal tax laws.

II. GENERAL CONSIDERATIONS

A. Effect of an acquisition on jurisdiction to tax.

1. If a purchasing corporation (P) that is not subject to a state's taxing jurisdiction buys the assets of a target corporation (T) that is doing business in the state, P will become taxable in the state and the state's apportionment formula may become applicable to P's worldwide operations. See, e.g., Reuters Ltd. v. Tax Appeals Tribunal, 180 A.D.2d 270, 584 N.Y.S.2d 932 (3d Dep't 1992), aff'd, 82 N.Y.2d 112, 603 N.Y.S.2d 795 (1993), cert. denied, 512 U.S. 1235 (1994) (corporation organized in the United Kingdom required to file a New York State corporate franchise tax return reporting its worldwide income); Schlumberger Limited, N.Y.S. Division of Tax Appeals (2000), CCH New York State Tax Reporter ¶ 403-642 (statutory argument to the contrary rejected).

2. If the acquired business is not part of a unitary business conducted by P in the taxing state, P's income cannot constitutionally be subject to the taxing state's apportionment formula even if the statute purports to do so. Central National-Gottesman, Inc. v. Director, Division of Taxation, 14 N.J. Tax 545 (1995), CCH New Jersey State Tax Reporter, ¶ 400-374, aff'd, 291 N.J. Super. 277 (1996), CCH New Jersey State Tax Reporter ¶ 400-455; Movie Service Functions, Inc., N.Y.S. Division of Tax Appeals (1988), CCH New York State Tax Reporter ¶ 252-143; Just Born, Inc., TAT(H) 93-456(GC) (N.Y.C. Tax Appeals Tribunal 1998) CCH New York State Tax Reporter ¶ 600-326; Emigrant Savings Bank, TAT(H) 94-130(BT) (N.Y.C. Administrative Law Judge Division 1997), CCH New York State Tax Reporter ¶ 600-294, rev'd, N.Y.C. Tax Appeals Tribunal (September 18, 1998) (on grounds that taxpayer had

failed to make enough of a showing that there was no unitary business to justify summary judgement), CCH New York State Tax Reporter ¶ 600-345; Siegel-Robert, Inc. v. Johnson, 2009 Tenn. App. LEXIS 722 (Tenn. Ct. App. 2009).

3. Effect on status under Public Law 86-272, 15 U.S.C. § 381(a)(1).

   a. P.L. 86-272, a federal statute, provides generally that a corporation that is engaged in the business of selling goods cannot be subject to a state net income tax if its only business activities within the state consist of the solicitation of orders that are sent outside the state for approval or rejection and, if approved, are filled by shipment or delivery from outside the state.

   b. If P acquires T's assets and T was protected by P.L. 86-272 from being taxed in a state, that protection can be lost if P's activities in the state go beyond solicitation. This problem can be avoided if P buy's T's stock so that T's operations and P's are not combined in the same corporate entity.

B. Effect of an acquisition on combined and consolidated reporting.

1. States ordinarily require corporations to be engaged in a unitary business for them to be permitted or required to file combined or consolidated reports.

2. The injection of a new member into a vertical corporate chain can fill a gap and create a unitary business where none previously existed.

3. In a particular case, it may be argued (by either the taxpayer or the taxing authorities) that unitary status should begin only after a period of time necessary to integrate the operations of the two corporations. Compare, Appeal of Allied Signal Company, Inc., CCH California State Tax Reporter ¶ 401-798 (S.B.E. 1990) (no immediate unitary business), with Appeal of Atlas Hotels, Inc., CCH California State Tax Reporter ¶ 401-014 (S.B.E. 1985, and Appeal of Paradise Systems, Inc., (Ca. S.B.E. 1997, 1997 Cal. Tax LEXIS 125) (unitary status immediately after acquisition). Generally, instant unity will be found only if the companies were engaged in a unitary business before the acquisition.

C. Effect of an acquisition on apportionment and allocation of income.

1. If P acquires T's assets and business, T's assets and business will become P's and will be taken into account in computing P's apportionment factors.

2. If P buys T's stock and not its assets, T's apportionment factor items (i.e., its property, payroll, and sales) will be trapped in T's corporate entity and will not affect P's as long as the two corporations do not file combined or consolidated reports.

III. TAXABLE ACQUISITIONS

A. Treatment of the seller.

1. General principles of gain calculation and recognition.

a. The sale of a business is generally treated as is the sale of any other asset. Gain is recognized unless a specific provision exempts or defers it.

b. Under federal tax law, the sale of a corporate business will be tax-free if the consideration consists substantially of P stock (or stock of P's parent). The technical requirements for tax-free treatment vary depending on the form of the transaction. I.R.C. § 368. Gain will be taxable to the extent of non-stock consideration. I.R.C. §§ 354, 356.

c. Calculation of gain.

(1) The gain on the sale of T's assets or stock is often the same for state and local purposes as it is for federal purposes. Many jurisdictions have no special basis rules and the federal gain is automatically incorporated into the tax base.

(2) Some states have different depreciation rules than the federal rules, sometimes reflecting a conscious decision not to adopt the tax subsidy inherent in the federal accelerated depreciation system. See, e.g., Cal. Rev. & Tax Code § 24349. Typically, these states adjust gain or loss on sale to reflect the different depreciation rules. See, e.g., Tenn. Code Ann. § 67-4-2006(b)(1)(G), (H); Kan. Stat. Ann.

§§ 79-32,117(c)(iii) and 79-32,138(c)(i); Wis. Stat. § 71.26(2)(a).

(3) Another area of possibly nonconforming basis involves the filing of consolidated and combined returns by related corporations.

(a) Corporations linked by 80% or more common ownership with a corporation at the top of the chain may, but cannot be required to, file consolidated federal returns. The typical pattern in the states is for consolidated or combined returns to be allowed only if, in addition to common ownership, the corporations are engaged in a unitary business. Moreover, corporations that are linked by common ownership and that are engaged in a unitary business can be compelled to file combined or consolidated returns against their will. Thus, often corporations that file consolidated federal returns file separate state returns, and vice versa.

(b) Under federal regulations, the basis of a parent in a subsidiary's stock when the corporations file consolidated returns is adjusted for a variety of factors, including the subsidiary's income and loss, distributions, and other items. Regs. § 1.1502-32. The states typically do not have special basis adjustment rules nor do they change federal basis to reflect differences between federal and state filing status. Thus, discontinuities can arise when corporations file consolidated returns in one jurisdiction and separate returns in another and federal basis adjustments (or the lack thereof) are automatically reflected in state basis.

(i) Taxpayers in particular situations may urge the taxing authorities in their states to exercise discretionary powers to adjust basis to reflect the state filing method. See Walsh v. State of New Jersey, Department of the Treasury, Division of Taxation, 10 N.J. Tax 447 (N.J. Tax Ct. 1989), aff'd per curiam, 240 N.J. Super. 42, 572 A.2d 222 (App. Div. 1990) (shareholders of S corporation not required to use federal basis on sale of their stock where state did not recognize subchapter S and federal basis adjustments would produce an "anomalous result"); Koch v. Director, Division of Taxation, 157 NJ 1, 722 A.2d 918 (1999) (partner need not reduce basis in partnership interest by losses that he could not deduct for New Jersey purposes); The Bank of Baltimore v. State Department of Assessments and Taxation, Maryland Tax Court (1995), CCH Maryland State Tax Reporter ¶ 201-518 (recapture of federal bad debt reserve not taxable by Maryland when bank had not used bad debt reserve method for Maryland tax purposes). One the other hand, the Maryland Court of Appeals in NIHC, Inc. v. Comptroller (2014) did not allow a separately filing subsidiary to recognize gain on a distribution to its parent under I.R.C. section 311(b) because the gain was deferred for federal income tax purposes (the corporations filed consolidated federal income tax returns).

(ii) Some states have insisted on conformity with federal rules absent a specific modification provision. Taxpayer filing California combined returns on a worldwide unitary basis was not allowed to increase the basis of a subsidiary's stock by the subsidiary's undistributed earnings and profits. California had not adopted a statute or regulations comparable to the federal investment adjustment regulations and statute allowing adjustments for items "properly chargeable to capital account" was inapplicable. Appeal of Rapid-American Corporation (SBE 1996), CCH California State Tax Reporter ¶ 402-893, replaced by new opinion (SBE 1997), CCH California State Tax Reporter ¶ 402-934. S corporation shareholders were allowed to use the federal tax basis of their stock even though the S election was not recognized for North Dakota tax purposes in Erdle v. Dorgan, 300 N.W.2d 834 (N.D. 1980). An Alabama case required a taxpayer to reduce the basis of real property for depreciation deducted on his federal tax returns during years in which he did not live in Alabama and did not file Alabama tax returns. Alabama Dep't of Revenue v. Robertson, 733 So.2d 397 (Ala. Civ. App. 1998), cert. denied, 120 S.Ct. 183 (1999). Massachusetts has gone both ways. In one case, a distribution to a parent corporation that did not result in federal tax because it was a "deferred intercompany transaction" under the federal consolidated return regulations did not result in Massachusetts tax even though the parent and subsidiary did not file combined Massachusetts returns. R.J. Reynolds Tobacco Co. v. Commissioner, 21 Mass. App. Tax Bd Rep. 23 (1997). In another case, however, federal income from the recapture of losses from futures contracts that had been deducted for federal but not state purposes was held not taxable by Massachusetts. Weston Marketing Corp. v. Commissioner, 16 Mass. App. Tax Bd Rep. 76 (1994), aff'd, 40 Mass. App. Ct. 1108, 662

N.E.2d 249 (1996). In T.H.E. Investment Corp. v. Commissioner, 8 Mass. App. Tax Bd Rep. 12 (1986), a recaptured federal excess loss account was not taxable because the deductions that created the ELA had not been claimed for Massachusetts purposes. A Connecticut court required a shareholder of an S corporation to reduce the basis of his stock by corporate losses that reduced his federal basis in years in which Connecticut did not have an income tax. Berkley v. Commissioner of Revenue Services (Superior Court 1998), CCH Connecticut State Tax Reporter ¶ 400-288.

(iii) Taxpayers may be able to bring about appropriate basis adjustments by engaging in actual intercorporate transactions that mirror the transactions that are deemed to occur for state tax purposes.

(iv) For a general discussion of departures from federal conformity, see Peter L. Faber, "Logic v. the Statute: When Federal Conformity Makes no Sense," State Tax Notes, March 16, 2015.

