Stephen Moore, Research Analyst, Revenue Committee, Nebraska Legislature (12092011).

LR 223 (2011) Revenue Committee Report: Examine Issues Pertaining to Nebraska's Special Capital Gains Income Tax Deduction, the Extraordinary Dividend Income Tax Deduction, Codification of the Economic Substance Doctrine, and Transactions Governed by Internal Revenue Code section 338

Table of Contents **Page**

I. Purpose of LR 223: "The purpose of this resolution is to examine issues pertaining to Nebraska's special capital gains income tax deduction and the extraordinary dividend income tax deduction, examine issues pertaining to codification of the economic substance doctrine, and examine issues pertaining to transactions governed by section 338 of the Internal Revenue Code of 1986, as amended, including, but not limited to, the following issues: (1) Whether the special capital gains income tax deduction and the extraordinary dividend income tax deduction authorized by sections 77-2715.08 and 77-2715.09 should be changed or eliminated; (2) Whether the economic substance doctrine as codified in section 7701(o) of the Internal Revenue Code of 1986, as amended by the Health Care and Education Reconciliation Act of 2010 (Public Law 111-152) should be codified in Nebraska's statutes for purposes of state income taxation; and (3) Whether the Department of Revenue has encountered problems with transactions governed by section 338 of the Internal Revenue Code of 1986, as amended."

II. Examine Whether the Special Capital Gains Income Tax Deduction and the Extraordinary Dividend Income Tax Deduction Authorized by Neb. Rev. Stat. §§ 77-2715.08 and 77-2715.09 Should Be Changed or Eliminated.

The following material might help readers decide whether the Legislature should change or eliminate the special capital gains deduction and the extraordinary dividends deduction (e.g., change it by reducing the amount of the special capital gains deduction from 100 percent to 50 percent of the qualified capital gain).

A. What Are the Special Capital Gains and Extraordinary Dividend Income Tax Deductions?

The rule governing the special capital gains income tax deduction and the extraordinary dividend income tax deduction is set forth in Neb. Rev. Stat. § 77-2715.09, which provides as follows:

> "(1) Every ***resident*** individual may ***elect*** under this section to subtract from federal adjusted gross income, or for trusts qualifying under subdivision (2)(c) of this section from taxable income, the ***extraordinary dividends*** paid on ***and*** the ***capital gain*** from the sale or exchange of capital stock of ***a*** corporation acquired by the individual (a) on account of employment by such corporation or (b) while employed by such corporation.
>
> (2)(a) Each individual shall be entitled to ***one election*** under subsection (1) of this section ***during his or her lifetime*** for the capital stock of ***one corporation***.
>
> (b) ***The election shall apply to subsequent extraordinary dividends*** paid ***and sales and exchanges*** in any taxable year ***if*** the ***dividend*** is received on, ***or*** the ***sale or exchange*** is of, capital stock in the ***same corporation and*** such ***capital stock was acquired as provided in subsection (1)*** of this section.
>
> (c) After the individual makes an election, such election shall apply to extraordinary dividends paid on, and the sale or exchange of, capital stock of the corporation transferred by inter vivos gift from the individual to his or her spouse or issue or a trust for the benefit of the individual's spouse or issue if such capital stock was acquired as provided in subsection (1) of this section. This

subdivision shall apply, in the case of the spouse, only if the spouse was married to such individual on the date of the extraordinary dividend or sale or exchange or the date of death of the individual.

(d) If the individual dies without making an election, the surviving spouse or, if there is no surviving spouse, the oldest surviving issue may make the election for capital stock that would have qualified under subdivision (c) of this subsection.

(3) ***An election under subsection (1) of this section shall be made by including a written statement with the taxpayer's Nebraska income tax return or an amended return for the taxable year for which the election is made.*** The written statement shall identify ***the corporation*** that issued the stock and the grounds for the election under this section and shall state that the taxpayer elects to have this section apply."[1]

For purposes of the special capital gains income tax deduction and the extraordinary dividend income tax deduction, the Neb. Rev. Stat. § 77-2715.08 defines the terms "capital stock", "corporation", "extraordinary dividend", and "predecessor or successor corporation" as follows:

- "***Capital stock means*** common or preferred stock, either voting or nonvoting. Capital stock does not include stock rights, stock warrants, stock options, or debt securities".[2]

- "(a) ***Corporation means*** any corporation which, at the time of the first sale or exchange for which the election is made, has been in existence and actively doing business in this state for at least three years.

  (b) ***Corporation also includes:*** (i) Any corporation which is a member of a unitary group of corporations, as defined in section 77-2734.04, which includes a corporation defined in subdivision (2)(a) of this section; and (ii) Any predecessor or successor corporation of a corporation defined in subdivision (2)(a) of this section.

  (c) All corporations issuing capital stock for which an election under section 77-2715.09 is made shall, at the time of the first sale or exchange for which the election is made, have (i) at least five shareholders and (ii) at least two shareholders or groups of shareholders who are not related to each other and each of which owns at least ten percent of the capital stock.

  For purposes of this subdivision, two persons shall be considered to be related when, under section 318 of the Internal Revenue Code of 1986, one is a person who owns, directly or indirectly, capital stock that if directly owned would be attributed to the other person or is the brother, sister, aunt, uncle, cousin, niece, or nephew of the other person who owns capital stock either directly or indirectly."[3]

- "***Extraordinary dividend means*** any dividend exceeding twenty percent of the fair market value of the stock on which it is paid as of the date the dividend is declared".[4]

1 Neb. Rev. Stat. § 77-2715.09, as originally enacted by Laws 1987, LB 775, § 11, and as amended by Laws 1991, LB 773, § 11, and Laws 2007, LB 343, § 4.

2 Neb. Rev. Stat. § 77-2715.08(1)(emphasis added).

3 Neb. Rev. Stat. § 77-2715.08(2)(emphasis added).

4 Neb. Rev. Stat. § 77-2715.08(3)(emphasis added).

- "***Predecessor or successor corporation means*** a corporation that was a party to a reorganization that was entirely or substantially tax free and that occurred during or after the employment of the individual making an election under section 77-2715.09."[5]

B. Origin of the Special Capital Gains Income Tax Deduction

Laws 1987, LB 775, § 12, created the special capital gains income tax deduction. LB 775 also established Nebraska's first large-scale business tax incentives program.

During initial floor debate concerning LB 775 on April 22, 1987, the bill's special capital gains income tax deduction was one of the first components of LB 775 explained and the rational for it laid out by then-Senator Vard Johnson who was chairperson of the Revenue Committee at that time and who explained the special capital gains income tax deduction in the proposed Revenue Committee amendment to LB 775 (which rewrote the bill) as follows:

> "SENATOR V. JOHNSON: . . . It's a big powerful bill in terms of what it does for heavy industry in our state. Now there is a provision in here on capital gains. You're going to hear about that today. Senator Nelson has got an amendment to eliminate this provision and it will be discussed at some length. The Lincoln Journal has already spotted it and decried it and thought it was terribly unfair and so on and so forth. The bill says that if you received stock in a company for which you work, either as compensation for your work or because you're an employee of the company, and if at one time in your lifetime you decide to sell that stock, and you have some profit or gain on that stock, then that gain does not have to be included in your income. Then you may say, and this is a fairly narrow provisions, you may say well how come that is in this bill? That is in this bill because there are a number of businesses in our state that have rewarded employees through stock grants. They have given them stock or sold them cheap stock or given them the opportunity to buy stock when nobody else had the opportunity and over a long period of time those employees, that stock ownership has become extraordinarily valuable to those employees. And so what those employees do when they decide to retire from the company, they move away from Nebraska. They go to Florida or they go to Wyoming where there is no taxation whatsoever on the liquidation of the stock and they move away, and then they sell the stock because they are now a resident of some other state, there is no tax paid on the sale of the stock and they have gone from Nebraska and so, too, has their economic portfolio gone from Nebraska. And if you want to know how true this really is, it is my understanding that within the past one year a major Omaha corporation literally relocated four of its employees to Boca Raton, Florida, for the sole purpose of allowing those employees to establish residence in Florida so that they could sell their stock in the corporation without having to pay a tax on the sale of their stock. . . . . In any event, we provide simply under very limited circumstances, people will not have to pay a state income tax which they wouldn't pay in any event because they would be doing the transaction in some other state., we provide an exemption. Now, . . . what some of the costs are. . . . what you will discover is that these are figures given to us by the Department of Revenue. The Department of Revenue says we expect the bill to generate so much in new jobs, to generate so much in new investment. We have some sense as tp what the employee profiles will look like and we will give you some ranges of either gains or losses. . . ."[6]

---

5 Neb. Rev. Stat. § 77-2715.08(4)(emphasis added).

6 Official transcript of floor debate on LB 775, pp. 3788-3789 (April 22, 1987).

* * *

"SENATOR NELSON: Yes, members of the body, I have an amendment which, in essence, Senator Johnson addressed a lit bit ago. . . . My amendment would, in essence, eliminate the corporate . . . the capital gains tax [deduction]. . . . when it comes to giving away a benefit such as this capital gains exemption on tax, I think we have simply gone too far. We are giving excessively favored tax treatment to one kind of economic investment, corporate stock ownership when the rest of the citizens would have to bear the price. . . . Preferred individuals . . . it passes this corporate capital gains tax [deduction] on not only to maybe the wife or the husband, but in this case it also passes it on to the aunt, the uncle, the cousin, the niece and the nephew, and right on down the line, whether they are directly or indirectly involved. Again, this just carriers it too far. . . . ***By this section of the bill, we are giving preferred individual taxpayers adjusted gross income break of 50 percent in 1987 and 100 percent by 1988.*** . . . We simply do not even know what price of this tax benefit is in the bill and I don't think anyone hesitates to guess. But I will tell you that it's no small amount I'm thinking of. It has been estimated that one individual in the state will receive $2.7 million from this simple little exemption. Another individual, [$]300,000. . . . Okay, we will hear the argument that the adjustment, we just as well have it because we are losing this money anyhow. They are taking it out of the state. By doing this, tome, we are nothing but condoning this little tax gimmick. . . . If they want to do that, if they want to take it away from the people of this state that thy have earned that money through, that has given them the opportunity to collect and to gain this stock, if they want to avoid it, I guess we can't possibly can't help it. But what I am saying is we don't have to condone that act by allowing this capital gains [deduction]. . . . My bottom line, if this was not going to make more business, I would certainly be for it. But it's only creating a tax haven that's available to a selected few, with no guarantee, absolutely no guarantee on the returns. And that's my biggest concern."[7]

C. How Much Income Tax Revenue Is Foregone Annually Due to the Special Capital Gains and Extraordinary Dividend Income Tax Deductions?

The dollar figures in ***Table 1*** on page 7 show the ***estimated*** amount of foregone Nebraska income tax revenue attributable to the special capital gains deduction and the extraordinary dividend deduction.

The dollar figures shown in ***Table 1*** were published by the Nebraska Department of Revenue in its biennial *Tax Expenditure Report* (reports published in 1998, 2000, 2002, 2004, 2006, 2008, and 2010). The dollar figure shown for tax year 1998 ($8.6 million) is significantly smaller than the figures shown for tax years 2000 to 2010 (which range from a low of $24 million in tax year 2008 to a high of $40.1 million in tax year 2002).

---

7 Official transcript of floor debate on LB 775, pp. 3804-3805 (April 22, 1987)(emphasis added).

Table 1: Foregone Nebraska Income Tax Revenue Attributable to the Special Capital Gains Deduction and the Extraordinary Dividend Deduction	
1998	$8,649,000
2000	$39,777,036
2002	$40,174,800
2004	$37,053,000
2006	$35,000,000
2008	$24,000,000
2010	$29,300,000

D. Origin of the Extraordinary Dividend Income Tax Deduction

Laws 2007, LB 343, § 5, created the extraordinary dividend income tax deduction, which is operative for tax years beginning on or after January 1, 2007. That provision was added to LB 343 via adoption of an amendment AM1146 during floor debate on the bill (the provision was not in the introduced version of LB 343 nor was it in the Revenue Committee amendment to the bill). The Fiscal Note (Revision 3) for LB 343 states that the estimated fiscal impact of the extraordinary dividend deduction is "immaterial" due to the "rarity" of such extraordinary dividend payments.[8]

E. Compliance Problems Associated with the Special Capital Gains Income Tax Deduction Identified by the Department of Revenue

1. Taxpayer Compliance Problem and Ideas for Possible Solutions

The special capital gains income tax deduction is a deduction for which a taxpayer can make a ***once-in-a-lifetime election*** to claim that deduction for sales or exchanges of the capital stock of ***only one eligible corporation***. Nebraska's Tax Commissioner has indicated that some taxpayers have attempted to claim the special capital gains deduction with respect to sales or exchanges of the capital stock of ***more than one corporation***, which is ***not*** allowed by Neb. Rev. Stat. § 77-2715.09. ***Such non-compliant taxpayer behavior can inequitably reduce Nebraska state income tax revenue and that can be a problem if the department's auditors do not catch the non-compliance and deny the unlawfully claimed deduction before the applicable statutes of limitations on audit and tax collection expire.***

8 D. Rippe, Fiscal Note (Revision 3) to LB 343, Legislative Fiscal Analyst, Nebraska Legislature (May 16, 2007): "Due to the rarity of extra ordinary dividend payments, the effect they have on the value of the stock, and the current allowance for subtraction of a one time capital gain, it is estimated that the fiscal impact associated with this provision will be immaterial." Id., p. 2.

