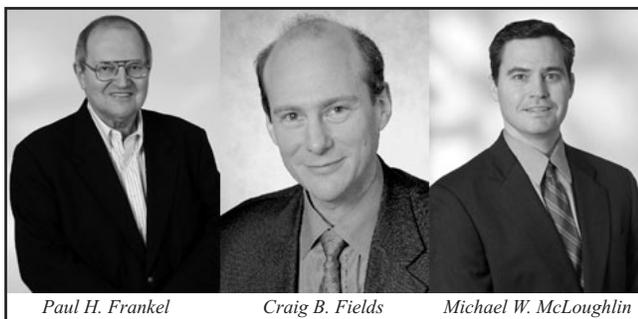


Missouri Supreme Court Holds Gain From Deemed Asset Sale Under IRC Section 338(h)(10) Is Nonbusiness Income

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The Missouri Supreme Court has upheld a decision of the Administrative Hearing Commission that the gain from a deemed asset sale under Internal Revenue Code section 338(h)(10) generated nonbusiness income that was not taxable in Missouri. The court held that the transaction constituted a liquidation that was not part of the taxpayer's ordinary business and thus did not produce business income under either the "functional" or "transactional" tests for determining business income (*ABB C-E Nuclear Power, Inc. v. Director of Revenue*, Case No. SC 87811 (Mo. Jan. 30, 2007)).

The Deemed Asset Sale

ABB C-E Nuclear Power Inc. was engaged in the nuclear energy business in several states, including Missouri. Its principal place of business and commercial domicile was in Windsor, Conn. On April 28, 2000, ABB C-E Nuclear's then-parent corporation, Asea Brown Boveri Inc., sold all of ABB C-E Nuclear's stock to a third party. Although the actual transaction involved the sale of ABB C-E Nuclear's stock, an election was made for federal income tax purposes under IRC section 338(h)(10) to treat the stock sale as a deemed asset sale.

Under that election, the transaction was treated as the sale of all of "old ABB C-E Nuclear's" assets to "new ABB C-E Nuclear," followed by the deemed liquidation of old ABB C-E Nuclear and the subse-

quent deemed distribution of the deemed sales proceeds to old ABB C-E Nuclear's parent corporation. Any gain realized by Asea Brown Boveri on the sale of ABB C-E Nuclear's stock was disregarded for federal income tax purposes and, instead, a gain from the deemed sale of all of ABB C-E Nuclear's assets to the unrelated party was reflected in the federal tax return.

As part of the IRC section 338(h)(10) election, new ABB C-E Nuclear is treated for federal tax purposes as a new corporation with a new owner and with none of its previous tax history. It is treated for federal income tax purposes as if the buyer had formed a new corporation and that corporation purchased all of the assets of old ABB C-E Nuclear.

On its separate Missouri corporation income tax return for its year that ended April 28, 2000, ABB C-E Nuclear reported the gain from the deemed sale of all of its assets under IRC section 338(h)(10) as nonbusiness income, and therefore, not subject to Missouri tax (the deemed sale of the assets that were located in Missouri did not result in any gain). The Missouri director of revenue disallowed the characterization of the gain from the deemed asset sale as nonbusiness income subject to allocation and recharacterized the gain as business income subject to apportionment.

Missouri Apportionment Provisions

A corporation that does business both within and without Missouri has two alternatives for the allocation and apportionment to Missouri of a percentage of the corporation's total income. The taxpayer has the option under R.S. Mo. section 143.451.2 to use a single-factor formula based on the company's sales or, alternatively, to allocate and apportion its income using the Multistate Tax Compact formula under R.S. Mo. section 32.200, et seq. ABB C-E Nuclear chose the Multistate Tax Compact formula to allocate and apportion its income.

The Multistate Tax Compact draws a distinction between apportionable and nonapportionable (or allocable) income. Specifically, the compact provides that a multistate corporation's net taxable income is divided into two classes: (1) business income, which is apportioned among the states according to a three-factor formula of property, payroll, and sales; and (2) nonbusiness income, which is allocated to the state most closely associated with the generation of the income (generally the commercial domicile of the taxpayer). R.S. Mo. section 32.200, Article IV.

R.S. Mo. section 32.200, Article IV.1(1) defines business income as follows:

“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 the acquisition, management, *and* disposition of the property constitute integral parts of *the taxpayer's regular trade or business operations*.

(Emphasis added.)

In contrast, nonbusiness income is defined as “all income other than business income” (R.S. Mo. section 32.200, Article IV.1(5)).

There is some disagreement among the states that adopt similar definitions of business income about whether the definition contains one or two tests. Some courts have held that the definition contains both a “transactional” test and a “functional” test. See, for example, *Blessing/White, Inc. v. Zehnder*, 768 N.E.2d 332 (Ill. App. Ct. 2002), and *Lenox, Inc. v. Tolson*, 548 S.E.2d 513, 516 (N.C. 2001). However, others have held that there is only a transactional test. See, for example, *Ex Parte Uniroyal Tire Co.*, 779 So.2d 227 (Ala. 2000). (For the Illinois Appeals Court's decision in *Blessing/White*, see *Doc 2002-9071* or *2002 STT 74-13*; for the North Carolina Supreme Court's decision in *Lenox*, see *Doc 2001-19945* or *2001 STT 143-19*; for the Alabama Supreme Court's decision in *Uniroyal*, see *Doc 2000-21049* or *2000 STT 156-2*.)

A gain is classified as business income under the transactional test if it is derived from a transaction in which the taxpayer regularly engages. Therefore, income arising from extraordinary or unusual events will *not* give rise to business income under the transactional test. Under the functional test, income constitutes business income only “if the acquisition, management, *and disposition* of the property *constitute integral parts of the taxpayer's regular trade or business operations*” (emphasis added).