2. Sale of assets by T.

a. Federal tax treatment.

(1) T is taxed on any gain and can deduct any loss.

(2) If T is liquidated and T is not a subsidiary of another corporation, T's shareholders are taxed on any gain on the liquidation. I.R.C. § 331. Thus, the same economic gain can be subject to a double tax. If T is a subsidiary of another corporation, T's shareholder is not taxed on the liquidation. I.R.C. § 332.

(3) The shareholder-level gain can be deferred if T is not liquidated and is kept in existence as a holding company that invests the sale proceeds.

b. Recognition of gain or loss.

   (1) The recognition of gain or loss for state and local purposes will generally conform to the recognition of gain or loss for federal purposes.

   (2) If an asset has a different basis for state and local purposes than it does for federal purposes, the amount of gain may differ and some states require that the federal gain or loss be modified to reflect the difference. See, e.g., Wis. Stat. § 71.26(2)(a).

c. Allocation of sale price among assets.

   (1) Allocation of the sale price among different assets can affect the nature of the gain as business or nonbusiness and, hence, can affect each state's share of the gain.

      (a) Gains that are treated as business income are apportioned under the normal apportionment methods. UDITPA §§ 1(a) and 9.

      (b) Gains and losses from the sale of nonbusiness property are allocated based on the nature of the property. UDITPA § 6.

         (i) Gains and losses from the sale of real property are ordinarily allocated to the state in which the property is located.

         (ii) Gains and losses from the sale of tangible personal property are ordinarily allocated to the state in which the property is located or, if the corporation is not taxable in that state, to the state of the taxpayer's commercial domicile.

         (iii) Gains and losses from the sale of intangible property are ordinarily allocated to the state of the taxpayer's commercial domicile.

   (2) The allocation of the sale price for federal tax purposes is subject to the requirements of section 1060 of the Internal Revenue Code.

(a) In general, section 1060 requires the price to be allocated to different classes of assets to the extent of the fair market value of the assets falling within each class. Any excess price is allocated to good will.

(b) Section 1060 applies only if the assets sold comprise a business.

(c) The parties are required to report certain information about the allocation to the Internal Revenue Service.

d. Characterization of income.

(1) The states generally apply two tests (or variations) in determining whether gain on the sale of a corporation's assets is business income or nonbusiness income: the transactional test and the functional test. See Faber, "When does the Sale of Corporate Assets Produce Business Income for State Corporate Franchise Tax Purposes," The Tax Executive (May/June 1995).

(2) The Uniform Division of Income for Tax Purposes Act (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." § 1(a).

(3) The transactional test.

(a) Gain is treated as business income if the taxpayer regularly engages in the type of transaction producing the gain.

(b) The sale of an entire business would ordinarily produce nonbusiness income under this test.

(i) See, e.g., Union Carbide Corporation v. Huddleston, 854 S.W.2d 87 (Tenn. 1993) CCH Tennessee State Tax Reporter ¶ 400-332; Federated Stores Realty, Inc. v. Huddleston, 852 S.W.2d 206

(Tenn. 1992), CCH Tennessee State Tax Reporter ¶ 400-296, petition for rehearing denied (May 3, 1993), CCH Tennessee State Tax Reporter ¶ 400-331. (The Tennessee Legislature later amended the statute to adopt the functional test, effective for taxable years ending after July 14, 1993.) Western Natural Gas Co. v. McDonald, 202 Kan. 98, 446 P.2d 781 (1968); McVean & Barlow, Inc. v. New Mexico Bureau of Revenue, 88 N.M. 521, 543 P.2d 489 (1975), cert. den., 89 N.M. 6, 546 P.2d 71 (1975).

(ii) But the sale of a business has been held to produce business income under the transactional test when the taxpayer regularly bought and sold businesses. PPG Industries, Inc. v. Illinois Department of Revenue (Ill. App. Ct. 2002).

(c) Factors considered in applying the transactional test.

(i) Whether sale of the property was the taxpayer's principal business activity. McVean & Barlow, Inc. v. New Mexico Bureau of Revenue, supra.

(ii) Whether sales of similar property were common, even if not the taxpayer's normal business activity. Atlantic Richfield Company v. The State of Colorado, 198 Col. 413, 601 P.2d 628 (1979) (taxpayer often sold entire businesses). See, Welded Tube Co. of America v. Commonwealth of Pennsylvania, 101 Pa. Commw. 32, 515 A.2d 988 (Pa. Commw. 1986) (gain on sale of plant and equipment was business income because a normal incident of business even though only two sales of real estate in 30 years); BP Products North America, Inc. v. Bridges (La. Ct. App. 2011) (gain on sale of oil refinery was apportionable business income, as taxpayer requested, because taxpayer often sold refineries and this was in the ordinary course of its business).

(iii) Frequency of sales. Ross-Araco Corp. v. Commonwealth of Pennsylvania, 165 Pa. Commw. 49, 644 A.2d 235 (Pa. Cmwlth. 1994), aff'd, 544 Pa. 74, 674 A.2d 691 (1996), CCH Pennsylvania State Tax Reporter ¶ 202-651 (sale of undeveloped land by company in the construction business held nonbusiness income).

(iv) Whether sale proceeds are distributed in liquidation and not reinvested in the business. Union Carbide Corporation v. Huddleston, supra.

(v) Whether the sale was prompted by extraordinary circumstances. Phillips Petroleum Company v. Iowa Department of Revenue and Finance, 511 N.W.2d 608 (Ia. 1993); Union Carbide Corporation v. Huddleston, supra (sales incurred to raise money to pay massive tort liabilities and to buy back stock to resist hostile takeover attempt); Kroger Co., Kan. Board of Tax Appeals 1997, CCH Kansas State Tax Reporter ¶ 200-746 (sale of leasehold interests as part of the discontinuance of a business pursuant to a restructuring).

(vi) Size of the transaction. Phillips Petroleum Company v. Iowa Department of Revenue and Finance, supra.

(4) The functional test.

(a) Gain is treated as business income if the assets were used to generate business income, even if their sale is not a regular incident of the business.

(b) The Multistate Tax Commission regulations incorporate a strong presumption in favor of business income. The general definition of business and nonbusiness income provides:

> "[A]ll income which arises from the conduct of trade or business operations of a taxpayer is business income. For purposes of administration of Article IV, the income of the taxpayer is business income unless clearly classifiable as nonbusiness income. . . . 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 a business." § IV.1.(a).

The regulation specifically dealing with gain from the sale of property clearly adopts the functional test:

> "Gain or loss from the sale, exchange or other disposition of real or tangible personal property constitutes business income if the property while owned by the taxpayer was used in the taxpayer's trade or business." § IV.1.(c)(2).

(c) The theory of the functional test is that the second clause of the UDITPA definition contains a separate and independent test. States adopting this interpretation hold that income will be business income if it meets either the transactional or the functional test.

(d) Under this approach, gain from the sale of the assets of a business will ordinarily be treated as business income. <u>Gannett Satellite Information Network Inc. v. Montana Department of Revenue</u>, 348 Mont. 333 (2009); <u>National Realty and Investment Co. v. Department of Revenue</u>, 144 Ill. App.3d 541, 494 N.E.2d 924 (1986); <u>Texaco-Cities Service</u>

Pipeline Company v. Department of Revenue (Cir. Ct. Cook County, Ill. 1995), CCH Illinois State Tax Reporter ¶400-723, aff'd, 286 Ill. App.3d 529, 675 N.E. 2d 1004 (1997), aff'd, 182 Ill.2d 262, 695 N.E.2d 481 (1998), CCH Illinois State Tax Reporter ¶ 400-925 (distinguishing cases applying transactional test because functional test is followed in Illinois); Kroger Co. v. Department of Revenue 284 Ill. App. 3d 473, 673 N.E. 2d 710 (1996), CCH Illinois State Tax Reporter ¶ 400-790; Welded Tube Co. v. Commonwealth, 101 Pa. Commw. 32, 515 A.2d 988 (1986); Pledger v. Getty Oil Exploration Co., 309 Ark. 257, 831 S.W.2d 121 (1992); District of Columbia v. Pierce Associates, Inc., 462 A.2d 1129 (D.C. 1983); L.A.F. Delaware Co. v. Missouri Director of Revenue, CCH Missouri State Tax Reporter ¶ 201-077 (Mo. Admin. Hearing Comm'n 1987) (gain from the sale of all of the assets of a business was business income); Appeal of Triangle Publications, CCH California State Tax Reporter ¶ 400-905 (SBE 1984) (gain from the sale of two divisions and part of a third division was business income); Virginia Department of Taxation Ruling PD 95-60 (gain from sale of former headquarters building leased to former division was business income).

(e) There may be an exception to business income treatment under the functional test for sales in liquidation of a business.

(i) The Pennsylvania Supreme Court has held that gain is nonbusiness income under the functional test when the sale is pursuant to a complete or partial liquidation of a business, even if the assets were used in the business. The Court reasoned that the sale was not an integral part of the business's operations. Laurel

Pipe Line Company v. Commonwealth of Pennsylvania, 537 Pa. 205, 642 A.2d 472 (1994). (In a statement of policy adopted on November 12, 1994, the Pennsylvania tax authorities said that they would interpret Laurel Pipe narrowly. For example, the Department said that it viewed the case as being limited to situations in which the property had not recently been used in the business (the assets in Laurel Pipe Line had been idle for three years) and in which the sale proceeds were distributed to shareholders and were not reinvested in the business. CCH Pennsylvania State Tax Reporter ¶ 14-801.) The Department's reading of Laurel Pipe Line is overly restrictive. Although the assets had been idle before their sale, the Court did not regard that as controlling. It relied on McVean & Barlow, which it said was factually similar and which involved assets that were used in the business until their sale. See, MTC Regs. § IV.1.(c), Ex. (iii) (business income when property was put up for sale when business use ended and sold 18 months later).