Generally, under Nebraska law, the period of limitations for ***auditing*** an income tax return and issuing a "notice of proposed deficiency determination" is 3 years after the return was filed, unless the taxpayer understates taxable income by 25 percent or more, in which case the period of limitations is 6 years after the return was filed.[9] "If no return is filed or a false or fraudulent return is filed with intent to evade the income tax imposed by the Nebraska Revenue Act of 1967, a notice of deficiency determination may be mailed to the taxpayer at any time."[10]

Another reason why such noncompliant taxpayer behavior can be a problem is that the statute of limitations governing the ***collection*** of lawfully owed but unpaid income taxes, penalties, and interest ***might expire*** before the department collects the amount owed: "***Except as otherwise provided*** in the Nebraska Revenue Act of 1967, ***no deficiency shall be assessed or collected*** with respect to the year for which the return was filed ***unless*** a notice of a proposed deficiency determination is mailed within three years after the return was filed or the period otherwise fixed."[11]

Ideas for Possible Solutions to Those Problems: One possible solution to those problems is to enact legislation providing that the statutes of limitation that govern the ***audit*** of income tax returns ***and*** the ***collection*** of lawfully owed but unpaid income taxes, penalties, and interest ***by taxpayers who claim the special capital gains deduction never begins to run.*** That change in the law would give the department a very effective tool in auditing the income tax returns of taxpayers who have claimed that deduction for more than one corporation over a period of time spanning decades and also in collecting income taxes, penalties, and interest that are due from such a noncompliant taxpayer. Another possible solution to such problems would be to prospectively outright repeal the special capital gains deduction, but that alternative is much less desirable than the first alternative because repealing the deduction would arguably diminish Nebraska's efforts to build and sustain viable economic development and business tax incentive programs.

F. Compliance Problems Associated with the Extraordinary Dividend Income Tax Deduction Identified by the Department of Revenue

The Tax Commissioner has indicated that the Department of Revenue has not encountered any significant compliance problems with the extraordinary dividend deduction. The Fiscal Note for LB 343, which created the extraordinary dividend

9 Neb. Rev. Stat. § 77-2786 (1) through (9). Numerous exceptions to the 3-year and 6-year period of limitations are spread throughout Neb. Rev. Stat. § 77-2786 (1) through (9) (e.g., Neb. Rev. Stat. § 77-2786(6) allows "both the Tax Commissioner and the taxpayer" to consent "in writing" to "the mailing" of "a notice of deficiency determination . . . at any time prior to the expiration of the period agreed upon" and the "period so agreed may be extended by subsequent agreement in writing made before the expiration of the period previously agreed upon."

10 Neb. Rev. Stat. § 77-2786 (3).

11 Neb. Rev. Stat. § 77-2786 (1) (emphasis added).

deduction, states that extraordinary dividends are rare events and indicates that revenue foregone due to that deduction is expected to be nominal.[12]

III. Should the "Economic Substance Doctrine" as Codified in Internal Revenue Code (IRC) § section 7701(o) Be Codified in Nebraska's Statutes for Purposes of State Income Taxation?

The following material will help readers decide whether the Legislature should codify the economic substance doctrine for purposes of Nebraska's income tax laws. In the United States, the history of the economic substance doctrine is largely confined to federal courts using it to decide federal income tax cases.

The Tax Commissioner has indicated that the Nebraska Department of Revenue has not taken position as to whether the economic substance doctrine should be codified. Research (e.g., Westlaw and Premise database case law searches) shows that Nebraska's courts have *never used* the economic substance doctrine in deciding any state or local tax cases arising in Nebraska and the state's Tax Commissioner is also unaware of any Nebraska court cases that have invoked the economic substance doctrine.

In light of that, consider whether the economic substance doctrine—codified or not for purposes of state income taxation—can play a helpful role in reaching well-reasoned decisions in state income tax cases involving complex multi-step transactions that lack economic substance aside from their promised tax benefits.

A. What Is the "Economic Substance" Doctrine?

"For more than fifty years, courts have interpreted and applied the tax law with the aid of various 'common law' doctrines, such as substance over form, step transaction, business purpose, sham transaction, and economic substance."[13] Essentially, courts have used the economic substance doctrine to disallow tax benefits (e.g., deductions, exemptions, and credits) claimed by taxpayers who have entered into a business or investment transaction that has *no* economic substance *aside from* its tax benefits (e.g., sham transactions).

> "A number of general principles apply in determining whether a transaction lacks economic substance and thus should be disregarded for tax purposes. These include:
>
> (1) A lack of economic substance is sufficient to disqualify a transaction even without proof that the taxpayer's sole motive is tax avoidance.

12 See footnote 8 of this report.

13 J. Bankman, "The Economic Substance Doctrine", 74 *University of Southern California Law Review* 5, (2000).

(2) When a taxpayer claims a deduction, it is the taxpayer who bears the burden of proving that the transaction has economic substance. (3) The economic substance of a transaction must be viewed objectively rather than subjectively.

(4) The transaction to be analyzed is the one that gave rise to the alleged tax benefit.

(5) Arrangements with subsidiaries that do not affect the economic interest of independent third parties deserve particularly close scrutiny."[14]

An October 2011 decision of a federal district court in Iowa involving a limited liability company's claim to Internal Revenue Code (IRC) § 901 foreign tax credits is a good example of how federal courts have used the economic substance doctrine (before it was codified) to unravel complex transactions to reach a well-reasoned decision as to whether the taxpayer in that case was entitled to the benefits of the sought-after foreign tax credits:

"A limited liability company (LLC) taxed as a partnership was not entitled to foreign tax credits (FTC) disallowed by a Notice of Final Partnership Administrative Adjustment (FPAA) and, therefore, was not entitled to a tax refund. The claimed FTCs arose from a very complicated multi-level transaction that was, in fact, a loan from a U.S. taxpayer to French banks. Moreover, the facts demonstrated that the focus of the transaction was to generate FTCs.

Further, the transaction failed to have any economic substance because it lacked credible subjective and objective business purpose other than to obtain FTCs for the partners. The LLC's argument that it sought to earn higher yields on foreign bonds and an enhanced yield on the transaction was rejected because economic realities suggested that no corporation would chose to earn less money on such transactions unless they were backed by foreign credits. There was essentially no economic risk in investing in the entities because any market fluctuations were controlled by the restrictions placed on the investment portfolio. The existence of alleged potential profit was insufficient to introduce substance into an otherwise sham transaction.

Finally, the transaction violated the anti-abuse rule under Reg. §1.701-2 because the partnership was used contrary to the intent of the Subchapter K provisions. The transaction was not a *bona fide* partnership because the transaction was designed to be a loan to the banks and its entities and not an equity investment; therefore, the transaction lacked substantial business purpose and the partnership was likely to be disregarded under the anti-abuse rule. The economic agreement did not accurately reflect the partners' income and the transaction improperly shifted the foreign tax credit to the LLC for no apparent economic reason."[15]

In another well-reasoned October 2011 case that involved use of the economic substance doctrine before it was codified, the U.S Supreme Court refused to review a 10th Circuit

14 "Federal Circuit overturns taxpayer's victory in contingent liability transaction", *Newsstand*, RIA (June 2006), citing *Coltec Industries, Inc. v. U.S.*, 98 AFTR 2d ¶2006-5095, Court of Federal Claims (June 12, 2006), *cert. denied* 98 AFTR 2d 2006-5249 (February 20, 2007).

15 "Foreign Tax Credit Transaction Lacked Business Purpose and Economic Substance; Refund Claim Denied", *Tax Newsletter*, CCH (October 11, 2011), citing *Pritired 1, LLC, v. United States*, 2011-2 USTC ¶50,654, Federal District Court of Iowa (2011).

Court of Appeals decision ***reversing*** a federal district's court's determination that the complex transactions at issue in an "abusive transactions" case (i.e., a "Son of BOSS" tax shelter scheme) case had economic substance; therefore, the 10th Circuit Court of Appeals denied the taxpayer's sought-after tax benefits:

> "In the *Sala* case, the Court of Appeals for the Tenth Circuit, reversing the district court, found that a tax shelter lacked substance and that the losses it generated couldn't offset huge amounts of compensation.
>
> * * *
>
> ***Background on Son of BOSS.*** A "Son of BOSS" tax shelter is a variation of the BOSS (bond and option sales strategy) shelter transaction which generates artificial tax losses that can be used to offset legitimate income from other transactions. Son of BOSS transactions have been identified as abusive transactions.
>
> ***Losses were artificial.*** The Tenth Circuit, reversing the district court, held that an individual couldn't offset $60 million of compensation income with losses from a Son of BOSS transaction. The Court found that the tax shelter transaction lacked economic substance . . . .
>
> Carlos Sala, who had income of more than $60 million, claimed a tax loss as a result of his involvement in a multi-step foreign currency options investment transaction. The transaction made use of the then-existing tax rule that disregarded short options as liabilities for purposes of establishing partnership basis.
>
> The Tenth Circuit found that Sala's participation in the transaction lacked economic substance. It was clear that the transaction was designed primarily to create a reportable tax loss that would almost entirely offset Sala's income with little actual economic risk. The losses that were generated were entirely artificial. The Court concluded that, while a taxpayer is allowed to structure a transaction in a way that minimizes his tax liability, the transaction must nevertheless have economic substance." [16]

B. What Is the "Codified" Economic Substance Doctrine?

Congress ***partially*** codified the economic substance doctrine as IRC § 7701(o) when it enacted the Health Care and Education Reconciliation Act of 2010.[17] As so codified, the economic substance doctrine basically provides that ***after*** a court finds that the economic substance doctrine applies to a transaction, the transaction has economic substance ***only if*** the taxpayer shows that the transaction changed the taxpayer's economic position in a meaningful way—***without taking into account the federal income tax consequences of the transaction***—and that the taxpayer had a substantial purpose for entering into the transaction other than for the transaction's federal income tax consequences.

16 "Supreme Court won't review cases on capital contribution and economic substance.", *Newsstand*, RIA (October 6, 2011), citing *Sala v. U.S.* (CA 10 7/23/2010) 106 AFTR 2d 2010-5406, 10th Circuit Court of Appeals (July 23, 2010) *cert. denied* US Supreme Court (October 3, 2011).

17 Public Law No. 111-152.

1. Did Congress Codify All or Only Part of the Economic Substance Doctrine? <u>Answer</u>: Congress Codified Only Part of that Doctrine.

In the following excerpt from a published article concerning congressional codification of the economic substance doctrine, the author correctly concludes that Congress codified only ***part*** of the economic substance doctrine when it created IRC § 7701(o):

> "In September the Joint Committee on Taxation issued JCS-3-09 describing in great detail the President's 2010 Omnibus Budget's proposal to "codify" the "economic substance doctrine" (ESD). ***Of course the proposal, and earlier proposals in the Senate and the House, do not really undertake to fully codify the "doctrine," but rather only to codify the test applied once the doctrine is determined to apply. Indeed, the proposal's signal feature is defining a test for economic substance while not defining when the ESD is to be applied to a taxpayer's case.***"[18]

2. Did the IRS Oppose Congressional Codification of the Economic Substance Doctrine? <u>Answer</u>: Yes.

> "The Supreme Court declined to review two important tax shelter cases won by the IRS based on the economic substance doctrine: *The Dow Chemical Company* (CA-6, 2006-1 USTC ¶50,126), and *Coltec Industries, Inc.* (CA-FC, 2006-2 USTC ¶50,389).
>
> ***The federal government*** opposed review and ***continues to oppose codification of the economic substance doctrine. Many practitioners were hoping the Supreme Court would grant review to clarify the economic substance doctrine but also oppose codification.***
>
> Lawrence Hill of Dewey Ballantine and a member of the CCH Tax Shelter Alert Advisory Board, predicted that the *Coltec* decision will sound the death knell for the codification of the economic substance doctrine. Still, congressional Democrats seem to be moving toward codifying the doctrine."[19]

C. Does Use of the Federal Judiciary's Economic Substance Doctrine to Trump Literal Provisions of Congress' Internal Revenue Code Constitute an Unconstitutional Breach of Separation of Powers? <u>Answer</u>: No.