The Missouri Supreme Court's Decision

In addressing the business income definition, the Missouri Supreme Court first stated that “other jurisdictions have derived from the definition of ‘business income’ a two-part test.” The Missouri

courts had not previously addressed whether the definition contained one or two tests. The court determined that the gain from the deemed asset sale did not “constitute business income under either test.”

The court found that the “sale of [ABB C-E Nuclear's] assets in complete liquidation [was] not a type of business in which [ABB C-E Nuclear] regularly engaged” and that it was not “a disposition of the sort that constituted an integral part of the [company's] ordinary business.” Instead, the court found that the sale was a “one-time, extraordinary event.”

The court's determination that the deemed asset sale generated nonbusiness income is a correct result based on Missouri law.

The court's determination that the deemed asset sale generated nonbusiness income is a correct result based on Missouri law and is consistent with decisions regarding similar transactions, and business income definitions, in other states. See, for example, *American States Ins. Co. v. Hamer*, 816 N.E.2d 659 (Ill. App. Ct. 2004), *appeal denied*, 829 N.E.2d 786 (Ill. 2005); *Canteen Corp. v. Pennsylvania*, 854 A.2d 440 (Pa. 2004), *aff'g* 818 A.2d 594 (Pa. Commw. 2003); *Osram Sylvania, Inc. v. Pennsylvania*, 863 A.2d 1140 (Pa. 2004), *aff'g* No. 310 F&R 1998 (Pa. Commw. Mar. 6, 2003). ABB C-E Nuclear was not in the business of selling all of its assets and then liquidating and distributing all of the sales proceeds to its parent corporation (which is what is deemed to have occurred under IRC section 338(h)(10)). Thus, the transaction should not produce business income. (For the Illinois Appeals Court's decision in *American States*, see *Doc 2004-17964* or *2004 STT 177-15*; for the Pennsylvania Supreme Court's decision in *Canteen*, see *Doc 2004-16180* or *2004 STT 155-25*.)

Other States' Decisions

The Pennsylvania Supreme Court affirmed decisions of the Pennsylvania Commonwealth Court that held that the gain from a deemed sale of assets from an IRC section 338(h)(10) election constituted nonbusiness income under a statute identical to the one adopted by Missouri.¹ *Canteen Corp. v. Pennsylvania*, 854 A.2d 440 (Pa. 2004), *aff'g* 818 A.2d 594

¹ Pennsylvania has subsequently amended its definition of business income to state that the income from the acquisition, management, *or* disposition of tangible or intangible property produces business income. The law also now states that

(Footnote continued on next page.)

(Pa. Commw. 2003); *Osram Sylvania, Inc. v. Pennsylvania*, 863 A.2d 1140 (Pa. 2004), *aff'g* No. 310 F&R 1998 (Pa. Commw. Mar. 6, 2003).

In determining that the gain constituted nonbusiness income, the commonwealth court, *en banc*, found that:

The panel misapplied *Laurel Pipe Line* to reach a result that is inconsistent with the definition of "business income" in our corporate income tax statute and that ignores the Section 338(h)(10) election while still employing the fiction such an election creates to tax the fictional income. *If we ignore the fiction arising under the Section 338(h)(10) election, Canteen has no gain from the transaction and, if we embrace the election, Canteen is deemed to have sold all of its assets in a complete liquidation, which results in non-business income.*

Canteen Corp., 818 A.2d at 599 (emphasis added).

In *Laurel Pipe Line*, the Pennsylvania Supreme Court made clear that the gain resulting from the sale of a corporation's assets in liquidation of the corporation's business constitutes nonbusiness income even though the assets that were sold may have generated business income before the sale. *Laurel Pipe Line*, 642 A.2d at 475 ("[T]he effect of the sale was that the company liquidated a portion of its assets. This is evidenced by the fact that the proceeds of the sale were not reinvested back into the operations of the business, but were distributed entirely to the stockholders of the corporation."). (For the Pennsylvania Supreme Court's decision in *Laurel Pipe Line*, see 94 STN 107-27.)

The gain from an IRC section 338(h)(10) transaction should not generate apportionable business income.

In *American States Insurance Co. v. Hamer*, 816 N.E.2d 659, 664 (Ill. App. Ct. 2004), *appeal denied*,

business income includes all income that can be constitutionally apportioned. Bill 334, 2001 Pa. Law 23.

829 N.E.2d 786 (Ill. 2005), the issue was whether the gain from a deemed sale of assets from an IRC section 338(h)(10) election constituted business income under the functional test (the Illinois Department of Revenue did not claim that the gain constituted business income under the transactional test). In affirming the trial court's finding that the gain constituted nonbusiness income under a statute that is virtually identical to the statute adopted by Missouri, the court stated:

In sum, the trial court correctly applied the applicable case law. Moreover, the applicable case law is in accord with the growing consensus of opinion on the issue. The transaction at issue must be treated legally as a complete liquidation and cessation of business by the "old" American States . . .

816 N.E.2d at 667-68.

Conclusion

Regardless of whether a state that adopts a similar business income definition elects to follow the transactional test only, or both the transactional and functional tests, the gain from an IRC section 338(h)(10) transaction should not generate apportionable business income. If the federal income tax deemed asset sale treatment of the transaction controls the outcome (that is, the transaction is viewed as a deemed sale of all of the subsidiary's assets followed by the deemed distribution of the sales proceeds to the parent in a complete liquidation), the resulting gain does not constitute business income under the transactional test because the deemed sale of all of the subsidiary's assets was not a transaction in the "regular course" of its business, and it does not constitute business income under the functional test because it arises from the complete liquidation of an entire business. Consequently, the gain constitutes nonbusiness income under the standard business income definition. ☆

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