(ii) The North Carolina Court of Appeals held in Lenox, Inc. v. Offerman that a sale in liquidation of one of a corporation's operating divisions produced non-business income under the functional test. It said that "when the asset is sold pursuant to a complete or partial liquidation, courts focus on more than whether or not the asset is integral to the corporation's business. Instead, they concentrate on the totality of the circumstances, including the nature of the transaction and how the proceeds are used. In this regard, whether the liquidation results in a complete cessation of the company's involvement in that line of business is particularly relevant." (N.C. Ct. App. 2000) CCH North Carolina State Tax Reporter ¶ 202-116. The decision was affirmed by the North Carolina Supreme Court. Lenox, Inc. v. Tolson, 353 NC. 659, 548 S.E.2d 513 (2001), CCH North Carolina State Tax Reporter ¶ 202-130. The Department of Revenue has announced that it will follow Lenox. Directive No. CD-01-1 (Nov. 20, 2001). See Polaroid Corp. v. Offerman, 349 N.C. 290, 306, 507 S.E.2d 284, 296 (1998), cert. denied, 526 U.S. 1098 (1999). Cf., Union Carbide Corporation v. Offerman, (N.C. Ct. App. 1999) (reversion of pension plan funds nonbusiness income because an extraordinary event and not an integral part of the business (no mention of tax benefit rule)), CCH North Carolina State Tax Reporter ¶ 202-053.

(iii) Other cases holding that a sale in liquidation produces nonbusiness income under the functional test even though the assets were used in the business are Kemppel v. Zaino, Tax Comm'r, 91 Ohio St.3d 420, 746 N.E.2d 1073 (2001); Blessing/White, Inc. v. Zehnder, 329 Ill. App.3d 714, 768 N.E.2d 332 (Ill. App. Ct. 2002); National Holdings, Inc. Zehnder, 369 Ill. App.3d 977 (App. Ct.Ill, 4th Dist. 2007) (after distribution to parent, proceeds contributed to another subsidiary but not reinvested in business). In The Mead Corp. v. Illinois Dept. of Revenue, 371 Ill. App.3d 108 (1st Dist., 4th Div. 2007), cert granted on other grounds (Sep. 25, 2007), the court held that the sale in liquidation of a business produced business income because the sale proceeds were not distributed to the shareholders, distinguishing Blessing/White.

(iv) In rejecting the existence of a functional test, the Supreme Court of Alabama said that even if there were a functional test sales in liquidation of a business would produce nonbusiness income. Uniroyal Tire Co. v. State Department of Revenue, 779 So.2d 227 (Ala. Sup. Ct. 2000). The Court commented that "the Department [of Revenue] has not directed us to *any* case holding that gains realized from a complete liquidation and cessation of business operations produced business income." The court recently reaffirmed this holding. Kimberly-Clark Corp. v. Ala. Dep't of Revenue (Ala. Sup. Ct. 2010).

(v) Some courts have held that there was no liquidation exception to the functional test. Jim Beam Brands Co. v. Franchise Tax Bd., 34 Cal.3d 874 (2005); Crystal Communications, Inc. v. Oregon Dep't of Revenue, 353 Ore. 300, 297 P.3d 1256 (2013); First Data Corp. v. Arizona Department of Revenue, 233 Ariz. 405, 313 P.3d 548 (Az. Ct. App. 2013); Harris Corp. v. Arizona Department of Revenue, 233 Ariz. 377, 313 P.3d 1143 (Az. Ct. App. 2013).

(vi) A Pennsylvania case held that a "liquidation" means the cessation of a substantial business operation. It is not enough that the sale proceeds are distributed to the shareholders. Glatfelter Pulpwood Co. v. Commonwealth, 19 A. 3d 572 (Comm'w Ct. 2011), aff'd on other grounds, 61 A.3d 993 (Pa. Sup. Ct. 2013).

(vii) Will a deemed sale of assets and liquidation under Internal Revenue Code section 338(h)(10) be treated as a sale and actual liquidation, resulting in non-business income? The Pennsylvania Com monwealth Court held that it should in Canteen Corp. v. Commonwealth, 818 A.2d 594 (2003), aff'd, 854 A.2d 440 (Pa.Sup.Ct. 2004). Accord, American States Insurance Company v. Hamer, 352 Ill. App.3d 521, 816 N.E.2d 659 (Ill. App. 2004), leave to appeal den., Ill. Sup. Ct. (January 26, 2005); Nicor v. Illinois Department of Revenue, Ill. App. Ct.,1st Dist (2008); ABB C-E Nuclear Power Inc. v. Missouri Dir. of Rev., 215 S.W.3d. 85 (Mo. 2007); McKesson Water Products Co. v. Director, Division of Taxation, 23 N.J. Tax 449 (N.J. Tax Ct. 2007) (describing the issue under the UDITPA language as being whether the taxpayer's income was "operational"). In a case involving a non-UDITPA statute, the Minnesota Tax Court held that an S corporation's gain in a deemed sale of its assets was investment income and was not apportionable, Nadler v. Commissioner of Revenue, 2006 Minn. Tax LEXIS 12 (Mn. Tax Ct. 2006); contra, Newell Window Furnishing Inc. v. Johnson, 311 S.W.3d 441 (Tenn. Ct. App. 2008).

(A) Nevertheless, a BNA survey reported that many state tax departments take the position that the gain must be business income. The North Carolina Department of Revenue treats the gain as business income even though gain from an actual sale of assets and liquidation would be non-business income. Directive CD-02-3 (2002). The South Carolina Department of Revenue treats the gain as apportionable business income but allows gain on the deemed sale of real estate to be allocated to the situs state except to the extent that it results from depreciation recapture. Revenue Ruling 09-4. (The Massachusetts Appellate Tax Board has held that the gain in a section 338(h)(10) transaction was apportionable, but the Massachusetts statute makes all income apportionable, whether business income or nonbusiness income, so the case is not authority as to the classification of the gain. General Mills, Inc. v. Commissioner, Appellate Tax Board (2001), CCH Massachusetts State Tax Reporter ¶ 400-718), aff'd, 440 Mass. 154, 795 N.E.2d 552 (2003), cert. den., 541 U.S. 973 (2004) (taxpayer's constitutional argument rejected).

(B) In First Data Corp. v. Arizona Department of Revenue, 233 Ariz. 405, 313 P.3d 548 (Az. Ct. App. 2013), the Court held that there was no liquidation exception to the functional test and, hence that gain in a section 338(h)(10) transaction was business income.

(C) In CenturyTel, Inc. v. Dep't of Revenue, the Oregon Tax Court did not acknowledge that there was a liquidation exception to the functional test but it said that if there was it would not apply to the facts before it because the selling parent used the sale proceeds in a business that was unitary with the business conducted by the subsidiary the stock of which was sold. Oregon Tax Ct. 2010. This is the only case that has focused on the use of the sale proceeds by the seller. See Peter L. Faber, "Oregon Court Adds New Test for Nonbusiness Income in Liquidating Sale," State Tax Notes (September 13, 2010).

(f) The Indiana Tax Court has held that gain from the sale of the assets of a division of T that did not amount to a liquidation was not business income because it was not "integral" to T's business. May Department Stores Co. v. Indiana Department of State Revenue (May 7, 2001). The New Jersey Appellate Division held that gain was not "operational income" and, hence, was not apportionable and should be allocated to the taxpayer's commercial domicile. McKesson Water Products Co. v. Division of Taxation, 408 N.J. Super. 213, 974 A.2d 443 (N.J. App. Div. 2009), certif. denied, Nov. 17, 2009). The New Jersey Tax Court distinguished McKesson in Elan Pharmaceuticals, Inc. v. Director, Division of Taxation (N.J. Tax Ct. 2014), holding that gain on the sale of part of the business was operational because the taxpayer sold only part of its pharmaceutical business, kept some rights to use the drug that was sold, and did not distribute the sale proceeds.

(g) The functional test has been applied to a sale of a subsidiary's stock. Indiana Department of Revenue Admin. Decision 94-070

(h) 9 ITC (1996) (sale by gasoline station owner of stock of gasoline producer from which it purchased gasoline).

(i) Is the functional test a valid interpretation of the statute?

  (i) Yes.

    (A) The UDITPA language is based on prior California case law.

      (I) The California cases held that income from property the acquisition, management, and disposition of which was an integral part of the taxpayer's business was business income. Houghton Mifflin Co. (SBOE 1946); International Business Machines Corp. (SBOE 1954); National Cylinder Gas Co. (SBOE 1957).

      (II) Applying this test, several cases held that the fact that property was used in the business was sufficient to make gain on its sale business income. See, e.g., American Airlines, Inc. (SBOE 1952) (sale of aircraft); American President Lines, Inc. (SBOE 1961) (sale of charter boat); Velsicol Chemical Corp. (SBOE 1961) (sale of patents, specifically referring to the "acquisition, management, and disposition" standard); Voit Rubber Corp. (SBOE 1964) (sale of all of the assets of a business).

(B) Later cases have cited this background in holding that UDITPA incorporates the functional test. See e.g., Borden, Inc. (CA SBOE 1977); Appeal of Chief Industries, Inc., 255 Kan. 640, 875 P.2d 278 (1994) (dissent).

(ii) No.

(A) The argument against the functional test is based on a literal reading of the statutory language.

(I) The use of the word "and" before the word "disposition" indicates that the disposition of the property and not just its use must be an integral part of the taxpayer's business.

(II) See the analysis of the court in General Care Corporation v. Olsen, 705 S. W.2d 642 (Tenn. 1986); The Kroger Co. v. Department of Revenue (Cir. Ct. Cook County, Ill. 1995), CCH Illinois State Tax Reporter ¶400-716. See, also, Western Natural Gas Co. v. McDonald, supra; McVean & Barlow, Inc. v. New Mexico Bureau of Revenue, supra; Appeal of Chief Industries, Inc., 255

Kan. 640, 875 P.2d 278 (1994).

(B) Opponents of the functional test concede the presence of the legislative history in California and often concede that the functional test is appropriate from a tax policy standpoint, but they argue that these considerations must yield to the clear language of the statute. See Uniroyal Tire Company v. State Department of Revenue, 779 So.2d 227 (Ala. Sup. Ct. 2000), CCH Alabama State Tax Reporter ¶ 200-786 (functional test supported by tax policy but not by statutory language, citing Faber, supra, at III.A.4.d(1)). The court recently reaffirmed this holding. Kimberly-Clark Corp. v. Ala. Dep't of Revenue (Ala. Sup. Ct. 2010).

(C) An argument can be made that even if there is a separate functional test the statutory language requires that a sale of property produces nonbusiness income unless the property's disposition is an integral part of the seller's regular business operations.

(j) Some states have adopted statutory language that clearly incorporates the functional test (by replacing the word "and" before "disposition" with the word "or"). See, e.g., Ala. Code § 40-27-1.1; Idaho Code § 63-3027(a)(1); Tenn. Code Ann. §67-4-2004(3) (see Blue Bell Creameries LP v. Roberts, _____ Tenn. ____ (2011), applying the functional test under the revised statute to find gain from a stock redemption to be business income); N.C.