> "The U.S. Court of Federal Claims improperly awarded a refund of over $82 million to a corporation that claimed a loss on its consolidated return from a subsidiary's sale of high-basis stock for a relatively low price. Although the stock's basis was determined under the literal terms of the statute, the transaction that resulted in the high-basis of the stock lacked economic substance. ***In reaching its decision, the U.S. Court of Appeals for the Federal Circuit rejected the Court of Federal Claim's holding that the use of the economic substance doctrine to trump the Code was an unconstitutional separation of powers.***"[20]

---

18 J. Cumminngs, "Economic substance doctrine—Joint Committee explains economic substance codification", *Newsstand* (October 6, 2009)(emphasis added).

19 "The Economic Substance Doctrine Is Not Codified", *Tax Newsletter*, CCH (February 26, 2007).

20 "Loss From Sale of High-Basis Stock Disregarded Under Economic Substance Doctrine", *Newsstand*, RIA (June 6, 2006)(emphasis added), citing *Coltec Industries, Inc. v. U.S.*, 98 AFTR 2d ¶2006-5095, Federal Circuit Court of Appeals (June 12, 2006), *cert. denied* 98 AFTR 2d 2006-5249, U.S. Supreme

D. Has the Economic Substance Doctrine Been Used by a Federal Court of Appeals to Uphold a Taxpayer-Defendant's Criminal Convictions for Tax Evasion under IRC § 7201 and Filing False Tax Returns under IRC § 7206? Answer: Yes. *However*, the U.S. Supreme Court Vacated the Court of Appeals Decision and Remanded the Case to the Federal District Court to Allow the Taxpayer-Defendant to Introduce Certain Evidence.

"An individual's convictions for tax evasion and filing false tax returns were vacated and remanded because the trial court refused to allow him to introduce evidence that corporate distributions to him were a return of capital. Contrary to the Ninth Circuit's holding in *M. Miller*, CA-9, 76-2 USTC ¶9809, a corporate distributee accused of tax evasion may claim return-of-capital treatment for a distribution without producing evidence that either he or the corporation intended a capital return at the time of the distribution.

At trial, the individual sought to introduce evidence that the corporation had no retained or current earnings in the tax years at issue and, therefore, the corporate distributions he received were returns of capital. Since return of capital is not taxable income, he argued, the government could not establish the tax deficiency required to convict him of tax evasion. However, the trial court excluded his return-of-capital evidence because he failed to demonstrate that either he or the corporation intended the distribution to be a return of capital as required by *Miller*.

But *Miller's* view that a criminal defendant may not treat a distribution as a return of capital without evidence of a corresponding contemporaneous intent violates ***the economic substance rule*** as well as Code Secs. 301 and 316(a). Code Secs. 301 and 316(a) govern the tax consequences of constructive distributions made by a corporation to a shareholder with respect to its stock. As those sections are written, the tax consequences of such a corporate distribution depend, not on the intent to return or receive capital, but on whether the corporation had earnings and profits (E&P) and the amount of the stockholder's basis in his stock.

According to Code Sec. 301, the portion of a distribution that is a dividend must be included in gross income. The portion that is not a dividend is, depending on the stockholder's basis in the stock, either a nontaxable return of capital or capital gain. Code Sec. 316 defines a dividend as a corporate distribution made out of earnings and profits . Thus, the existence of E&P is decisive when determining the tax consequences of corporate distributions to shareholders with respect to their stock.

There is no criminal tax evasion without a tax deficiency and there is no deficiency related to a distribution if a corporation has no E&P and the amount distributed does not exceed the stockholder's basis in his stock. Thus, the fact that a shareholder distributee of a successful corporation may have different tax liability from a shareholder of a corporation without E&P merely follows from the way Code Secs. 301 and 316(a) are written and from the requirement of a tax deficiency in order to be convicted of tax evasion. ***Under Code Sec. 7201, bad intentions alone are not punishable.***"[21]

Court (February 20, 2007).

21 "Introduction of Return-of-Capital Evidence by Corporate Distributee Accused of Tax Evasion Allowed", *Tax Newsletter*, CCH (March 2008), citing *M.H. Boulware v. United States,* 2008-1 USTC ¶50,206, US Supreme Court (March 3, 2008), *vacating and remanding* 2007-1 USTC ¶50,516, the 9th Circuit Court of Appeals decision upholding a federal district court's criminal conviction of the taxpayer-

In light of the foregoing information, it is arguably prudent to inquire whether the Nebraska Department of Revenue and/or the Nebraska Attorneys General have ever used (or would ever use) the economic substance doctrine—whether or not it is codified in Nebraska statutes—in an effort to convict a taxpayer-defendant of criminal tax fraud or evasion under Nebraska law.

E. Specifically, What Does IRC § 7701(o) Provide?

IRC § 7701(o) codifies the court-made economic substance doctrine, *in part*, as follows:

"**(o) Clarification of economic substance doctrine.--**

(1) Application of doctrine.--*In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if--*

(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and

(B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

(2) Special rule where taxpayer relies on profit potential.--

(A) In general.--The potential for profit of a transaction shall be taken into account in determining whether the requirements of subparagraphs (A) and (B) of paragraph (1) are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

(B) Treatment of fees and foreign taxes.--Fees and other transaction expenses shall be taken into account as expenses in determining pre-tax profit under subparagraph (A). The Secretary shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases.

(3) State and local tax benefits.--*For purposes of paragraph (1), any State or local income tax effect which is related to a Federal income tax effect shall be treated in the same manner as a Federal income tax effect.*

(4) Financial accounting benefits.--For purposes of paragraph (1)(B), achieving a financial accounting benefit shall not be taken into account as a purpose for entering into a transaction if the origin of such financial accounting benefit is a reduction of Federal income tax.

(5) Definitions and special rules.--For purposes of this subsection--

(A) Economic substance doctrine.--*The term "economic substance doctrine" means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.*

defendant on several counts of tax evasion prohibited by IRC § 7201 and filing a false income tax return prohibited by IRC § 7206.

> **(B) Exception for personal transactions of individuals.**--In the case of an individual, paragraph (1) shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.
>
> **(C) Determination of application of doctrine not affected.**--***The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted.***
>
> **(D) Transaction.**--The term "transaction" includes a series of transactions."[22]

Therefore, IRC § 7701(o)(1) sets forth a two-prong test for determining whether certain transactions (i.e., transactions entered into after March 30, 2010) have "economic substance" ***without*** taking into consideration the ***federal*** income tax consequences of such transactions.

Also note that, for purposes of IRC § 7701(o)(1), "any State or local income tax effect which is related to a Federal income tax effect shall be treated in the same manner as a Federal income tax effect."[23]

> ***Observation:*** If legislation is drafted to codify the economic substance doctrine, *in part* (as Congress did), for purposes of Nebraska income taxation, bill drafters should be aware of the need to *reverse* (*or flip-flop*) the phrases "Federal income tax" and "State of local income tax" with each other, so that properly drafted state legislation comparable to IRC § 7701(o)(3) would state as follows: "<u>(3) **Federal tax benefit.** For purposes paragraph (1), any Federal income tax effect which is related to a State or local income tax effect shall be treated in the same manner as a State or local income tax effect.</u>" Astute drafting may also be necessary elsewhere throughout the draft of a state statute comparable to IRC § 7701(o).

The two-prong test set forth in of IRC § 7701(o)(1) also applies for purposes of determining underpayments of federal income tax, understatements of federal income tax, and refunds and credits of federal income tax attributable to transactions entered into after March 30, 2010.

> "[A] transaction to which the economic substance doctrine is relevant is treated as having economic substance under a conjunctive two-prong test only if—apart from Federal income tax effects—both: (1) the transaction changes in a meaningful way the taxpayer's economic position; . . . and (2) the taxpayer has a substantial purpose for entering into the transaction. . . . That is, the taxpayer's non-Federal-income-tax purpose for entering into a transaction must be "substantial."[24]

---

22 IRC § 7701(o) (emphasis added); 26 U.S.C. § 7701(o).

23 IRC § 7701(o)(3).

24 "LB&I instructs examiners on how to seek approval to apply economic substance doctrine", *Newsstand*, RIA (July 18, 2011), citing LB&I-4-0711-015 *"Guidance for Examiners and Managers on the Codified*

Additionally, for purposes of

> "underpayments attributable to transactions entered into after Mar. 30, 2010, a 20% strict liability penalty applies to an underpayment attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance (as defined in Code Sec. 7701(o)), or failing to meet the requirements of any similar rule of law. . . . The penalty rate is increased to 40% if the taxpayer doesn't adequately disclose the relevant facts affecting the tax treatment in the return or a statement attached to the return. . . . Code Sec. 6664 's reasonable cause exception doesn't apply to the Code Sec. 6662(b)(6) penalty. . . . Additionally, a maximum 20% strict liability penalty under Code Sec. 6676 also applies to refund claims based on any transaction described in Code Sec. 6662(b)(6)."[25]

If legislation is introduced to codify the economic substance doctrine for purposes of Nebraska income taxation, the legislation should include provisions that make the results of its application producing an income tax liability subject to the Nebraska statutes governing penalties and interest for unpaid or untimely paid state income tax liabilities.

F. Have Other States Codified the Economic Substance Doctrine?

At this point in time, no states that impose an income tax appear to have codified the economic substance doctrine; at least there have been no articles or tax news stories published in prominent state and local tax journals telling of such legislative action.

G. What Official Guidance Has the IRS Provided to Its Tax Auditors in Connection with Congress' Codification of the Economic Substance Doctrine?

It come as no surprise that IRS, when it had the first chance to do so, seized the opportunity to capture arguably the best of both worlds with respect to application of both Congress' codified economic substance doctrine and the preexisting Court-made common law economic substance doctrine.

1. Interim IRS Guidance Issued

> "The IRS has provided interim guidance regarding the codification of the economic substance doctrine under Code Sec. 7701(o) and the related amendments to the penalties under Code Secs.

Economic Substance Doctrine and Related Penalties" and IRC §§ 7701(o)(1)(A) and 7701(o)(1)(B).

25 "LB&I instructs examiners on how to seek approval to apply economic substance doctrine", *Newsstand*, RIA (July 18, 2011), citing LB&I-4-0711-015 *"Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties"* and IRC §§ 6662(b)(6), 6662(i)(1), and 6664(c)(2).

6662, 6662A, 6664 and 6676 by the Health Care and Education Reconciliation Act of 2010 (HCERA) (P.L. 111-152). The guidance applies with respect to transactions entered into on or after March 31, 2010, the effective date of the amendments.

Economic Substance Doctrine

The IRS will continue to rely on relevant case law when applying the two-prong conjunctive test in Code Sec. 7701(o)(1). The first prong requires a meaningful change in the taxpayer's economic position (other than the federal income tax effects) and the second prong requires the taxpayer to have a substantial purpose for entering into the transaction (other than the federal income tax effects). ***Accordingly, the IRS will apply cases under the common-law economic substance doctrine to determine whether the tax benefits of a transaction are not allowable because the transaction does not satisfy the economic substance prong of the economic substance doctrine. Similarly, the IRS will apply cases under the common-law economic substance doctrine to determine whether the tax benefits of a transaction are not allowable because the transaction lacks a business purpose.***

The IRS will challenge taxpayers who seek to rely on case law under the common-law economic substance doctrine for the proposition that a transaction has economic substance merely because it satisfies either Code Sec. 7701(o)(1)(A) or its common-law corollary, or Code Sec. 7701(o)(1)(B) or its common-law corollary.

In addition, the IRS will continue to analyze when the economic substance doctrine will apply in the same manner as before the enactment of Code Sec. 7701(o). Thus, the Service will continue to take the position that the economic substance doctrine is not relevant to whether tax benefits are allowable when pre-Code Sec. 7701(o) authorities provided that the economic substance doctrine was not relevant to the allowability of certain tax benefits. Moreover, the Treasury Department and the IRS do not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine either does or does not apply.

When calculating the net present value of a taxpayer's reasonably expected pre-tax profit, the IRS will take the taxpayer's profit motive into account only if the present value of the reasonably expected pre-tax profit is substantial in relation to the present value of the net tax benefits that would be allowed if the transaction were respected for federal income tax purposes. The IRS will use existing relevant case law and other published guidance when making this calculation.

Accuracy-Related Penalties

The adequate disclosure requirements of Code Sec. 6662(i) will be satisfied if a taxpayer adequately discloses on a timely filed original return (including extensions) or a qualified amended return all of the relevant facts affecting the tax treatment of the transaction. However, if a transaction lacking economic substance is a reportable transaction, the adequate disclosure requirement under Code Sec. 6662(i)(2) will be satisfied only if the taxpayer meets the disclosure requirements described in the new guidance and the disclosure requirements under Code Sec. 6011. Similarly, a taxpayer will not meet the Code Sec. 6011 disclosure requirements for a reportable transaction by only attaching Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement, to an original or qualified amended return.