Gen. Stat. § 105-130.4(e); Kan. Stat. Ann § 79-3271(a) (taxpayer may elect the application of the functional test); Ia. Code § 422.32.2 (business income includes gain from the sale of property that is "operationally related" to the taxpayer's business); N.M. Stat. Ann. § 7-4-2(A) (business income includes income from the "disposition or liquidation of a business or segment of a business").

(k) Some states have attempted to avoid the controversy by repealing the UDITPA definition.

(i) In some states, all income that can be apportioned under the Constitution is business income. See, e.g., 72 Pa. Cons. Stat. § 7401 (3)(2)(a)(1)(A).

(ii) In Minnesota, only income "not derived from the conduct of a trade or business" may be allocated and not apportioned. Minn. Stat. § 290.17.

(5) The Oregon Tax Court has held that a taxpayer that treated a gain as business income in another state was not barred from arguing that the gain was nonbusiness income under Oregon law despite a similarity in statutory language. <u>Oracle Corp. v. Dep't of Revenue</u> (Ore.Tax Ct. 2010).

(6) The U.S. Supreme Court in <u>MeadWestvaco Corp. v. Illinois Department of Revenue</u>, 553 U.S. 16 (2008), made clear that under the Constitution an asset must be part of a unitary business being conducted in a state for gain or loss on its sale to be apportionable.

(7) The North Carolina Department of Revenue's Office of Administrative Hearings held that gain on the sale of a limited partnership interest was not apportionable because the taxpayer was a passive investor in the partnership and was not unitary with it, even though the partnership was closely held and operated a series of related businesses. The fact that the taxpayer had reported income

from the partnership as apportionable business income was irrelevant. Final Agency Decision No. 09 REV 5669 (2011).

e. Gain from the sale of out-of-state real property may be separately accounted for if including it in the apportionment formula would distort income. See People ex rel. Sheraton Buildings, Inc. v. New York State Tax Commission, 15 A.D.2d 142 (3d Dep't 1961) aff'd without opinion (1963) (separate accounting allowed); British Land (Maryland), Inc. v. Tax Appeals Tribunal, 85 N.Y.2d 139 (1995), reversing 202 A.D.2d 867 (3d Dep't 1994), CCH New York State Tax Reporter ¶ 401-456 (separate accounting allowed where income would have been distorted and appreciation occurred before taxpayer was doing business in New York, despite presence of unitary business).

f. Depreciation recapture was held to be apportionable even though capital gain would be allocable to the state where sold property was located in CNA Holdings, Inc. v. Delaware Director of Revenue (Del. Sup. Ct., New Castle County, 2002).

g. Liquidation of T.

(1) If T distributes assets in kind to its shareholders, it will be treated as if it sold them to its shareholders for their fair market values. Gain (and perhaps loss) will be recognized unless T is an 80% or more subsidiary of another corporation. I.R.C. §§ 336, 337.

(2) T's gain on the distribution of appreciated assets will ordinarily be treated as business or nonbusiness income under whichever of the functional or the transactional test as is normally applied in the taxing state.

(3) If a T shareholder receiving a distribution in liquidation of T is a corporation, its gain or loss will be classified as business or nonbusiness as if it had sold its T stock.

h. If T's assets are sold in an installment sale with the price (and gain) being spread over a period of years, a question arises as to what year's apportionment factors are used in apportioning business gain. See Tenneco West, Inc. v. Franchise Tax Board, 234 Cal. App. 3d 1510 (1991) (factors for the year of the sale are used, rather than for the year in which payment is received, on the theory that this more accurately reflects the activities that produced the income).

3. Sale of subsidiary stock.

a. Federal tax treatment.

(1) The sale of stock of a subsidiary is ordinarily taxable as is the sale of any other asset.

(2) The parent's gain or loss is ordinarily capital.

(3) The basis of the subsidiary's assets does not change unless a special election is made. I.R.C. § 338.

b. State taxation of gain or loss.

(1) Ordinarily, gain from the sale of a subsidiary's stock is taxable, mirroring the federal treatment.

(2) The use of an intermediate holding company in another state may not divert gain from the parent. See, e.g., Trans-Lux Corp. v. Meehan, 43 Conn. Sup. 314, 652 A.2d 539 (Ct. Super. Ct. 1993), CCH Connecticut State Tax Reporter ¶ 400-056, in which an intermediate holding company's gain on the sale of its subsidiaries' stock was allocated to its parent in order clearly to reflect income despite uncontroverted evidence that the holding company was formed and held the subsidiaries' stock for non-tax business purposes.

c. Apportionment or allocation of gain.

(1) The characterization of the parent's gain or loss as business or nonbusiness income can be important. Business income is typically apportioned among the states in which the taxpayer does business, usually based on the relative amounts of the taxpayer's property, payroll, and sales in each state.

Nonbusiness income is usually allocated entirely to the state of the taxpayer's commercial domicile.

(2) The Uniform Division of Income for Tax Purposes Act (UDITPA) defines business income to include income from intangible property (presumably including gains from the sale of subsidiary stock) "if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." UDITPA § 1(a).

(3) Gain from the sale of a subsidiary's stock will be business income if the subsidiary and the selling parent were engaged in a unitary business. See, e.g., Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768 (1992); Dep't of Revenue v. Tate & Lyle Ingredients Americas Inc. (Montgomery County, Alabama, Cir. Ct. 2009).

(4) The Supreme Court has held that income from a subsidiary that is not engaged in a unitary business with the parent cannot constitutionally be treated as business income subject to apportionment under the Due Process Clause. ASARCO, Inc. v. Idaho State Tax Commission, 458 U.S. 307 (1982); F.W. Woolworth Co. v Taxation and Revenue Department, 458 U.S. 354 (1982). The Court reaffirmed this principle, after specifically requesting argument on the point, in Allied-Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768 (1992).

    (a) Cases holding that gain on the sale of a corporation's stock was apportionable business income because of the presence of a unitary relationship include Super Valu Stores, Inc. v. Iowa Dep't of Revenue and Finance, 479 N.W. 2d 255 (La. 1991) cert. den., 505 U.S. 1213 (1992); Borden, Inc. v. Illinois Dep't of Revenue, 295 Ill. App. 3d 1001, 692 N.E. 2d 1335 (1998).

    (b) Cases holding that gain on the sale of a subsidiary's stock was not apportionable business income because of the lack of a unitary relationship include In re Appeal of VSI Corporation (Calif. SBE 1991); In re Hercules, Inc. (Kansas Bd. Tax App. 2000).

(c) The California Franchise Tax Board has ruled that the mere intent when stock is acquired to establish a unitary or business relationship later does not make the stock a business asset if it is sold before the unitary relationship is established. Legal Ruling No. 2012-01.

(5) The Supreme Court in Allied-Signal did, however, state that income from the sale of stock could be treated as business income if it served an "operational" rather than an investment function.

(a) Income from the sale of stock of a 20%-owned corporation was business income under this exception where the seller acquired and later sold stock of a corporation that did contract manufacturing for it in a new market area. CTS Keene, Inc. (SBE 1993), CCH California State Tax Reporter ¶ 402-589, petition for rehearing denied, June 23, 1993.

(b) Stock of a 50%-owned corporation was not an operational asset even though the taxpayer provided services to the corporation and purchased goods from it. Hercules, Inc. v. Comptroller of the Treasury, Maryland Tax Court (1995), CCH Maryland State Tax Reporter ¶ 201-521, aff'd, 351 Md 101, 716 A.2d 276 (1998); Hercules, Inc. v. Commissioner of Revenue, 575 N.W.2d 111 (Mn. 1998), CCH Minnesota State Tax Reporter ¶ 202-792, rev'g decision of Minnesota Tax Court, CCH Minnesota State Tax Reporter ¶ 202-716 (1997); Appeal of Hercules, Inc., Kans. Bd. of Tax App. (1999). CCH Kansas State Tax Reporter ¶ 200-841, aff'd on reconsideration (2000), CCH Kansas State Tax Reporter ¶ 200-842; Hercules, Inc. v. Illinois Department of Revenue (Ill. App. Ct., 1st Dist. 2001), CCH Illinois State Tax Reporter ¶ 401-273.

(c) In MeadWestvaco Corp. v. Illinois Department of Revenue, 553 U.S. 16 (2008), the Supreme Court explained that the operational function reference in Allied Signal was not intended to add an additional ground for apportionability. It only meant that an asset that served an operational function could be part of a taxpayer's unitary business even if there was no unitary relationship between the payor and the payee.

(6) In Oracle Corp. v. Dep't of Rev., the Oregon Tax Court held that the DOR could not exclude gain on the sale of stock from the denominator of the receipts fraction. The gain was business income and was incurred in the regular course of Oracle's business. (Ore. Tax Ct, 2012)..

d. Basis of target assets.

(1) Ordinarily, the basis of T's assets does not change when its stock is sold.

(2) Under federal law, an election to change the basis of T's assets to reflect the purchase price of its stock is available under certain circumstances. I.R.C. § 338.

(a) General requirements of section 338.

(i) The buyer must be a corporation.

(ii) P must acquire at least 80% of T's stock.

(iii) The acquisition of T's stock must be in a taxable transaction.

(b) The general pattern of a section 338 transaction is that T is treated as if it sold its assets to itself. The assets get a new basis but T must recognize gain. Since the T shareholders also recognize gain on the sale of their stock, the double tax generally makes section 338 unattractive unless T has net operating losses that can shelter the gain.

(c) If T is a subsidiary of another corporation or is an S corporation, section 338(h)(10) of the Code offers a viable alternative.

(i) If both P and T's parent (or shareholders, if T is an S corporation) elect, the transaction is treated as if T sold its assets in a taxable transaction and liquidated into its parent tax-free under section 332 of the Code. The sale of T stock by its parent is ignored for tax purposes.

(ii) Under section 338(h)(10), only a single tax is imposed, on the deemed sale by T of its assets.

(iii) T's tax attributes, including net operating loss carryovers, pass to T's selling parent.

(d) The states have taken different approaches to section 338(h)(10).

(i) New York State now respects the section 338(h)(10) construct, although it has not formally announced its position. Advisory Opinion TSB-A-99(22)C. Under its prior approach, T had to file two reports: one for the short year ending with and including the day on which the deemed sale occurs, and one for the rest of the year. The gain was included in the selling parent's combined report with T if combined reports were filed. The sale of T stock by the parent was not ignored, but it was ordinarily not taxed because gains from the sale of subsidiary stock are not taxable in New York. TSB-M-91 (4)(C) (April 17, 1991); Regs. §§ 3-2.2, 6-2.7, 18-2.2, 21-2.7. New York City took the same position.