Finally, the IRS will not issue a private letter ruling or determination letter pursuant to Rev. Proc. 2010-3, §3.02(1), I.R.B. 2010-1, 110, or subsequent guidance, regarding whether the

economic substance doctrine is relevant to any transaction or whether any transaction complies with the requirements of Code Sec. 7701(o). . . .."[26]

2. IRS Large and Mid-Size Business Division Directive Issued

"A day after the IRS issued interim guidance on the codification of the economic substance doctrine . . . [see discussion of IRS Notice Notice 2010-62 above] , the IRS Large and Mid-Size Business Division (LMSB) has issued a directive on penalty administration. When Congress codified the economic substance doctrine (effective for transactions entered into after March 30, 2010), it also amended the tax code to expand the application of penalties to transactions that lack economic substance.

The 20-percent accuracy-related penalty now applies to a disallowed transaction. The penalty increases from 20 percent to 40 percent if the relevant facts affecting the tax treatment of the transaction are not adequately disclosed. Notice 2010-62 provides guidance on how taxpayers can provide adequate disclosure.

To ensure consistent administration of the accuracy-related penalty for transactions that lack economic substance, the LMSB directive requires LMSB examiners who propose to apply the penalty to obtain review and approval from the appropriate LMSB Director of Field Operations before the penalty is proposed."[27]

3. IRS Large Business & International Division Directive Issued

On July 15, 2011, the IRS's Large Business & International Division issued formal guidance for the IRS' tax auditors and their managers setting forth the procedures they must follow to obtain approval from the IRS' Director of Field Operations (DFO) to apply the codified economic substance doctrine while performing their job duties. An excerpt from a published summary of that official IRS guidance is shown below:

"The directive lays out a multi-step analysis for examiners to complete before submitting their requests to the DFO. . . .

The new LB&I directive provides instructions to examiners and their managers on determining when to seek the approval of the DFO in order to raise the economic substance doctrine. This approval was mandated by a prior LB&I directive designed to ensure consistent application of the associated strict liability penalty (see article in Federal Taxes Weekly Alert 09/23/2010).

Once an examiner determines that raising the doctrine might be warranted, the directive sets out a series of four steps that the examiner must develop and analyze in order to seek approval for the ultimate application of the doctrine in the examination.

---

26 "Interim Guidance Released on Codification of Economic Substance Doctrine and Related Penalties", Notice 2010-62, CCH, 2010FED ¶46,451 (emphasis added); Rev. Proc. 2010-3, I.R.B. 2010-1, 110, is modified.

27 "Economic Substance Doctrine and Code Section 7701(o)—LMSB Requires Higher Level Approval of Penalties for Violating Economic Substance Doctrine", LMSB Directive, LMSB-4-0910-024, Codification of Economic Substance Doctrine and Related Penalties. By Brant Goldwyn, CCH News Staff, *Tax Newsletter* (September 17, 2010).

(1) The examiner must determine whether the facts and circumstances of a transaction are similar to those listed in the directive that tend to show that application of the economic substance transaction is likely not appropriate. Among the factors indicating that the doctrine is inappropriate are that the transaction is not promoted by a tax department or outside advisors, is not highly structured, is at arm's length with unrelated third parties, and carries a significant risk of loss.

(2) The examiner must determine whether the facts and circumstances of a transaction are similar to those listed in the directive that tend to show that application of the economic substance transaction is likely appropriate. These factors include that the transaction includes unnecessary steps, accelerates a loss or duplicates a deduction, has no credible business purpose apart from federal tax benefits, and is outside the taxpayer's ordinary business operations.

(3) The examiner must answer each of the following inquiries before seeking the approval of the appropriate DFO to apply the doctrine. If the answer to (i) through (iv) is affirmative, then application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel. In answering (v) and (vi), the examiner should seek the advice of his manager in consultation with local counsel.

(i) Is the transaction a statutory or regulatory election?

(ii) Is the transaction subject to a detailed statutory or regulatory scheme, and if so, does it comply with this scheme?

(iii) Does judicial or administrative precedent exist that either rejects the application of the economic substance doctrine to the type of transaction or a substantially similar transaction, or upholds the transaction without reference to the doctrine?

(iv) Does the transaction involve tax credits (e.g., for low-income housing or alternative energy) that are designed by Congress to encourage certain transactions that would not be undertaken but for the credits?

(v) Does another judicial doctrine more appropriately address the noncompliance that is being examined?

(vi) Does recharacterizing a transaction more appropriately address the noncompliance that is being examined?

(vii) In considering all the arguments available to challenge a claimed tax result, is the application of the doctrine among the strongest arguments available? If not, it shouldn't be pursued without specific approval of the examiner's manager in consultation with local counsel.

(4) If an examiner completes the above inquiries and concludes that it is appropriate to seek approval to apply the doctrine, the examiner, in consultation with his manager and territory manager, should describe for the appropriate DFO in writing how the analysis was completed. The DFO should then review the written material provided and consult with counsel. If the DFO believes it is appropriate to approve the request, the DFO should provide the taxpayer an opportunity to explain their position. The DFO should convey the final decision to the examiner in writing.

Individual steps of multi-step transactions. The directive provided that when a transaction involves a series of interconnected steps with a common objective, the steps are generally viewed together in applying the above guidance. However, in certain circumstances, it may be appropriate to apply this guidance separately to one or more steps that are included within a series of arguably interconnected steps, such as when an integrated transaction includes one or more tax-motivated steps that bear only a minor or incidental relationship to a single common business or financial transaction. If an examiner wants to apply this guidance separately to one or more steps with a common objective, the examiner must first seek guidance from their manager and consult with their local counsel.

Taxpayer notification. An examiner should notify a taxpayer that he is considering whether to apply the economic substance doctrine to a particular transaction as soon as possible, but not later than when the examiner begins the four-step analysis.

Penalties limited to economic substance doctrine. The directive also clarifies that, until further guidance is provided, the penalties under Code Sec. 6662(b)(6) and Code Sec. 6676 are limited solely to the application of the economic substance doctrine. They may not be imposed due to the application of any other similar "rule of law" or judicial doctrine, like the step transaction doctrine or substance over form."[28]

4. Should the Department of Revenue Issue Directives and Develop Procedures Similar to The Directives and Procedures Issued by the IRS in Connection with the Codification of the Economic Substance Doctrine?

In light of the IRS' recent experience with issuing special directives and procedures concerning Congress' codification of the economic substance doctrine, should the Department of Revenue issue somewhat similar directives and special procedures (e.g., requiring approval of the Tax Commissioner (or other high-ranking official within the department) before the department's tax auditors attempt to apply the economic substance doctrine in any given tax audit situation?

Observation: Complex prior-approval procedures could become an unnecessary bureaucratic burden for which the Tax Commissioner would be responsible. If the department's tax auditors are well trained and can consistently and correctly apply a codified or court-made economic substance doctrine to the facts of any given income tax audit situation, then arguably such prior-approval procedures would be unnecessary. However, either way—from a tax policy perspective—the significant risk and consequence of something going awry is possible civil or criminal litigation, depending on the facts of a given case.

28 "LB&I instructs examiners on how to seek approval to apply economic substance doctrine", *Newsstand*, RIA (July 18, 2011), citing LB&I-4-0711-015 "*Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties*". A digital copy of IRS Directive LB&I-4-0711-015 is available online here: http://www.irs.gov/businesses/article/0,,id=242253,00.html.

IV. Has the Nebraska Department of Revenue Encountered Problems with Transactions Governed by IRC § 338?

The answer to that question is ***no***, not since the department issued Revenue Ruling 22-10-1 on September 8, 2010.

A. What Does IRC § 338 Allow Taxpayers To Do?

"A corporation that makes a qualified stock purchase of another corporation may elect under Code Sec. 338 to treat it as a purchase of the target corporation's assets. The target ("old target") is treated as if it sold all of its assets at the close of the acquisition date at fair market value in a single transaction and (as "new target") purchased all of the assets as of the beginning of day after the acquisition date.

Under Code Sec. 338(h)(10), if there is a qualified stock purchase of a target that is a member of a consolidated group, the purchasing corporation and selling consolidated group can jointly elect to have the selling consolidated group recognize (and report) gain or loss as though the target sold all of its assets in a single taxable transaction while still a member of the selling group, and liquidated. If the purchasing corporation makes a Code Sec. 338(g) election, old target's gain or loss from the deemed asset sale is included in old target's final return unless it is a member of a consolidated group or is an S corporation.

Where a series of transactions would give one tax result if viewed independently of each other, but if viewed together would give a different tax result, under the step transaction doctrine the transactions may be combined and viewed together as one transaction."[29]

B. What Problems Has the Nebraska Department of Revenue Encountered with Transactions Governed by IRC § 338?

The most common problem that state tax administrators encounter with IRC § 338 involves application of IRC § 338(h)(10). For example, the Nebraska Department of Revenue issued Revenue Ruling 22-10-1, *Special Capital Gains for Federal § 338 Election*,[30] on September 8, 2010, to address application of IRC § 338(h)(10) in situations involving Nebraska's special capital gains income tax deduction. Revenue Ruling 22-10-1 holds that the IRC § 338(h)(10) election ***does not disqualify*** the sale from Nebraska's special capital gains deduction and that "any capital gains from the sale of capital stock attributed to redemption of capital stock in the deemed liquidation under IRC § 338 ***do qualify*** for Nebraska's special capital gains deduction.[31]

---

29 "Final regs won't apply step transaction doctrine where Code Sec. 338(h)(10) election is made", *Newsstand*, RIA (July 2006)(emphasis added), citing Treasury Decision. 9271 (July 5, 2006) and Treasury Regulation § 1.338(h)(10)-1.

30 Revenue Ruling 22-10-1, *Special Capital Gains for Federal § 338 Election*, Nebraska Department of Revenue (September 8, 2010) (http://www.revenue.ne.gov/legal/rulings/rr221001.html). ***Appendix A*** contains a copy.

31 *Source:* "Nebraska—Income Tax: Special Capital Gains Exclusion Discussed", *State Tax Review*, p. 14, CCH (September 23, 2010), citing Revenue Ruling 22-10-1 and IRC §§ 338(h)(10), 1231, 1245, and 1250.

Revenue Ruling 22-10-1 also holds that gains on the sale of assets under IRC §§ 1231, 1245, or 1250 ***do <u>not</u> qualify*** for Nebraska's special capital gains deduction. (The provisions of IRC §§ 1231, 1245, and 1250 are summarily explained in footnote 28 on page 21.)

Nebraska's Tax Commissioner has indicated that the Department of Revenue has not encountered any significant problems with IRC §338(h)(10) transactions since it issued Revenue Ruling 22-10-1 and that, therefore, there is no need for new legislation. The Tax Commissioner has also indicated that it is too early to discuss any type of legislation concerning codification of that doctrine.

C. State and Local Tax Planning Considerations

Because assets (including IRC § 197 intangibles) rather than stock of the new target corporation are purchased by the acquiring corporation, IRC § 338 transactions can have significant implications for purposes of state and local taxation. For example, such transactions can produce liability for property taxes levied on depreciable tangible personal property and for sales and use taxes.

IRC § 338 transactions can also produce favorable capital gain tax treatment for shareholders of the old target corporation (e.g., Nebraska's special capital gains deduction authorized by Neb. Rev. Stat. 21 77-2715.09, which has already been discussed above in Part II of this report).

Thorough state and local tax planning for such corporate acquisitions is an indispensable exercise for the corporations (and their shareholders) involved in such transactions:

The following material explains how the interaction among IRC §§ 1231, 1245, and 1250 can result in income being characterized as ordinary income rather than capital gain income, which helps explains why Revenue Ruling 22-10-1 determined that income characterized as ordinary income—due to IRC §§ 1231, 1245, and 1250—does <u>not</u> qualify for Nebraska's special capital gains deduction.

> "Under Code Sec. 1231, gain from the sale or exchange of property that is not a capital asset may be treated as capital gain if the property is used in the trade or business, held for more than one year, and depreciable under Code Sec. 167. Since Code Sec. 1231 gain includes gain from the sale or exchange of depreciable property, it may be subject to recapture of depreciation and amortization under Code Sec. 1245. (Code Sec. 1245(a)(3)(A); Reg. § 1.1245-3(b)(2)) Gain on the disposition of Code Sec. 1245 property is treated as ordinary income to the extent of depreciation or amortization allowed or allowable on the property. (Code Sec. 1245(a))
>
> Code Sec. 1250 property is any depreciable real property that isn't Code Sec. 1245 property. (Code Sec. 1250(c)) Gain realized on the disposition of Code Sec. 1250 property is recaptured as ordinary income to the extent that the depreciation amount allowed or allowable exceeds the amount of depreciation that would have resulted under the straight-line method. (Code Sec. 1250(a)) The remaining depreciation claimed is taxed at 25%." ["Taxpayers liable for tax on gains from sale of mixed-use property, but not for penalty", *Newsstand*, RIA (July 29, 2011), citing *Wickersham v. Commissioner*, TC Memo 2011-178 (2011).]

> "[T]he state and local tax aspects of mergers and acquisitions pose great risks of exposure as well as great opportunities for tax planning. . . . [B]ecause no two transactions are alike, one must approach each transaction creatively and without preformed expectations. . . . [D]ue diligence is a process generally undertaken on behalf of the buyer in merger and acquisition transactions. The goals of the due diligence process . . . are to identify, quantify, and limit to the extent possible potential tax liabilities that the buyer may inherit. . . . [I]f the issues uncovered in this process are big enough, one may obtain substantial price concessions.
>
> The type of acquisition will drive the scope of due diligence. . . . For example, stock acquisitions are very complex and may involve the buyer inheriting the seller's tax liabilities. Asset acquisitions, by contrast, have a much more limited focus in that the buyer generally will only inherit the liabilities it agrees to assume. . . . [A] practitioner needs to focus on the form of the transaction to minimize sales and transfer taxes and to map out what the entities will look like . . . . [F]or the acquisition of both stock and assets, much depends on whether the transaction is friendly or hostile.
>
> [B]ecause the seller's problems will become the buyer's problems after a transaction, a practitioner must discover the seller's preexisting tax liabilities, such as any outstanding assessments, ongoing audits, taxes being contested, problems identified in prior audit examinations, and any state and local ramifications of federal tax issues. . . . [T]he buyer should also keep an eye out for potential problems. For example, if the effective tax rate of the target or the portion of the target's income subject to tax appears unreasonably low, the buyer should investigate further. Also, the buyer should look for inadequate sales and use tax compliance, whether NOLs utilized or available for carryforward may be overstated, and aggressive debt 'pushdowns.'
>
> [T]he state tax consequences of buying, selling, or reorganizing corporations have become a significant consideration in structuring and performing a transaction. . . . [I]n many instances, the state tax issues surrounding a transaction may drive its form, and the state and local tax costs may outweigh the federal tax costs of a transaction. Thus, . . . 'Today's tax professional must be aware of the diverse state tax systems in order to make informed decisions.'"[32]

Failure on the part of taxpayers to engage in thoughtful state and local tax planning before deciding to carry out an IRC § 338 transaction can and has resulted in liability for personal property taxes in Nebraska. The Nebraska Supreme Court's decision in *Pfizer, Inc., v. Lancaster County Board of Equalization*[33] illustrates that very well.

---

32 "Experts Discuss State Tax Incentives, LLCs, Intangibles At Georgetown Conference", *State Tax Notes*, pp. 2227-2228, Tax Analysts (May 29, 1995), quoting Jerrold S. Gattengo of Deloitte & Touche, LLP, New York.

33 *Pfizer, Inc., v. Lancaster County Board of Equalization*, 260 Neb. 265, 616 N.W.2d 326 (2000). In the *Pfizer* case:

> "a multinational corporation authorized to do business in Nebraska (Pfizer) purchased the assets ("personal property, real property, and a range of tangible and intangible assets located in 26 different countries," including property located in Nebraska) of a subsidiary of a publicly-owned British corporation, SmithKline Beecham, PLC. Pfizer challenged the constitutionality of Nebraska's depreciable tangible personal property tax, which is "based on the acquisition cost, or purchase price, of the property, as adjusted for depreciation. . . ." Pfizer alleged that Nebraska's tax violates "the Equal Protection and Commerce Clauses of the U.S. Constitution and the special legislation and uniformity clauses of the Nebraska Constitution" and argued that

D. What Challenges Have Other States Encountered with IRC § 338?

As shown below, nine states have encountered a variety of challenges involving state and local tax issues arising from IRC § 338(h)(10) transactions.

1. California: Income Tax Issues and IRC § 338(h)(10)

California has engaged in litigation over the proper state income tax treatment of an IRC § 338(h)(10) transaction involving an S corporation:

> "An S corporation and its shareholders were prohibited from making a separate IRC §338 election for California corporation franchise and income tax purposes during the tax year at issue. The taxpayer was attempting to prevent the classification of the sale of the S corporation's stock to the purchasing corporation as a sale of its assets at fair market value on the date of the sale and therefore avoid the tax on the resultant capital gains.
>
> The court found that the plain language of the governing statute clearly prohibited an S corporation from making a separate §338 election. The court rejected the taxpayer's contention that the statute was ambiguous, finding that the taxpayer failed to show how the plain language of the statute could be interpreted in more than one manner. Consequently, the court refused to look to the legislative history or bill analysis presented by the taxpayer to support its contention that the statute prohibiting a separate election applied only in instances in which the S corporation was acquiring a subsidiary, and not when it was the target of an acquisition.
>
> Similarly, the court found that subsequent amendments made to the separate election prohibition provision that clarified that the prohibition applied to both the S corporation and its shareholders and also added a cross-reference to the personal income tax provision governing elections merely made more explicit what was already provided by the prior-year amendments that enacted the separate election prohibition and were not material changes.
>
> Finally, even if taxpayer were allowed to make a separate election, the election filed by the taxpayer was not timely made. The taxpayer filed the election with its timely filed return. However, the statute governing the filing of the election required that the taxpayer make the election before either the 15th day of the ninth month beginning after the month in which the acquisition date occurs or May 15, 1998, whichever date was later. However, the taxpayer filed its election after these deadlines had lapsed. Although another provision allowed for the election to be

---

> 'the impact of the classification of sales, between asset sales and stock sales, will fall most significantly on large multi-national companies that cannot know, much less take into consideration, the impact of doing large asset sales transactions with impact in many jurisdictions. There will be no opportunity to structure such transactions to minimize Nebraska property taxes, thereby shielding Nebraska businesses by forcing higher property taxes upon large companies who acquire Nebraska businesses in asset sales.'

The Nebraska Supreme Court rejected all of Pfizer's arguments and 'had little difficulty in concluding that . . . there is substantial nexus between Nebraska and the subject of the tax, as the property at issue is located in this state.'" [S. Moore, "A Reformed Intangible Personal Property Tax: A Cure for Inequity?", *Journal of State Taxation*, pp. 25, 32, CCH (March-April 2006) (footnotes omitted).]

> filed with the taxpayer's timely filed return, this provision applied only to the acquiring corporation, and not the target corporation."[34]

2. Georgia: Income Tax Issues and IRC § 338(h)(10)

Georgia has also engaged in litigation over the proper state income tax treatment of an IRC § 338(h)(10) transaction involving an S corporation:

> "***In a case of first impression,*** where an S corporation's shareholders sold their stock and agreed to treat the sale under IRC §338(h)(10), the gain from the deemed asset sale was subject to Georgia corporate income tax. Although the S corporation could not make the election as a matter of law, it affirmatively agreed under a stock purchase agreement that it would join in making the election. As a result of the deemed sale, the S corporation received a tax benefit of a stepped-up basis in assets, allowing it to claim increased depreciation and amortization deductions, thereby reducing its Georgia tax liability for subsequent periods. Further, the gain on the deemed sale of assets primarily consisting of goodwill was treated as income subject to apportionment since goodwill was key to the S corporation's longtime operational business success in Georgia. Finally, the assessment of additional tax based upon business income from the deemed asset sale did not violate the nexus requirements of the Due Process and Commerce Clauses of the U.S. Constitution. The S corporation took advantage of the privilege of doing business in Georgia in a manner which added value to the company's assets and the value of its shareholders' stock."[35]

Georgia subsequently enacted legislation requiring "that all elections under IRC §338 apply for purposes of calculating Georgia taxable net income for corporations, with respect to stock purchases and sales occurring on or after June 3, 2010."[36]

3. Illinois: Income Tax Issues and IRC § 338(h)(10)

Illinois has also engaged in litigation over the proper state income tax treatment of an IRC § 338(h)(10) transaction. However, the significant issue in that case involved Illinois' adoption of the Multistate Tax Commission's model income tax act known as the "Uniform Division of Income for Tax Purpose Act" (UDITPA) and its reliance on an important distinction between "business" and "nonbusiness" income, which is a

---

34 "California—Corporate Income: Tax Acquired S Corporation Prohibited From Making Separate IRC Section 338 Election", *Tax Newsletter*, CCH (Aug. 12, 2011), citing ELS Educational Services, Inc. v. Franchise Tax Board, Court of Appeal, Third Appellate District, No. C063450 (Aug. 10, 2011). See also, "Appeal Court: S Corp Bound by Federal IRC Section 338 Election", State Tax Notes, pp. 475-476, Tax Analysts (August 22, 2011), .citing *ELS Educational Services, Inc. v. Franchise Tax Board*, Court of Appeal, Third Appellate District, No. C063450 (Aug. 10, 2011).

35 "Georgia—Corporate Income Tax: S Corporation Taxed on Gain From Deemed Asset Sale", Tax Newsletter, CCH (February 2009)(emphasis added), citing Georgia Department of Revenue v. Trawick Construction Co., Inc., Court of Appeals of Georgia, No. A08A2323, February 23, 2009, ¶200-647; Explanations at ¶10-540 and ¶11-520.

36 "Georgia—Corporate, Personal Income Taxes: Decoupling Enacted; Electronic Filing Amended", *Tax Newsletter*, CCH (June 2010), citing H.B. 1138, Laws 2010, effective June 3, 2010.

distinction that is not relevant for purposes of income taxation in Nebraska because Nebraska has not adopted UDITPA..

> "An Illinois appellate court affirmed a lower court's decision that a taxpayer properly characterized income as nonbusiness income, for corporate income tax purposes, from the sale of a subsidiary. The taxpayer sold all of its stock in a subsidiary to a buyer and both parties agreed to treat the sale as a deemed asset sale pursuant to IRC Sec. 338(h)(10). The Department conceded that the sale was made with a valid 338 election. The taxpayer listed the income from this sale as nonbusiness income on its state tax return. The appellate court, relying on precedent, held that pursuant to IRC Sec. 338(h)(10), the taxpayer's sale must be treated as a complete liquidation and cessation of business resulting in nonbusiness income as a matter of law.
>
> Further, the court noted for the record that, effective July 30, 2004, Illinois radically amended, prospectively, the definition of "business income" which applied to this case. As a result, the functional test, which also applied here, no longer exists. Essentially, then, the arguments raised in this appeal would have no relevance in a similar situation occurring today."[37]

4. Missouri: Income Tax Issues and IRC § 338(h)(10)

Like the Illinois case referred to above, Missouri has also engaged in litigation over the proper state income tax treatment of an IRC § 338(h)(10) transaction in a case where UDITPA's distinction between "business" and "nonbusiness" income was an important element of the case:

> "Gain from the sale and liquidation of a subsidiary by its parent company in an IRC §338(h)(10) transaction was nonbusiness income that, after adjustments, ultimately resulted in no taxable income that could be apportioned to Missouri for corporate income tax purposes.
>
> According to the Missouri Supreme Court, the sale and liquidation of the subsidiary was a one-time, extraordinary event that did not generate business income under either the transactional test or the functional test, because it was not a type of business transaction in which the subsidiary regularly engaged, nor was it a disposition of the sort that constituted an integral part of the subsidiary's ordinary business.
>
> The subsidiary was a Delaware corporation headquartered in Connecticut with operational facilities in several states, including Missouri. The sale of the subsidiary was part of a $435 million divestiture between two European multinational consolidated groups of companies with diverse business interests, including nuclear energy. The parties and their American affiliates elected to treat the stock sale as an asset sale for federal income tax purposes, as permitted by IRC §338(h)(10), to enable the seller to avoid taxable gain from the sale proceeds and to enable the buyer to receive a higher basis in the acquired company's assets. Pursuant to IRC §338(h)(10), the subsidiary was deemed to have sold its assets to a newly formed corporation owned by the buyer of its stock; received the proceeds from the sale; and distributed the proceeds in a complete liquidation to its pre-acquisition parent company, which had no presence in Missouri. The subsidiary reported the gain from the fictional asset sale as nonbusiness income that, after adjustments, ultimately resulted in no taxable income apportionable to Missouri. The Director of

37 "Illinois—Corporate Income Tax: Sale of Subsidy's Stock Deemed Asset Sale Under IRC Sec. 338(h)(10)", *Tax Newsletter*, CCH (December 2008), citing *Nicor v. Illinois Department of Revenue*, Illinois Appellate Court, First District, Nos. 1-07-1359 & 1-07-1591 (December 5, 2008).