Ruling No. X-2-006-001 (September 24, 1990) (the City has not announced a change in its position to conform to the new State approach). If T is an S corporation, however, New York has followed the federal characterization of a section 338(h)(10) transaction and the sale of T stock by its shareholders is ignored. Advisory Opinion TSB-A-97 (2)I.

(ii) However, the New York State Tax Appeals Tribunal has held that section 338(h)(10) does not apply to a sale of an S corporation's stock, relying on a statute that provides that an S corporation's income is calculated as if it were a C corporation (a C corporation owned by individuals could not be sold in a 338(h)(10) transaction). Petition of Baum, N.Y.S. Tax Appeals Tribunal (2009). The Georgia Supreme Court held that a federal section 338(h)(10) election with respect to an S corporation was ineffective for Georgia tax purposes because Georgia law recognized only elections made by corporations and the election before it was made by the S corporation's individual shareholders. Trawick Construction Co., Inc. v. Dep't of Revenue, 690 S.E.2d 601 (Ga. Sup. Ct. 2010). In contrast, the Alabama Court of Appeals held that a nonresident S corporation shareholder was taxable on his share of the corporation's gain on the deemed sale of its assets, rejecting the taxpayer's constitutional arguments. Prince v. Dep't of Revenue, Docket 2080634 (Ala. Ct. App. 2010).

(iii) California allows the corporations to elect section 338(h)(10) treatment or not, regardless of whether they have elected section 338(h)(10) treatment for federal purposes, if T is a subsidiary of another corporation. Cal. Rev. & Tax. Code § 23051.5(e). FTB Chief Counsel Ruling C1-88-254 (November 15, 1988); FTB Information Letter (October 28, 2003). The choice may depend on the relative bases of T in its assets and of T's parent in T's stock and whether it would be preferable to have the gain treated as business or nonbusiness income. If T is an S corporation, the parties do not have a choice. The federal election (or lack of one) controls. Cal. Rev. & Tax. Code § 23806.

Wisconsin also gives taxpayers a choice, regardless of whether a section 338(h)(10) election is made for federal tax purposes.

(iv) Some states automatically accept the section 338(h)(10) election if it is made for federal purposes. See, e.g., Arizona Corporate Tax Ruling CTR 98-2, CCH Arizona State Tax Reporter ¶ 300-269 (1998) (noting that normal rules for determining business or nonbusiness character of gain apply); Ga. Code § 48-7-21(b)(7)(containing special rules for S corporations); Michigan, Revenue Administrative Bulletin 1994-12, CCH Michigan State Tax Reporter ¶ 319-253; Virginia, Ruling of Commissioner P.D. 91-317 (1991), reported at CCH Virginia State Tax Reporter ¶ 202-115; West Virginia Department of Taxation and Revenue, Technical Assistance

Advisory 95-003; Illinois Private Letter Rulings 89-0306 and 89-0222.

(v) New Jersey recognizes section 338(h)(10) with respect to sales of stock of corporate subsidiaries occurring after January 13, 1992. New Jersey State Tax News, Summer 1995. N.J. Admin. Code §§ 18:7-5.8. See also letter ruling of July 10, 1995, in which section 338(h)(10) was held to be available with respect to the sale of an S corporation. Before then, the Division of Taxation did not allow section 338(h)(10) treatment, thus imposing a double tax as if a regular section 338 election had been made. See, e.g., prior N.J. Regs. §§ 18:7-11.12, 18:7-11.15, 18:7-12.1, and 18:7-12.3; <u>General Building Products Corp. v. State of New Jersey, Division of Taxation</u>, 14 N.J. Tax 232 (N.J. Tax Court (1994)), CCH New Jersey State Tax Reporter ¶ 400-320, <u>aff'd</u>, 15 N.J. Tax 213 (N.J. Sup. Ct. App. Div. 1995), CCH New Jersey State Tax Reporter ¶ 400-390 (taxpayer's argument that it should not be bound by its regular section 338 election because of the unavailability of section 338(h)(10) rejected). With respect to S corporations, the New Jersey courts have rejected the section 338(h)(10) fiction and have treated the transaction as a sale of stock by the shareholders. <u>Miller v. State of New Jersey, Division of Taxation</u>, 352 N.J. Super. 98, 799 A.2d 660 (N.J. Sup. Ct. App. Div. 2002); <u>Mandelbaum v. State of New Jersey, Division of Taxation</u>, 20 N.J. Tax 141 (N.J. Tax Court (2002)).

(vi) Some states do not recognize section 338 (h)(10). See, e.g., Or. Admin. R. § 150-317.329(5) (if T and its parent are not engaged in a unitary business or do not file a consolidated Oregon return).

(e) Even if a state purports to recognize section 338(h)(10), if it does not allow the selling parent and T to file combined reports the tax liability with respect to the deemed sale will be T's and the burden will pass to P unless the parent agrees by contract to assume it. See Illinois Dep't of Revenue Letter Ruling IT-89-306 (1989), CCH Illinois State Tax Reporter ¶ 11-101.40; Newell Window Furnishing, Inc. v. Johnson, 311 S.W.3d 441 (Tenn. Ct. App. 2008). This is particularly a problem in states that do not permit combined reports under any circumstances.

(f) If the buyer does not want some of the target's assets, the target may distribute them to its selling parent before the sale of the target's stock. The actual distribution of assets is treated as part of a liquidation for federal income tax purposes. Temp. Regs. § 1.338(h)(10)-IT(e), Example (2). It is likely that the states will take the same position. See, e.g., New York State Advisory Opinion TSB-A-02(1)(C) (April 2, 2002); Virginia Ruling P.D. 01-192 (November 30, 2001); Illinois Priv. Ltr. Rul. IT 94-0012 (March 9, 1994). We have obtained unpublished private letter rulings from the tax authorities in a number of states to the same effect.

(g) In one Illinois case, T was required to increase its paid-in capital for purposes of the capital-based franchise tax by the amount of the increase in tax basis. E&E Hauling, Inc. v. Ryan, 306 Ill. App.3d 131, 731 N.E.2d 178 (Ill. App. Ct., 1st Dist., 4th Div. (1999)).

(h) Are the proceeds of the deemed sale included in the receipts factor of the apportionment formula?

(i) A section 338(h)(10) transaction is an extraordinary event and arguably should be excluded from the receipts factor. See MTC Regs. § IV.18(c)(1) (receipts factor does not include "substantial amounts of gross receipts…from an incidental or occasional sale of a fixed asset used in the regular course of a taxpayer's trade or business")

(ii) The California Franchise Tax Board discussed apportionment issues generally in Legal Ruling No. 2006-03. The deemed sale receipts will be excluded if they are "substantial."

(iii) The resolution of the question may depend on the extent to which the gain on the deemed sale is considered distortive. Compare Florida Department of Revenue Technical Assistance Advisements 97(C)1-007 (1997) (receipts excluded) and 00(C)1-012 (2000) (receipts not excluded).

(iv) The Connecticut Department of Revenue Services has ruled that the income is T's, arising from a sale of assets, and that the income is included in T's receipts factor. Ruling No. 2003-3 (July 14, 2003), CCH Connecticut State Tax Reporter ¶400-838.

(v) The income is included in the receipts factor in New Jersey. Regulations sections 18:7-8.10 and 8.12.

(vi) The Massachusetts Appellate Tax Board has held that the sale proceeds were not included in the receipts factor because the transaction was actually a sale of stock and the statute specifically excluded receipts from sales of securities. Combustion Engineering, Inc. v. Commissioner, Appellate Tax Board (2000), CCH Massachusetts State Tax Reporter ¶ 400-612; General Mills, Inc. v. Commissioner, Appellate Tax Board (2001), CCH Massachusetts State Tax Reporter ¶ 400-718, aff'd, 440 Mass. 154, 795 N.E.2d 552 (2003), cert. den., 541 U.S. 973 (2004).

(i) The Ohio Department of Taxation takes the position that T keeps its net operating losses and other tax attributes (even though they pass to its selling parent for federal income tax purposes). Information Release CFT 2004-02 (2004); unpublished letter to the writer dated April 4, 2001.

(j) The New York State Department of Taxation and Finance Counsel has opined that T should not be treated as a new corporation for purposes of a credit that was intended to encourage new businesses. TSB-M-03(1)C (January 28, 2003).

(k) The New York State Tax Appeals Tribunal has held that T's investment tax credits are recaptured. AIL Systems (2006).

(l) A nonresident shareholder was taxed on his gain from an S corporation's section 338 (h)(10) transaction. He elected to treat the sale as being of the corporation's assets and not as a sale of intangible property (i.e., his stock). General Accessory Mfg. Co. v. Oklahoma Tax Commission, 122 P.3d 476 (Ok. Civ. App. 2005); Accord, Nadler v. Commissioner of Revenue, 2006 Minn. Tax LEXUS 12 (Mn. Tax Ct. 2006).

(3) Significance of basis for state and local purposes.

(a) Calculation of gain on later sale of assets.

(b) Depreciation.

(c) Apportionment of income if property factor is based on income tax basis.

4. Sale of T stock by individual shareholders.

a. Selling T shareholders are generally taxed on any gain by their state of residence.

b. Shareholders contemplating a sale of their stock may move to a state with lower tax rates before the sale. A change in domicile must be genuine to be respected for tax purposes and there is a strong presumption against a change of domicile. See, e.g., N.Y. Tax Law § 689(e). In the Matter of Newcomb, 192 N.Y. 238 (1908).

c. Selling stock in an installment sale and then moving to a low-tax state will ordinarily not shift the incidence of taxation. Appeal of Gordon (SBE 1983), CCH California State Tax Reporter ¶ 400-631; N.Y. Tax Law § 639 (gain accelerated into last resident return).

d. Giving stock to a relative before the sale will transfer the gain to the donee, but not if the gift is made after the sale has been negotiated and not if the donor retains control of the stock and the sale proceeds. David M. Siegel, N.Y.S. Div. of Tax App., DTA 823107 (2011).

e. Nonresident shareholders of an Oklahoma S corporation were taxable on their shares of the corporation's gain on the deemed sale of its assets in a §338(h)(10) transaction in General Accessory Mfg. Co. v. Oklahoma Tax Comm., 122 P.3d 476 (OK.Civ.App. 2005). The court rejected the argument that the transaction was a stock sale that was not taxable to nonresidents.

B. Treatment of the buyer.

1. Basis of purchased assets.

a. Allocation of purchase price.

(1) P will generally want to allocate as much of the price as possible to assets that produce an early tax benefit (e.g., inventory, short-lived depreciable property).

(2) If T has separate businesses that are not part of a unitary business, P will want to allocate as much of the price as possible to depreciable assets of the business that is conducted in high-tax states.

(3) The allocation of purchase price can affect the property factor of the apportionment formula.

(4) See III.A.4.c.(2) for a discussion of allocation principles.

b. Election to adjust the basis of T's assets when P buys T's stock.

(1) For a discussion of the requirements for P to make a section 338 election, see III.A.2.d.

(2) The states generally respect an election to adjust basis under section 338. This is true even for states that, in taxing the seller side of the transaction, do not conform to the federal treatment of a section 338(h)(10) election.

(3) The allocation of basis under section 338 generally is similar to the allocation of basis in an asset purchase under I.R.C. section 1060.

2. Purchase of intangible assets.

a. The buyer should consider forming a separate subsidiary ("passive holding company," or "PHC") to purchase T's intangible assets and license them to the operating corporations that will use them. A separate purchase of the T intangibles by an unrelated buyer is more likely to withstand scrutiny than is a sale-licenseback after the acquisition.

b. If the corporation's operations are conducted in a jurisdiction that does not impose tax on income from owning intangible assets (such as Delaware or Nevada) or in a state that would effectively tax the corporation's income through unitary combined reporting, significant state and local tax savings can result. The operating companies can deduct royalties paid to the PHC in the states in which they do business to the extent that those states do not require unitary combined reporting. The tax economics are affected by the extent to which the cost of the intangibles can be recovered by depreciation deductions under I.R.C. section 197.

c. A PHC should have substance to be respected for business and tax purposes. See, Faber, "Planning for the Use of Intangibles Holding Companies," State Tax Notes (June 15, 1998).

3. Deduction of interest.

a. Interest is generally deductible by corporations.

b. Express limits on deduction of interest.

(1) Federal limits.

(a) Under I.R.C. § 279, interest in excess of $5,000,000 is not deductible if it is incurred to acquire another corporation, the debt has certain equity-type features, and the borrower is highly-leveraged.

(b) Under I.R.C. § 163(e)(5), original issue discount on certain high yield obligations is not deductible and, to some extent, may be treated as equity.

(c) Under I.R.C. § 163(j), interest paid to tax-exempt or nontaxable related parties (e.g., a foreign parent that is subject to a reduced tax on interest income under a tax treaty) by certain highly-leveraged taxpayers is not deductible.

(2) New York limits the deduction of interest when a corporate acquisition is made by a corporation whose leverage is significantly increased, even if the acquisition itself is not financed by debt. See Faber, "New York State Antitakeover Bill: First Step Down a Rocky Road," Tax Notes (June 5, 1989). N.Y. Tax Law § 208.9(b)(6-a). Repealed for New York State but not for New York City, effective January 1, 2000.

c. Limitations on deducting interest attributable to subsidiaries.

(1) Many states exempt from tax all or part of dividends from subsidiaries. See, e.g., Ala. Code § 40-18-35(a)(7), (b)(8) (dividends from 20%-owned subsidiaries excluded); Ark. Code Ann. § 26-51-404(b)(8) (dividends from 80%-owned subsidiaries excluded); Ky. Rev. Stat. Ann. § 141.010(12)(b) (all dividends excluded); N.J. Stat. Ann. § 54:10A-4(k)(5) (100% of dividends from 80%-owned corporations excluded and 50% of dividends from 50%-owned corporations excluded); Tenn. Code Ann. § 67-4-2006(b)(2)(A) (80% deduction for dividends from 80%-owned subsidiaries); Va. Code Ann. § 58.1-402(C)(10) (dividends from 50%-owned subsidiaries excluded); Wis. Stat. § 71.26(3)(j) (dividends from 70%-owned subsidiaries excluded).

(a) Some of these states do not expressly disallow expenses relating to subsidiary stock, presumably indicating that they are deductible. See, e.g., the Laws of Alabama, Arkansas, New Jersey and Virginia. In Tennessee, an attempt by the tax authorities to disallow expenses relating to tax-exempt dividends from subsidiaries was rejected because of the lack of statutory authority for such a position. Kellogg Co. v. Olsen, 675 S.W.2d 707 (Tenn. 1984); see, also, Director of Revenue v. First Federal Savings & Loan Association of New Castle County, Delaware Superior Court (1972), cited at CCH Multistate Corporate Income Tax Guide ¶ 338.46.

(b) Other states expressly disallow expenses relating to the production of tax-free income, including exempt dividends from subsidiaries. See, e.g., Ky. Rev. Stat. Ann. § 141.010(13)(d); Wis. Stat. §§ 71.26(2)(a), 71.26(3)(l). If a corporation does not borrow expressly for the purpose of buying a subsidiary's stock but has loans outstanding at a time that it makes an acquisition for cash, the tax authorities may allocate part of its debt to the acquisition on the theory that the debt should be allocated among all of its assets. See, e.g., Kentucky Revenue Policy 41P150, cited at CCH Kentucky State Tax Reporter ¶ 16-024. This can present a major problem for holding companies.

d. Interest deductions will be disallowed if the debt is reclassified as equity.

4. New York State investment income designation.

a. Under legislation effective January 1, 2015, a corporation's investment in corporate stock will not produce tax-exempt investment income unless the corporation identifies the stock as being held for investment on the day of purchase in a manner similar to Internal Revenue Code section 1236. N.Y.S. Tax Law §208.5.

b. If a corporation's stock is purchased in an I.R.C. section 338 (h)(10) transaction, it is treated as a new corporation for most income tax purposes. If such a corporation has previously made an identification under this provision, it is not clear whether it is treated as a new corporation that must make a new identification. It is also unclear whether the surviving corporation in a merger must make a new identification with respect to stocks that had been owned by the merged corporation and had been identified by it as having been held for investment.

IV. TAX-FREE REORGANIZATIONS

A. Under federal law, the acquisition of a corporate business can be made on a tax-free basis if the consideration largely consists of stock of the buyer or its parent. The technical requirements for tax-free treatment, including the extent to which nonstock consideration is permitted, vary depending on the form of the transaction. I.R.C. § 368.

B. State rules on tax-free reorganizations.

1. The states have generally not tried to define tax-free reorganizations, relying on their general conformity provisions to provide parity. See, e.g., Florida Department of Revenue, Technical Assistance Advisement No. 94(C)1-005, CCH Florida State Tax Reporter ¶ 202-737.

2. Alabama specifically incorporates the federal reorganization provisions by reference. Ala. Code § 40-18-8. California incorporates by a general reference those Internal Revenue Code provisions that deal with relations between corporations and shareholders without referring to Code sections. Cal. Rev. & Tax Code § 17321.

3. State tax attributes may pass to the acquiring corporation in a reorganization even if they are not referred to in I.R.C. § 381. See, e.g., International Paper Company v. Broadhead, 662 So.2d 277 (Ala. Civ. App. 1995) (credit for foreign corporations doing business in state).

4. Liabilities of a merged corporation were held to be not deductible by the surviving corporation when they related to non-City activities. Canadian Imperial Holdings, Inc., TAT (H) 98-48 (BT) (N.Y.C. Tax App. Trib., A.L.J. Div. 2002).

5. The liquidation and merger of a subsidiary into its parent was held not to be a "disposition" that would trigger recapture of the Massachusetts investment tax credit in Comm'r of Revenue v. Gillette Co., 454 Mass. 72 (2009).

V. SPINOFFS

A. A spinoff that is tax-free under section 355 of the Internal Revenue Code will generally be tax-free for state and local income tax purposes. Mississippi, while exempting the shareholders from tax on the receipt of the distribution, used to tax the distributing corporation on any gain in the stock that is distributed. Regs. § 801(f). This rule was repealed, effective as of January 1, 2012.

B. A spinoff can change the tax profiles of the distributing and the distributed corporations.

1. An analysis should be done before the transaction of what the corporations will look like afterward.

2. Distributing a division to shareholders can remove the distributing corporation from the taxing jurisdiction of states in which the division does business (or create the possibility of avoiding nexus by further adjustments).

3. The corporate readjustment can create new opportunities for filing (or avoiding) combined reports.

C. Effective May 17, 2006, section 355(b)(3) was added to the Internal Revenue Code, providing that the active trade or business ("ATOB") test will be met with respect to the distributing or distributed corporation if any member of the corporation's federal affiliated group is engaged in an ATOB. Spin-offs that are structured to take advantage of this new rule and in which either corporation is not itself engaged in an ATOB will fail to qualify for tax-free treatment in states that conform to the Internal Revenue Code as it existed as of a date before May 17, 2006. See California Franchise Tax Board Chief Counsel Rulings 2007-3 and 2008-1, confirming that California did not follow section 355(b)(3). The statute was amended to conform to section 355(b)(3), but only as of January 1, 2010, so transactions closing before that date were not able to meet the ATOB test on an affiliated group basis. Moreover, as a result of Proposition 26, adopted in 2010, it appears that the updated conformity bill became void on November 3, 2011, at which time section 355(b)(3) no longer applied in California. This is still a problem in New Hampshire, which conforms to the Code as it existed on December 31, 2000.

D. Are state qualification issues presented if saving state taxes is the business purpose justifying tax-free treatment at the federal level? See California Franchise Tax Board Chief Counsel Ruling 2007-3, in which the taxpayer had to represent that saving California taxes was not its purpose.

E. For a general discussion, see Faber, "State and Local Tax Aspects of Corporate Spinoffs," State Tax Notes (February 27, 2012).

VI. NET OPERATING LOSS CARRYOVERS

A. General state rules governing NOLs.

1. Periods of NOL carryforwards and carrybacks.

a. The federal rules allow NOLs to be carried back 2 years and forward 20 years.

b. States, such as New York, that incorporate the federal rules automatically under their conformity provisions now have the 2-year carryback and 20-year carryforward periods.

c. Some states allow the federal carryforward but allow no carryback.

d. Some states have a shorter carryforward period and no carryback.

e. Some states allow shorter carryforward periods.

2. Amounts of NOL carryforwards and carrybacks.

a. Most states have some mechanism for limiting carryforwards and carrybacks to NOLs attributable to the state.