Revenue rejected this characterization of the gain as nonbusiness income and issued a notice of deficiency.

Upon review, the Missouri Administrative Hearing Commission (AHC) decided that the gain was properly characterized as nonbusiness income under either the transactional test or the functional test. The Director of Revenue was unable to cite any authority to the contrary, but claimed that the evidence was insufficient to support the AHC's application of existing precedent to the instant case. However, the Supreme Court rejected the Director's argument, holding that the undisputed facts, summarized in its opinion and further detailed in an ample record to which the Director contributed through multiple discovery requests, were quite adequate to support the AHC's decision."[38]

5. New Jersey: Income Tax Issues and IRC § 338(h)(10)

New Jersey issued income tax regulations addressing the sourcing of receipts from the sale of tangible and intangible assets in an IRC § 338(h)(10) transaction:

> "For purposes of the New Jersey corporation business tax, receipts from the sale of tangible and intangible assets in a transaction pursuant to IRC §338(h)(10) (regarding nonrecognition of gain or loss by a target corporation together with the nonrecognition of gain or loss on the sale of stock by a selling consolidated group) are allocated and sourced to New Jersey by multiplying the gain by a three-year average of the allocation factors used by a target corporation for its three tax return periods immediately prior to the sale."[39]

New Jersey also engaged in litigation involving an IRC § 338(h)(10) transaction, but that case involved UDITPA's distinction between "operational" business income (i.e., income derived from ordinary business operations) and "non-operational" business income (e.g., income derived from investments in the stock and bond markets):

> "Gain from the sale of a corporation's stock was not subject to the New Jersey corporation business tax because it was a deemed sale of assets under IRC Sec. 338(h)(10), which was nonoperational income allocable to its principal state of business, California.
>
> The court, following the Uniform Division of Income for Tax Purposes Act (UDITPA) and decisions from other state courts, determined that an election made under IRC Sec. 338(h)(10) to treat a corporation's sale of stock as a deemed sale of all its assets, was not an integral part of the corporation's trade or business and was, therefore, nonoperational income. Also, because New Jersey, by regulation, specifically recognizes IRC Sec. 338(h)(10) elections for corporation business tax purposes, the Division of Taxation was bound to accept all consequences of such an election. Because the income was nonoperational and was not allocable to New Jersey, but to California, it was not subject to the corporation business tax."[40]

---

38 "Missouri—Corporate Income Tax: Gain from Sale and Liquidation of Subsidiary Was Nonbusiness Income," *Tax Newsletter*, CCH (February 2007), citing *ABB C-E Nuclear Power Inc. v. Director of Revenue*, Missouri Supreme Court, No. SC87811 (January 30, 2007).

39 "New Jersey—Corporate Income Tax: Sourcing Rule for IRC §338 Transaction Added", Tax Newsletter, CCH (July 2007), citing N.J.A.C. 18:7-8.12, New Jersey Division of Taxation, effective July 16, 2007.

6. New York: Income Tax Issues and IRC § 338(h)(10)

New York enacted legislation in 2010 to address situations concerning nonresident shareholders of an S corporations involved in an IRC § 338(h)(10) transaction:

> "If a nonresident is a shareholder in an S corporation that has distributed an installment obligation under IRC §453(h)(1)(A), then any gain recognized on the receipt of payments from the installment obligation for federal income tax purposes will be treated as New York source income, allocated in a manner consistent with the applicable methods and rules for allocation under Tax Law Article 9-A or 32 in the year that the assets were sold. In addition, if the shareholders of the S corporation have made an election under IRC §338(h)(10), then any gain recognized on the deemed asset sale for federal income tax purposes will be treated as New York source income, allocated in a manner consistent with the applicable methods and rules for allocation under Tax Law Article 9-A or 32 in the year that the shareholder made the §338(h)(10) election. For purposes of a §338(h)(10) election, when a nonresident shareholder exchanges his or her S corporation stock as part of the deemed liquidation, any gain or loss recognized will be treated as the disposition of an intangible asset and will not increase or offset any gain recognized on the deemed assets sale as a result of the §338(h)(10) election.
>
> Further, for taxable years beginning on or after January 1, 2010, in the case of an S corporation that terminates its taxable status in the state, New York source income includes any income or gain recognized on the receipt of payments from an installment sale contract entered into when the S corporation was subject to tax in New York, allocated in a manner consistent with the applicable methods and rules for allocation under Tax Law Article 9-A or 32 in the year that the S corporation sold its assets."[41]

New York followed up that legislation dealing with nonresident shareholders of an S corporation by issuing a formal tax policy directive:

> "The New York Department of Taxation and Finance has issued a personal income tax memorandum discussing recent amendments to the treatment of certain S corporation income received by nonresident taxpayers. The amendments were enacted as part of the 2010-2011 budget package.
>
> If a nonresident is a shareholder in an S corporation that has made the election to be a New York S corporation, and the S corporation has distributed an installment obligation under IRC §453(h)(1)(A) to the shareholders, any gain recognized on the receipt of payments from the installment obligation for federal income tax purposes will be treated as New York source income. The amount of the gain to be included in New York source income is determined using the applicable allocation percentage under the corporate franchise tax or bank franchise tax in effect for the year when the assets were sold.

40 "New Jersey—Corporate Income Tax: Deemed Sale of Assets Was Nonoperational Income", *Tax Newsletter*, CCH (August 2007), citing *McKesson Water Products Company v. Division of Taxation*, New Jersey Tax Court, No. 000156-2004 (August 13, 2007).

41 "New York—Corporate, Personal Income Taxes: Enacted Revenue Bill Includes Numerous Changes", *Tax Newsletter*, CCH (August 2010). citing Ch. 57 (A.B. 9710) and Ch. 312 (A.B. 11678), Laws 2010, effective August 4, 2010.

Stephen Moore, Research Analyst, Revenue Committee, Nebraska Legislature (12092011).

If a nonresident is a shareholder in an S corporation that has made the election to be a New York S corporation, and the S corporation has made an election under IRC §338(h)(10), then any gain recognized on the deemed asset sale for federal income tax purposes will be treated as New York source income. The amount of the gain to be included in New York source income is determined using the applicable allocation percentage under the corporate franchise tax or bank franchise tax in effect for the year that the §338(h)(10) election was made.

In addition, when a nonresident shareholder exchanges his or her S corporation stock as part of the deemed liquidation, the law provides that any gain or loss recognized on the stock sale for federal income tax purposes will be treated as the disposition of an intangible asset for New York purposes and will not increase or offset any gain recognized on the deemed asset sale as a result of the §338(h)(10) election. Therefore, the gain or loss from the deemed liquidation of S corporation stock is not included in New York source income.

Generally, the above amendments apply to taxable years beginning on or after January 1, 2007. However, they will also apply to any other taxable years where the statute of limitations for issuing an assessment remains open because the taxpayer, for that year, did any of the following:

-- failed to file a return;

-- failed to report federal changes;

-- filed a false or fraudulent return with the intent to evade tax; or

-- substantially omitted income under Tax Law §683(d).

In addition, the amendment related to IRC §453(h)(1)(A) applies to installment payments received in any tax year described above even if the payments are attributable to an installment obligation entered into prior to that year.

A taxpayer who is affected by these amendments for any prior year described above must file an amended return for any of the years affected if a return was previously filed for that year, or must file an original return if no return was filed for the prior year. Taxpayers amending returns or filing original returns will not be assessed penalties for any underpayment of tax attributable to these amendments.

If a nonresident is a shareholder in an S corporation that has made the election to be a New York S corporation, and that S corporation terminates its taxable status in New York, any income or gain recognized on the receipt of payments from an installment sale contract entered into when the S corporation was subject to tax in New York will be treated as New York source income. The amount of the income or gain to be included in New York source income is determined using the applicable allocation percentage under the corporate franchise tax or bank franchise tax in effect for the year that the S corporation sold the assets that gave rise to the installment sale contract. This amendment is applicable to installment payments received in taxable years beginning on or after January 1, 2010, even if the payments are attributable to an installment sale contract entered into prior to 2010."[42]

42 "New York—Personal Income Tax: Treatment of Certain S Corporation Income Received by Nonresidents Discussed", *Tax Newsletter*, CCH (September 2010), citing *TSB-M-10(10)I*, Office of Tax Policy Analysis, New York Department of Taxation and Finance (August 31, 2010).

7. Tennessee: Excise Tax Issues and IRC § 338(h)(10)

Tennessee enacted legislation in 2007 to address concerns about S corporations and IRC § 338(h)(10) transactions: "Excise tax modifications are enacted for S corporations for any gain or loss that is attributable to an IRC §338(h)(10) election and that is not included in net earnings or losses. The modifications apply to transactions occurring on or after October 1, 2007."[43]

8. Utah: Income Tax Issues and IRC § 338(h)(10)

Like the Illinois and Missouri cases referred to above, Utah has also engaged in litigation over the proper state income tax treatment of an IRC § 338(h)(10) transaction in a case where UDITPA's distinction between "business" and "nonbusiness" income was an important element of the case:

> "***In a case of first impression***, a Utah District Court held that gain realized on the complete sale of a corporation in an IRC Sec. 338(h)(10) transaction was nonbusiness income for Utah corporate income tax purposes because the transaction was not integral to the corporation's regular trade or business operations. Thus, the gain on the sale was neither apportionable to nor taxable by Utah, but was instead allocable to Alabama, the state of the corporation's commercial domicile.
>
> **Background**
> Prior to the sale, the corporation was involved in two ventures involving the operation of coalbed methane gas wells. The shareholders' sold all of their common stock in the corporation, and made an election under IRC Sec. 338(h)(10) to treat the gain on this transaction as if the corporation had sold all its assets.
>
> **Functional and Transactional Tests**
> The administrative decisions of the Utah State Tax Commission, although not binding, were illustrative of the fact that Utah's tax apportionment statute contains both a transactional test and a functional test for determining whether income is business income or nonbusiness income. Looking to the decisions of other states, the court held that, under the functional test, the disposition of property in this case was not integral to the corporation's regular trade or business operations, because it did not benefit the corporation's regular trade or business. Rather, the disposition benefited only the shareholders of the corporation, while resulting in the complete cessation of the corporation's operations. The court noted that the vast majority of cases dealing with partial or complete liquidations have held that the proceeds from these dispositions are nonbusiness income, except in cases involving the partial liquidation of a portion of a corporation's business and the reinvestment of the resulting proceeds back into the corporation. The court also noted, for the sake of clarification and certainty, that, although the parties agreed that the transactional test did not apply to this case, other courts applying the transactional test have consistently held that income arising from extraordinary events, such as a complete liquidation and cessation of business, cannot satisfy the transactional test.

---

43 "Tennessee—Corporate Income, Franchise Taxes: Credits Expanded, Other Changes Made", *Tax Newsletter, CCH (June 2007), citing S.B. 2223, Laws 2007, effective June 28, 2007.*

> **Contradictory Statute**
> The Commission cited another Utah statute defining "business income" for the proposition that there is a rebuttable presumption that the gain or loss on a deemed sale of assets constitutes business income. However, the court stated that this interpretation of the law would be contradictory not only to the functional test, but equally so to the transactional test, which all courts have agreed does not apply in the liquidation context. In construing the two statutes addressing the same subject matter, the court held that the tax apportionment statute, which was based on the Multistate Tax Compact, was controlling because its definition of "business income" was more specific than that in the other Utah statute. Moreover, even if the court did not find the tax apportionment statute to be controlling, the court stated that, because of the plain language of the tax apportionment statute and the overwhelming amount of case law supporting the proposition that a liquidation does not result in business income, the taxpayers in this case had, at a minimum, rebutted the presumption that gain on the sale in this case resulted in business income. The court further noted that it was required to construe taxation statutes liberally in favor of the taxpayers, and that the legislature would need to clarify its intent if it intended for the statute to be read as applying to a liquidation under either the functional test or the transactional test.
>
> **Constitutionality of Tax**
> Finally, the court noted that if the income in question had been business income, then the portion of the gain attributable to business income earned in Utah would have been taxable by Utah. The fact that the taxpayers may have overpaid taxes to Alabama would not result in any unconstitutional application of the law in Utah."[44]

However, the district court's decision was vacated on appeal to the Utah Supreme Court:

> "The Utah Supreme Court has vacated a Utah district court opinion, in which the lower court held, in a case of first impression, that gain realized on the complete sale of a corporation in an IRC §338(h)(10) transaction was nonbusiness income for Utah corporate income tax purposes. . . . [T]he lower court held that the gain on the sale was neither apportionable to nor taxable by Utah, but was instead allocable to the state of the corporation's commercial domicile under both the functional and transactional tests for determining whether income is business income or nonbusiness income. . . . The Utah Supreme Court ordered the lower court case vacated based upon the parties' participation in mediation, entering into a settlement agreement, and joint motion to vacate."[45]

9. Virginia: Income Tax Issues and IRC § 338(h)(10)

The Virginia Department of Taxation issued a revenue ruling addressing the proper state income tax treatment of an IRC § 338(h)(10) transaction in a situation where UDITPA's distinction between "business" and "nonbusiness" income was an important element of the transaction:

---

44 "Utah—Corporate Income Tax: Gain From Sale of Business Was Nonbusiness Income," *Tax Newsletter*, CCH (February 2007)(emphasis added), citing *Chambers v. Utah State Tax Commission*, Utah District Court, Fourth Judicial District, Utah County, No. 050402915 TX (January 29, 2007).