(1) The most common approach is to apply the state's apportionment formula to taxable income, determined by taking the NOL into account.

See, e.g., Colo. Rev. Stat. § 39-22-504(1). Colorado does not allow an NOL to be carried to a year in which a different apportionment method is used from that used in the year in which the loss was sustained. Colo. Rev. Stat. § 39-22-504(5). The Department of Revenue will allow a NOL sustained in a two-factor year to be carried forward to any other two-factor year in the carryforward period regardless of the number of intervening years. Letter of September 17, 1988, cited in CCH Colorado Tax Reporter at ¶ 10-440.55.

(2) Some states limit NOL carryforwards to losses actually sustained in the state.

See, e.g., Sesek & Associates v. Arizona Department of Revenue, 2004 Ariz. Tax LEXIS 9 (Ariz. Bd. of Tax App. 2004); Miss. Regs. § 506.

(3) Some states require the corporation to have been a taxpayer in the state for the year in which the loss was sustained.

See, e.g., Ga. Code Ann. § 48-7-21(b)(3); Idaho Code Ann. § 63-3022(c)(2); 48-030-001 Miss. Code R. § 506 (loss must have been reported on a return);

Mo. Code Regs. Ann. tit. 12, § 10-2.165(3) (declared invalid in Cooper Industries Inc. v. Director of Revenue, which held that it had no statutory basis (Admin. Hearing Comm. 2000)), CCH Missouri State Tax Reporter ¶ 202-355); R.I. Gen. Laws § 44-11-11(b); Wis. Stat. § 71.26(4).

b. Some states place a percentage or dollar limit on carryforwards or carrybacks.

(1) New Hampshire limits the amount of net operating loss that may be generated and then carried forward to $1,000,000. N.H. Rev. Stat. Ann. § 77-A:4(XIII).

(2) Some states limit carrybacks or refunds from carrybacks.

See, e.g., Idaho Code Ann. § 63-3022(c)(1) (maximum of $100,000 from any taxable year); N.Y. Tax Law § 208. (9)(f)(5) (maximum of $10,000 from any taxable year).

(3) Colorado limits the NOL deduction in any year to $250,000 (applicable to years starting after 2010 and before 2014). H.B. 1199.

c. In recent years, some states have restricted the use of net operating loss carryovers in order to raise revenue. See, e.g., Cal. Rev. & Tax Code § 24416.3 (no losses allowed for the 2002 and 2003 tax years); 72 Pa. Cons. Stat. § 7401(3)(4) (repeal of use of carryovers for years starting after 1990; NOLs restored beginning in 1995, but now only to the extent of $2,000,000 per year).

d. An argument can be made that an NOL that is used in a year for federal tax purposes should not be reduced in that year for state tax purposes if it produces no state tax benefit because the corporation pays tax in that year on a base other than net income (such as capital). See, TD Holdings II Inc., N.Y.S. Div. Tax App., ALJ Div., DTA No. 825329 (2015). See Peter L. Faber, "Logic v. the Statute: When Federal Conformity Makes no Sense," State Tax Notes, March 16, 2015.

B. State rules governing NOLs in acquisitions.

1. Transfer of NOL carryforwards in acquisitions (federal provision: I.R.C. § 381).

a. Some states allow the transfer of NOLs in the same manner as under § 381 of the Internal Revenue Code.

(1) Some statutes expressly adopt § 381.

See, e.g., Ala. Code § 40-18-35.1(6); Cal. Rev. & Tax Code § 24471 (as modified); 35 Ill. Comp .Stat. § 5/405(a); Minn. Stat. § 290.095(3)(d); Wis. Stat. § 71.26(3)(n) (as modified).

(2) Some states adopt § 381 because of a failure to vary from federal law.

See, e.g., Delaware, Kansas, New York; see analysis in Virginia Rulings P.D. 96-38, CCH Virginia State Tax Reporter ¶ 202-922 (1996), and P.D. 97-193, CCH Virginia State Tax Reporter ¶ 203-446 (1997)

(3) Idaho allows NOLs to move to the acquiring corporation in a merger but not in a section 368(a)(1)(C) reorganization or a section 332 liquidation of a subsidiary not accomplished by a merger. Id. Code §63-3021(c).

(4) Even if a state allows the transfer of NOLs under §381, the computational proration rule of §381(c) may not apply. <u>Illinois General Information Letter</u> IT-09-0032-GIL (2009).

b. Some states limit the circumstances in which T's losses can pass to P.

(1) Continuity of business.

(a) Several states have no provision for the passage of NOLs from one corporation to another in a merger. Litigation in those states has focused on the question of whether the surviving corporation is the same "taxpayer" as the merged corporation. They have often cited federal cases that addressed the same issue under the law that preceded the enactment of section 381. See, e.g., Libson Shops, Inc. v. Koehler, 353 U.S. 382. reh. denied, 354 U.S. 943 (1957), and other cases that generally established the principle that pre-merger losses could be carried over only to offset post-merger income that was generated by the same assets. See, Faber, "State Tax Treatment of Net Operating Loss Carryovers in Corporate Acquisitions," The Tax Executive (July/August 1996).

(b) In Arizona, there is no statutory provision but case law holds that T's NOLs can be used after a merger of T into P only to the extent of P's post-merger income from the old T business that sustained the losses. Oliver's Laundry & Dry Cleaning Co. v. Arizona State Tax Commission, 19 Ariz. App. 442, 508 P.2d 107 (1973); Case No. 200600161-C (Ariz. Dept of Revenue Hearing Officer Decision 2007). NOL carryovers in a combined report must be calculated on a combined group basis. Dial Industries Inc. v. Department of Revenue, 1995 Ariz. Tax LEXIS 31 (1995), CCH Arizona State Tax Reporter ¶400-217.

(c) North Carolina.

(i) The North Carolina Department of Revenue took the position that T's NOLs are destroyed unless surviving P is substantially the same corporation as pre-merger T. The statute provides that pre-merger losses can be used only against post-merger profits produced by the assets that generated the losses. 17 N.C. Admin. Code § 5C.1507. In one case, T's losses could not be used after a merger of T into P where P after the merger was much larger and had more extensive businesses than T before the merger. Good Will Distributors (Northern), Inc. v. Shaw, 247 N.C. 157, 100 S.E.2d 334 (1957). The Corporate Income and Franchise Tax Division interpreted this case restrictively and allowed T's loss to pass to P in a merger only if P was an empty shell before the merger. Letter of November 9, 1964, cited at CCH North Carolina State Tax Reporter at ¶ 10-320.51. In another case, T's losses could not be used by P after a merger when T's old business continued to produce losses. Fieldcrest Mills, Inc. v. Coble, 290 N.C. 586, 227 S.E.2d 562 (1976). On the other hand, a corporation (apparently a new "shell" corporation) into which three corporations were merged was allowed to use the merged corporations' pre-merger NOLs where one person owned all of the stock of all of the corporations and the survivor continued the businesses of the merged corporations. Benton Woods, Inc. (Tax Rev. Bd. 1993), CCH North Carolina State Tax Reporter ¶ 201-771. The Department of Revenue does not acquiesce. Id. ¶ 201-772. A more generous approach was followed in Bellsouth Telecommunications, Inc, v. N.C. Department of Revenue, 95-CVS-1982 (Mecklenburg County Superior Court 1996), CCH North Carolina State Tax Reporter ¶ 201-912, in which P was allowed to apply T's pre-merger NOLs against P's post-merger income even though it failed to show that T's assets generated a profit after the merger. The court noted that P had been forced to create T by an FCC ruling; but for this it would have conducted T's operations, and sustained its losses, directly. The North Carolina Court of Appeals reversed, holding that the taxpayer had

failed to show a continuity of business, citing Fieldcrest. 126 N.C.App. 409, 485 S.E.2d 333 (1997), CCH North Carolina State Tax Reporter ¶ 201-952.

(ii) The Department has now announced that it will take a more liberal approach, indicating that it will allow pre-merger losses of T to be applied against post-merger profits of P to the extent that the group of assets that generated the loss generate profits after the merger, Amendment to Department's position on NOL carryovers, http://www.dor.state.nc.us/taxes/corporate/loss.html (February 22, 2001).

(d) The Connecticut courts have shown some flexibility.

(i) The general rule is that NOLs of the merged corporation do not survive a merger. Golf Digest/Tennis, Inc. v. Dubno, 203 Conn. 455, 525 A.2d 106 (1987).

(ii) But in Thermatool Corporation v. Department of Revenue Services, 43 Conn. Sup. 260, 651 A.2d 763 (1994), the court held that, although T's NOLs could not be used by P after a merger, they could be used by a new corporation to which P later transferred the old T business and the stock of which it distributed to P's shareholder because there was a continuity of business.

(iii) In Grade A Market Inc. v. Commissioner of Revenue Services, 44 Conn. Sup. 377, 688 A.2d 1364 (1996), CCH Connecticut State Tax Reporter ¶ 400-140, the pre-merger NOLs of two corporations were allowed to be used against the post-merger income of a third corporation into which they were merged when the three corporations were effectively operated as one before the merger, with common employees and functions. It was unclear whether the post-merger income was generated by the same assets that had generated the NOLs.

(iv) The Department of Revenue has applied continuity of business principles in allowing a parent corporation's NOLs to pass to a newly-organized "shell" subsidiary into which the parent merged where the following factors were present:

(A) the merger was a statutory merger that qualified as a reorganization under I.R.C. § 368(a)(1)(F);

(B) the ownership of the subsidiary after the merger was the same as that of the parent before it;

(C) the primary purpose of the merger was not tax avoidance;

(D) the subsidiary continued the parent's business after the merger;

(E) the parent's old business was operated by the subsidiary as a separate division or its assets were separately accounted for; and

(F) the only income against which the parent's NOLs were applied after the merger was generated by the parent's old business. Ltr. Rul. No. 97-3, CCH Connecticut State Tax Reporter ¶ 360-535.

(v) In Cunningham Group, Inc. v. Commissioner of the Department of Revenue Service (Superior Court, 1997), CCH Connecticut State Tax Reporter ¶ 400-256, NOLs of the merged corporation were allowed to be used against post-merger income of the surviving corporation where the business that generated losses was continued, even though there was no showing that it generated income after the merger.