45 "Utah—Corporate Income Tax: Case Classifying IRC §338(h)(10) Gain as Nonbusiness Income Vacated", *Tax Newsletter*, CCH (January 2008), citing *Chambers v. State Tax Commission*, Utah Supreme Court (January 25, 2008).

"The taxpayer, an out-of-state multinational corporation with numerous subsidiaries, was not allowed a subtraction for nonbusiness income resulting from the gains of a sale of subsidiary stock to an unrelated third party on its Virginia corporate combined income tax return. The taxpayer, in concert with the unrelated third party, elected to treat the transaction as an asset sale under IRC Sec. 338(h)(10) and then subtracted the gain from the sale of stock as nonbusiness income. However, the Virginia Department of Taxation has held that if the seller, target, purchaser or any combination thereof are Virginia taxpayers, the IRC Sec. 338(h)(10) election actually made on a federal return will be recognized exactly as it is for federal purposes. To the extent that any gain or loss is deemed to be recognized for federal purposes by any party, it will be similarly recognized by the applicable entity for Virginia purposes. Because Virginia follows the federal treatment of the IRC Sec. 338(h)(10) election, the taxpayer's subsidiary is deemed to have sold its assets, and must recognize the gain.

The taxpayer's request for an alternative method of allocation and apportionment in regards to the gain was also rejected because the taxpayer's subsidiary sold its own assets and the gain was recognized in the subsidiary's separately computed Virginia taxable income. As such, the subsidiary had a unitary relationship with its operating assets (both tangible and intangible) and the gain was properly included in the subsidiary's apportionable income. Additionally, Virginia's treatment of the gain from the sale of the subsidiary was found to be fairly proportioned.

Finally, the taxpayer's return was adjusted to include Virginia net operating loss deductions (NOLDs), which were not carried forward to the taxable years at issue by the auditor. Although Virginia income tax laws do not address NOLDs, the starting point in computing Virginia taxable income is federal taxable income and as such, Virginia allows a NOLD to the extent that it is allowable in computing federal taxable income."[46]

E. Does the "Step Transaction Doctrine" Apply to IRC § 338(h)(10) Transactions? Answer: No.

1. What Is the "Step Transaction Doctrine?"

"The step transaction doctrine is a variation on the substance over form doctrine, designed to ensure that transactions are taxed according to their substance regardless of their form. Under this doctrine, separate transactions, or purportedly separate transactions, may be combined into a single transaction. For example, in Smith v. Commissioner, the Tax Court illustrated the application of the step transaction doctrine with the following example:

> The step transaction doctrine generally applies in cases where a taxpayer seeks to get from point A to point D and does so stopping in between at points B and C. The whole purpose of the unnecessary stops is to achieve tax consequences differing from those which a direct path from A to D would have produced. In such a situation, courts are not bound by the twisted path taken by the taxpayer, and the intervening stops may be disregarded or rearranged. (citation omitted)

Judging by the case law, there is no simple guideline for determining when the step transaction doctrine should be applied. As a general statement, formally separate steps are treated as a single

46 "Virginia—Corporate Income Tax: Subtraction for Nonbusiness Income, Alternative Method of Apportionment Disallowed", *Tax Newsletter*, CCH (October 2008), citing *Ruling of Commissioner, P.D. 08-188*, Virginia Department of Taxation (October 17, 2008).

transaction if such steps are, in substance, integrated, interdependent and focused towards a particular result. On the other hand, a court will not apply the step transaction doctrine if the substance of the transaction does not differ from its form. Nevertheless, the tests used in applying the step transaction doctrine vary depending on the circumstances and have been described as 'notably abstruse.'"[47]

2. U.S. Treasury Regulations: The Step Transaction Doctrine Does Not Apply to IRC § 338(h)(10) Transactions.

Final Treasury Regulations issued on July 5, 2006, governing IRC § 338(h)(10) provide that the "step transaction doctrine" does not apply to IRC § 338(h)(10) transactions:

"***Problem addressed.*** The reg addresses the conundrum presented by Rev Rul 2001-46, 2001-1 CB 321. That ruling concluded that a reverse subsidiary merger followed by a merger of the acquired target into the acquiring parent would be treated as a Type A reorganization, when there was sufficient equity consideration (50%), despite the fact that there was not sufficient equity consideration for a Code Sec. 368(a)(2)(E) reorganization (80%). [See Bittker & Eustice: Federal Income Tax Corps & Shareholders ¶ 12.25(5) Example 7]

The conundrum was that by so applying the step transaction doctrine the government may have upset the plans of the acquirer for a qualified stock purchase of target, setting the stage for a Code Sec. 338(h)(10) election, which would result in a deemed purchase of the target's assets, and an accompanying basis step-up. In contrast, the Rev Rul 2001-46 treatment would result in a carryover basis in the target's assets.

In order to give taxpayers the option for the basis step-up result, IRS issued the temporary reg in 2003 to recognize the existence of a qualified stock purchase, and hence a Code Sec. 338(h)(10) election, despite the fact that a second step converted the transaction into an asset reorganization, under general principles.

Nuances. To the casual observer, however, the case in which this result is allowed by the regulation is not so easily distinguishable from some other cases. The following comparison might be useful to understand what the reg does and does not do. Each case involves the acquisition of all of the stock of target for some mix of consideration of acquirer's cash or its voting stock, a Code Sec. 338(h)(10) election (or not), and a related merger of target with a sister corporation.

47 *Mertens Law of Federal Income Taxation*, § 43:180, "Step transaction doctrine—General" (Dec. 2011) (footnotes omitted). "One of the fundamental nonstatutory federal tax law principles is that the substance, and not the form, of a transaction controls the taxation of the transaction. The substance over form doctrine originated in Gregory v. Helvering, where the Supreme Court stated that '[a]s a general rule, the incident of taxation depends on the substance rather than form of the transaction."' [Id., footnotes omitted.]

Item of Interest	Case 1	Case 2	Case 3
Consideration Paid:	all cash	50:50 cash/stock	all stock
338(h)(10) election:	no	yes	can't
Merger of target with New sister:	yes	yes	yes
Result:	QSP + reorg	338 applies	Reorg. + liquidation

Case 1 is Reg. § 1.338-3(d)(5) Example. This is the "Yoc Heating" example. [See Bittker & Eustice: Federal Income Tax Corps & Shareholders ¶ 12.21(2)(b)] It rests on the premise that the QSP without a Code Sec. 338 election invests the acquirer with continuity of interest so as to support reorganization treatment of the follow-on sideways merger. The result is simply to prevent a housekeeping maneuver to reposition assets within a corporation group from causing a huge gain recognition. But the reorganization treatment does not extend to the stock seller, who has a taxable sale.

Case 2 is the case at which the new regulation is aimed: stepping together the two transactions would give you a Code Sec. 368(a)(2)(D) subsidiary merger, but the reg lets the parties elect out of that treatment by making the Code Sec. 338(h)(10) election. Note that if the steps are not stepped together there could be no reorganization treatment, election or not, because the acquirer acquired stock for a mix of stock and cash.

Case 3 is the case in which the new regulation cannot apply because the first step stock acquisition, viewed alone, could not be a QSP: it is a Code Sec. 368(a)(1)(B) reorganization ("solely for voting stock"). This choice of the reg sensibly solves the which-came-first problem by saying that if it is a reorganization in the first step, then the analysis stops and no QSP can result. Example 14 of the new regulation.

Conclusion. The finalized regulations don't tell you anything you didn't already know. But they do remind us that steps following stock acquisitions should be monitored carefully."[48]

V. Summary and Recommendations

This interim study committee report fulfills the requirements of LR 223 (2011) by:

1. Examining the provisions of Nebraska's special capital gains income tax deduction and its extraordinary dividends income tax deduction. This report also examines the legislative history of the special capital gains deduction, which originated with enactment of Laws 1987, LB 775, the bill that established Nebraska's first large-scale business tax

48 J. Cummings, "Section 338(h)(10) reg finalized", *Corporate Tax Insights on Checkpoint,* Volume 04, No. 13 (July 11, 2006).

incentives program known as the Employment and Investment Growth Act. This report also examines the legislative history of the extraordinary dividends deduction and the annual dollar value of foregone revenue attributable to both of those income deductions for tax years 1998, 2000, 2002, 2004, 2006, 2008, and 2010 and it provides reason to believe that substantially all of the foregone income tax revenue attributable to both of those deductions is attributable to the special capital gains deduction rather than the extraordinary dividends deduction, due to the rarity of extraordinary dividends.

2. Examining whether the economic substance doctrine should be codified. This report will help readers decide whether that doctrine should be codified for purposes of Nebraska state income taxation.

- This report also examines the origins of that doctrine, finds that Congress codified only part of that doctrine, that the Internal Revenue Service (IRS) opposed codification of it, and that after Congress codified part of that doctrine the IRS issued at least three formal directives to provide guidance for its officers and agents who are contemplating applying the partially codified doctrine.
- This report also shows that use of that doctrine by federal courts to trump literal provisions of the Internal Revenue Code (IRC) is not an unconstitutional breach of separation of powers and that at least one federal circuit court of appeals allowed use of that doctrine to uphold a taxpayer-defendant's criminal convictions for tax evasion and filing false tax returns but the U.S. Supreme Court vacated the lower court's decision and remanded the case to federal district court to allow the taxpayer-defendant to introduce certain evidence.
- This report also finds that no states that impose an income tax appear to have codified that doctrine.
- This report also finds that the Nebraska Department of Revenue has not taken a position on whether that doctrine should be codified and that the department believes it is too early to discuss any type of legislation concerning codification of that doctrine.

3. Examining whether the Nebraska Department of Revenue has encountered problems with transactions governed by IRC § 338. This report finds that the department has not encountered problems with IRC § 338 transactions since it issued Revenue Ruling 22-10-1 on September 8, 2010; explains what IRC § 338 does; examines state and local tax planning considerations; finds that at least nine states besides Nebraska have encountered problems with IRC § 338(h)(10) transactions which led to either litigation, the issuance of revenue rulings, and/or the enactment of legislation intended to overcome problems encountered; and finds that the "step transaction doctrine" does not apply to IRC § 338(h)(10) transactions.

The Revenue Committee made no recommendations concerning the LR 223 interim study.

APPENDIX A:

"SPECIAL CAPITAL GAINS FOR FEDERAL § 338 ELECTION"

Revenue Ruling 22-10-1, Individual Income Tax, Nebraska Department of Revenue (Sept. 10, 2010)

(http://www.revenue.ne.gov/legal/rulings/rr221001.html)

Issues:

1. The shareholders of a corporation have decided to sell all the stock of the corporation to another corporation. They have elected to treat the sale of stock under Internal Revenue Code (IRC) § 338(h)(10) as though it was the sale of assets. Some of the shareholders hold shares of stock that would qualify for Nebraska's special capital gains exclusion (Exclusion). Does the IRC § 338(h)(10) election disqualify the transaction from the Exclusion?
2. If the sale is not disqualified, what portion of the capital gains from the sale of the capital stock can be excluded?

Conclusions:

1. The election under IRC § 338(h)(10) to treat the sale as the sale of assets does not disqualify the sale from the Exclusion.
2. The capital gains determined on the deemed sale of assets under IRC §§ 1231, 1245, or 1250 do not qualify for the Exclusion, but any capital gains from the sale of capital stock attributed to redemption of capital stock in the deemed liquidation do qualify.

Definition:

Special Capital Gains Exclusion. A special capital gains exclusion is an exclusion provided in Neb. Rev. Stat. § 77-2715.09 that reduces Nebraska taxable income by the amount of the capital gains from the sale or exchange of capital stock of one corporation selected by a shareholder who received the stock while employed by the corporation, or on account of employment with the corporation, when the corporation meets certain other criteria (see Neb. Rev. Stat. § 77-2715.08).

Analysis:

The ownership of a business operated by a corporation is normally transferred either by the shareholders selling the stock of the corporation or by the corporation selling its capital assets. There are significant tax and nontax business reasons for using each of the two methods. In addition to the federal tax differences which are recognized by Nebraska, the Revenue Act of 1967, as amended, provides for an additional difference between the two methods. The Exclusion applies to the capital gains from the sale or exchange of capital stock, but does not apply to the capital gains related to the sale of the assets of a corporation.