(e) A Tennessee appellate court has denied the use of pre-merger NOLs against post-merger income of the acquired assets that had generated the losses. Little Six Corporation v. Johnson (Tenn. Ct. App., 1999), CCH Tennessee State Tax Reporter ¶ 400-669. This result has now become codified. Tenn. Code Ann. § 67-4-2006(c)(2). The Tennessee Department of Revenue has ruled that the NOL is extinguished in a tax-free liquidation or merger of a subsidiary into its parent corporation even if the corporations were engaged in a unitary business Ruling No. 07-14 (2007).

(f) A reincorporation into another state was held to result in a loss of pre-merger NOLs in Caterpillar Inc. v. Department of Revenue CCH Wisconsin State Tax Reporter ¶ 400-416 (Wis. Tax App. Comm. 1999) (involving pre-1987 year-Legislature adopted § 381 for later years); Cf McDermott Will & Emery, TSB-A-07(1)C (N.Y.S. Dept of Tax. And Fin. Advisory Opinion 2007) (grandfathered Article 9-A status lost when corporation reincorporated in another state).

(g) The NOLs of a defunct corporation were not allowed to pass to its parent in Appeal of Realprom Holding Corp. (CA SBE 1999) in a merger that the Board viewed as coming within I.R.C. § 332 because of a lack of business purpose and continuity of business enterprise. The Board cited U.S. Treasury Regs. § 1.368-1(d). California has incorporated I.R.C. § 381 by reference.

(h) NOLs may disappear in a merger of different kinds of corporations. The NOLs of a regular business corporation did not pass to a bank in Colonial BancGroup v. Alabama Department of Revenue (Ala. ALJ Division, January 5, 2001).

(2) Common ownership.

See, e.g., Ark. Code Ann. § 26-51-427(3), allowing the transfer of T's NOLs if P acquires T's assets but only if T and P had common ownership of at least 80% and only to the extent of P's post-acquisition income from the old T assets. (The statute literally applies to taxable asset purchases. It does not indicate what proportion of T's assets must be acquired by P.)

(3) Ohio law provides that T's NOLs survive a merger into P only if T was an Ohio taxpayer when the losses were sustained. Litton Industrial Products, Inc. v. Limbach, BTA No. 87-G-187 (1990), CCH Ohio State Tax Reporter ¶ 400-506.

c. In some states T's NOLs disappear in a merger into P.

(1) Mont. Admin. R. 42.23.415; N.J. Admin. Code. § 18:7-5.13(b) expressly provide that there is no exception for a mere change in state of incorporation; the Regulation was upheld and T's NOLs were not allowed to pass to P in a merger in A.H. Robins Co., Inc. v. Director, Division of Taxation, 365 N.J. Super. 472, 839 A.2d 914 (2004), aff'd per curiam, 2004 N.J. LEXIS 1404 (N.J. Sup.Ct. 2004), and Richard's Auto City, Inc. v. Director, Division of Taxation, 140 N.J. 523, 659 A.2d 1360 (1995), CCH New Jersey State Tax Reporter ¶ 400-378, rev'g 270 N.J. Super. 92 (App. Div. 1994); AT&T Corp. v. Johnson, 2004 Tenn. App. LEXIS 214 (Tenn. Ct. App. 2004) (no discussion of continuity of business), appeal denied (Tenn. Sup. Ct. 2004); Tennessee (Rule § 1320-6-1-.21(2)(d)); Texas, Ruling of Comptroller of Public Accounts, Microfiche No. 9406L1315B04 (1994); Texas,

Comptroller of Public Accounts hearings Nos. 36,030 (1996), 37,978 (2000); 34 Texas Administrative Code § 3.555(g)(3); Sergent Enterprises, Inc. v. Strayhorn (Tex. Ct. App. 3d Dist., Austin 2003); (codified by S.B. 1689, amending Tax Code § 171.110(e), signed by the Governor on June 15, 2001); Utah (Code Ann. § 59-7-110(5)(a); NOLs do pass to P in a merger that effects a mere change in state of incorporation).

(2) Massachusetts generally follows the same approach Regs. § 63.30.2(11)(a); Macy's East, Inc. v. Commissioner, 441 Mass. 797, 808 N.E.2d 1244 (2004), cert. den., 125 S.Ct. 454 (2004) (an "F" reorganization, no discussion of continuity of business). But NOLs will survive if the merger qualifies as a mere change in form under I.R.C. § 368(a)(1)(F). Letter Ruling 95-4, CCH Massachusetts State Tax Reporter ¶ 400-209.

(3) Some state statutes prohibit a transfer of NOLs from one corporation to another. New Jersey (N.J. Stat. Ann. . §54:10A-4.5); Texas (Tex. Code Ann. §171.110(e)); Tennessee (Tenn. Code Ann. §67-4-2006(c)(2)).

(4) In an apparent misapplication of federal law, the Idaho Tax Commission ruled that the NOLs of a wholly-owned subsidiary did not pass to the parent when the subsidiary merged into the parent because the subsidiary's business was discontinued after the merger, citing section 382 of the Internal Revenue Code. Docket No. 25749. The stated reasoning is wrong. Section 382 does not apply to a merger of a subsidiary into a parent because of the constructive ownership rules. Moreover, section 382 does not prevent an NOL from moving to the surviving corporation in a merger, it merely limits its use by the surviving corporation after the merger.

2. Curtailment of NOLs because of a change in stock ownership (federal provision: I.R.C. § 382).

a. Some states apply the § 382 limitations in the same manner as under the Internal Revenue Code.

(1) Some statutes expressly adopt § 382.

See, e.g., Ala. Code § 40-18-35.1(6); Ore. Rev. Stat. § 317.478; Wis. Stat. § 71.26(3)(n).

(2) Some states adopt § 382 because of a failure to vary from federal law.

See, e.g., California, Delaware, Kansas, New York.

(3) Illinois expressly rejects § 382 in cases of acquisitions subject to § 381 but, apparently, not in other acquisitions. 35 Ill. Comp .Stat. §§ 5/405(a), (b-5).

b. Some states have no provision comparable to § 382 and reject the concept.

See, e.g., Ruling 93-23 (Connecticut Department of Revenue Services 1993), CCH Connecticut State Tax Reporter ¶ 360-489.

c. New Jersey has its own rules limiting the use of NOLs when there is a change in stock ownership.

(1) New Jersey's statute is similar to I.R.C. § 382 before amendment by the Tax Reform Act of 1986. N.J. Stat. Ann. § 54:10A-4(k)(6)(D).

(2) T's NOLs are destroyed if:

(a) There is a 50% or more ownership change (N.J. Admin. Code. § 18:7-5.14(a) indicates that this refers to cumulative changes since June 30, 1984); and

(b) The corporation changes the business giving rise to the loss. (N.J. Admin. Code. § 18:7-5.14(c) indicates that a change does not occur even if all of the old product lines are replaced by new product lines, the corporation's name changes, and new employees are hired.)

(3) T's NOLs are also destroyed if there is a 50% or more ownership change and P's primary purpose in making the acquisition was to get the benefit of T's NOLs (similar to I.R.C. § 269).

(4) The New Jersey Division of Taxation holds that T's NOLs cannot be used by P after T merges into P because there is no provision in the statute for a transfer of the NOLs from T to P. Regs. § 18:7-5.13(b). This position was upheld in <u>Richard's Auto City, Inc. v. Director, Division of Taxation</u>, 140 N.J. 523, 659 A.2d 1360 (1995), CCH New Jersey State Tax Reporter ¶400-378, <u>rev'g</u> 270 N.J. Super. 92 (App. Div. 1994).

d. The allocation of §382 limits among related corporations is unclear when some members of a federal consolidated return group file separate state returns.

3. Use of NOLs in a consolidated or combined return after an acquisition.

a. The states generally do not limit the use of NOLs, although general limitations on the use of out-of-state losses apply.

b. New York applies the SRLY concept. Regs. § 3-8.7(a). See also Alabama Department of Revenue Proposed Rule § 810-3-35.1-.03. But SRLY rules were held inapplicable when the corporations were affiliated but filed separate returns when the losses were sustained. <u>Weyerhaeuser USA v. Ala. Dep't of Revenue</u>, Ala. Dep't of Revenue, Administrative Law Judge Division, Docket No. Corp. 04-511 (2005).

c. South Carolina expressly rejects the use of SRLY concepts. TAM # 89-22(1989), CCH South Carolina State Tax Reporter ¶ 200-377 (basing its holding on a policy of conforming to federal rules but not referring to the SRLY rules in the federal consolidated return regulations).

d. An attempt by the Florida Department of Revenue to apply SRLY principles was contrary to the statute and invalid. <u>Golden West Financial Corp. v. Florida Department of Revenue</u> (FL D. Ct. of App. 2008).

e. Arizona's Department of Revenue limits the use of a loss on a combined return to the income of the business that produced the loss. Corporate Tax Ruling No. CTR

91-2 (April 2, 1991), CCH Arizona State Tax Reporter ¶ 201-004.

f. The Utah State Tax Commission unsuccessfully attempted to prevent an acquired subsidiary from deducting its own losses against its own income on the buyer's consolidated return. Savage Industries, Inc. v. Utah State Tax Commission, 160 Utah Adv. Rep. 5, 811 P.2d 664 (Utah 1991).

g. In New York, the NOL deduction cannot exceed the federal NOL deduction. Tax Law ¶ 208.9(f)(3). If a corporation's federal NOL is applied against the income of other corporations with which it files a federal consolidated return, it will not be available to be carried forward for New York purposes, even if the corporation filed a separate New York return for that year and the related corporations were not New York taxpayers for that year. See, Royal Indemnity Co. v. Tax Appeals Tribunal, 75 N.Y. 2d 75, 550 N.Y.S. 2d 610 (1989) (NOLs carried back and exhausted for federal purposes could not be carried forward for New York State purposes even though corporation was not a New York taxpayer during the carryback years).

h. In Massachusetts, NOLs can be applied only against the income of the corporation that sustained them. Carryforwards cannot be applied against the income of other corporations in the combined report group, even though the corporations were affiliated when the losses were sustained. Farrell Enterprises, Inc. v. Commissioner of Revenue (Mass. Ct. App. 1999), CCH Massachusetts State Tax Reporter ¶ 400-538; 830 CMR § 63:32B.1(9)(a).

4. The Oregon Tax Court has held that the NOL of a parent corporation spinning off a subsidiary for the year of the spin-off can be used by the subsidiary only to the extent of a pro rata portion based on the number of days in the year before the spin-off (when the corporations had a unitary relationship). US West Inc. v. Dep't of Rev. (2011).

NOTES