In order to minimize the tax differences between the two types of transactions, the IRC provides an election under § 338(h)(10). This particular election is an election to treat the sale of stock as the deemed sale of assets. The transaction is taxed as if there were two separate corporations, "Old Target" and "New Target." Old Target is deemed to sell all of its assets to New Target at fair market value. New Target has a new depreciation basis for the assets, and Old Target recognizes gain on the assets as though the assets were sold at fair market value. The shareholder's basis of the stock in Old Target is adjusted, and then Old Target is deemed to make a distribution in liquidation which may create additional capital gains for the shareholders.

The actual transaction is the sale of stock that would qualify for the Exclusion. The making of the election does not disqualify the transaction. For Nebraska purposes, the federal election to treat the sale of the stock as the deemed sale of assets and liquidation is binding. The seller will have income for Nebraska in the same amount and of the same character as on the federal return.

Stephen Moore, Research Analyst, Revenue Committee, Nebraska Legislature (12092011).

Any ordinary income recognized, such as a recapture of accelerated depreciation, or gains on the sale of capital assets used in a trade or business under IRC §§ 1231, 1245, and 1250, recognized by Old Target, whether or not the gains flow through to, and are reported on, the shareholder's return are not allowable under the Exclusion. These items are deemed to arise from the sale of the assets.

Only the capital gains relating to the sale of stock recognized by the selling shareholder are eligible for the Exclusion. In the deemed transaction, the capital gains that arise from the deemed liquidation of the corporation are considered to be capital gains from the sale or exchange of capital stock. These capital gains on the deemed liquidation can be excluded from income subject to tax in Nebraska as indicated in Neb. Rev. Stat. § 77-2715.09 below (emphasis added):

> *77-2715.09 Capital stock; sale or exchange; extraordinary dividend and capital gains treatment.*
>
> *(1) Every resident individual may elect under this section to subtract from federal adjusted gross income, or for trusts qualifying under subdivision (2)(c) of this section from taxable income, the extraordinary dividends paid on and the capital gain from the sale or exchange of capital stock of a corporation acquired by the individual (a) on account of employment by such corporation or (b) while employed by such corporation.*

APPROVED:

Douglas A. Ewald
Tax Commissioner

September 8, 2010

APPENDIX B:

Internal Revenue Code § 338

Internal Revenue Code § 338 provides:

(a) General rule.--For purposes of this subtitle, if a purchasing corporation makes an election under this section (or is treated under subsection (e) as having made such an election), then, in the case of any qualified stock purchase, the target corporation--

(1) shall be treated as having sold all of its assets at the close of the acquisition date at fair market value in a single transaction, and

(2) shall be treated as a new corporation which purchased all of the assets referred to in paragraph (1) as of the beginning of the day after the acquisition date.

(b) Basis of assets after deemed purchase.--

(1) In general.--For purposes of subsection (a), the assets of the target corporation shall be treated as purchased for an amount equal to the sum of--

(A) the grossed-up basis of the purchasing corporation's recently purchased stock, and

(B) the basis of the purchasing corporation's nonrecently purchased stock.

(2) Adjustment for liabilities and other relevant items.--The amount described in paragraph (1) shall be adjusted under regulations prescribed by the Secretary for liabilities of the target corporation and other relevant items.

(3) Election to step-up the basis of certain target stock.--

(A) In general.--Under regulations prescribed by the Secretary, the basis of the purchasing corporation's nonrecently purchased stock shall be the basis amount determined under subparagraph (B) of this paragraph if the purchasing corporation makes an election to recognize gain as if such stock were sold on the acquisition date for an amount equal to the basis amount determined under subparagraph (B).

(B) Determination of basis amount.--For purposes of subparagraph (A), the basis amount determined under this subparagraph shall be an amount equal to the grossed-up basis determined under subparagraph (A) of paragraph (1) multiplied by a fraction--

(i) the numerator of which is the percentage of stock (by value) in the target corporation attributable to the purchasing corporation's nonrecently purchased stock, and

(ii) the denominator of which is 100 percent minus the percentage referred to in clause (i).

(4) Grossed-up basis.--For purposes of paragraph (1), the grossed-up basis shall be an amount equal to the basis of the corporation's recently purchased stock, multiplied by a fraction--

(A) the numerator of which is 100 percent, minus the percentage of stock (by value) in the target corporation attributable to the purchasing corporation's nonrecently purchased stock, and

(B) the denominator of which is the percentage of stock (by value) in the target corporation attributable to the purchasing corporation's recently purchased stock.

(5) Allocation among assets.--The amount determined under paragraphs (1) and (2) shall be allocated among the assets of the target corporation under regulations prescribed by the Secretary.

(6) Definitions of recently purchased stock and nonrecently purchased stock.--For purposes of this subsection--

(A) Recently purchased stock.--The term "recently purchased stock" means any stock in the target corporation which is held by the purchasing corporation on the acquisition date and which was purchased by such corporation during the 12-month acquisition period.

(B) Nonrecently purchased stock.--The term "nonrecently purchased stock" means any stock in the target corporation which is held by the purchasing corporation on the acquisition date and which is not recently purchased stock.

[**(c) Repealed.** Pub.L. 99-514, Title VI, § 631(b)(2), Oct. 22, 1986, 100 Stat. 2272]

(d) Purchasing corporation; target corporation; qualified stock purchase.--For purposes of this section--

(1) Purchasing corporation.--The term "purchasing corporation" means any corporation which makes a qualified stock purchase of stock of another corporation.

(2) Target corporation.--The term "target corporation" means any corporation the stock of which is acquired by another corporation in a qualified stock purchase.

(3) Qualified stock purchase.--The term "qualified stock purchase" means any transaction or series of transactions in which stock (meeting the requirements of section 1504(a)(2)) of 1 corporation is acquired by another corporation by purchase during the 12-month acquisition period.

(e) Deemed election where purchasing corporation acquires asset of target corporation.--

(1) In general.--A purchasing corporation shall be treated as having made an election under this section with respect to any target corporation if, at any time during the consistency period, it acquires any asset of the target corporation (or a target affiliate).

(2) Exceptions.--Paragraph (1) shall not apply with respect to any acquisition by the purchasing corporation if--

(A) such acquisition is pursuant to a sale by the target corporation (or the target affiliate) in the ordinary course of its trade or business,

(B) the basis of the property acquired is determined wholly by reference to the adjusted basis of such property in the hands of the person from whom acquired,

(C) such acquisition was before September 1, 1982, or

(D) such acquisition is described in regulations prescribed by the Secretary and meets such conditions as such regulations may provide.

(3) Anti-avoidance rule.--Whenever necessary to carry out the purpose of this subsection and subsection (f), the Secretary may treat stock acquisitions which are pursuant to a plan and which meet the requirements of section 1504(a)(2) as qualified stock purchases.

(f) Consistency required for all stock acquisitions from same affiliated group.--If a purchasing corporation makes qualified stock purchases with respect to the target corporation and 1 or more target affiliates during any consistency period, then (except as otherwise provided in subsection (e))--

(1) any election under this section with respect to the first such purchase shall apply to each other such purchase, and

(2) no election may be made under this section with respect to the second or subsequent such purchase if such an election was not made with respect to the first such purchase.

(g) Election.--

(1) When made.--Except as otherwise provided in regulations, an election under this section shall be made not later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs.

(2) Manner.--An election by the purchasing corporation under this section shall be made in such manner as the Secretary shall by regulations prescribe.

(3) Election irrevocable.--An election by a purchasing corporation under this section, once made, shall be irrevocable.

(h) Definitions and special rules.--For purposes of this section--

(1) 12-month acquisition period.--The term "12-month acquisition period" means the 12-month period beginning with the date of the first acquisition by purchase of stock included in a qualified stock purchase (or, if any of such stock was acquired in an acquisition which is a purchase by reason of subparagraph (C) of paragraph (3), the date on which the acquiring corporation is first considered under section 318(a) (other than paragraph (4) thereof) as owning stock owned by the corporation from which such acquisition was made).

(2) Acquisition date.--The term "acquisition date" means, with respect to any corporation, the first day on which there is a qualified stock purchase with respect to the stock of such corporation.

(3) Purchase.--

(A) In general.--The term "purchase" means any acquisition of stock, but only if--

(i) the basis of the stock in the hands of the purchasing corporation is not determined (I) in whole or in part by reference to the adjusted basis of such stock in the hands of the person from whom acquired, or (II) under section 1014(a) (relating to property acquired from a decedent),

(ii) the stock is not acquired in an exchange to which section 351, 354, 355, or 356 applies and is not acquired in any other transaction described in regulations in which the transferor does not recognize the entire amount of the gain or loss realized on the transaction, and

(iii) the stock is not acquired from a person the ownership of whose stock would, under section 318(a) (other than paragaraph [FN1] (4) thereof), be attributed to the person acquiring such stock.

(B) Deemed purchase under subsection (a).--The term "purchase" includes any deemed purchase under subsection (a)(2). The acquisition date for a corporation which is deemed purchased under subsection (a)(2) shall be determined under regulations prescribed by the Secretary.

(C) Certain stock acquisitions from related corporations.--

(i) In general.--Clause (iii) of subparagraph (A) shall not apply to an acquisition of stock from a related corporation if at least 50 percent in value of the stock of such related corporation was acquired by purchase (within the meaning of subparagraphs (A) and (B)).

(ii) Certain distributions.--Clause (i) of subparagraph (A) shall not apply to an acquisition of stock described in clause (i) of this subparagraph if the corporation acquiring such stock--

(I) made a qualified stock purchase of stock of the related corporation, and

(II) made an election under this section (or is treated under subsection (e) as having made such an election) with respect to such qualified stock purchase.

(iii) Related corporation defined.--For purposes of this subparagraph, a corporation is a related corporation if stock owned by such corporation is treated (under section 318(a) other than paragraph (4) thereof) as owned by the corporation acquiring the stock.

(4) Consistency period.--

(A) In general.--Except as provided in subparagraph (B), the term "consistency period" means the period consisting of--

(i) the 1-year period before the beginning of the 12-month acquisition period for the target corporation,

(ii) such acquisition period (up to and including the acquisition date), and

(iii) the 1-year period beginning on the day after the acquisition date.

(B) Extension where there is plan.--The period referred to in subparagraph (A) shall also include any period during which the Secretary determines that there was in effect a plan to make a qualified stock purchase plus 1 or more other qualified stock purchases (or asset acquisitions described in subsection (e)) with respect to the target corporation or any target affiliate.

(5) Affiliated group.--The term "affiliated group" has the meaning given to such term by section 1504(a) (determined without regard to the exceptions contained in section 1504(b)).

(6) Target affiliate.--

(A) In general.--A corporation shall be treated as a target affiliate of the target corporation if each of such corporations was, at any time during so much of the consistency period as ends on the acquisition date of the target corporation, a member of an affiliated group which had the same common parent.

(B) Certain foreign corporations, etc.--Except as otherwise provided in regulations (and subject to such conditions as may be provided in regulations)--

(i) the term "target affiliate" does not include a foreign corporation, a DISC, or a corporation to which an election under section 936 applies, and

(ii) stock held by a target affiliate in a foreign corporation or a domestic corporation which is a DISC or described in section 1248(e) shall be excluded from the operation of this section.

[**(7) Repealed.** Pub.L. 100-647, Title I, § 1006(e)(20), Nov. 10, 1988, 102 Stat. 3403]

(8) Acquisitions by affiliated group treated as made by 1 corporation.--Except as provided in regulations prescribed by the Secretary, stock and asset acquisitions made by members of the same affiliated group shall be treated as made by 1 corporation.

(9) Target not treated as member of affiliated group.--Except as otherwise provided in paragraph (10) or in regulations prescribed under this paragraph, the target corporation shall not be treated as a member of an affiliated group with respect to the sale described in subsection (a)(1).

(10) Elective recognition of gain or loss by target corporation, together with nonrecognition of gain or loss on stock sold by selling consolidated group.--

(A) In general.--Under regulations prescribed by the Secretary, an election may be made under which if--

(i) the target corporation was, before the transaction, a member of the selling consolidated group, and

(ii) the target corporation recognizes gain or loss with respect to the transaction as if it sold all of its assets in a single transaction,

then the target corporation shall be treated as a member of the selling consolidated group with respect to such sale, and (to the extent provided in regulations) no gain or loss will be recognized on stock sold or exchanged in the transaction by members of the selling consolidated group.

(B) Selling consolidated group.--For purposes of subparagraph (A), the term "selling consolidated group" means any group of corporations which (for the taxable period which includes the transaction)--

(i) includes the target corporation, and

(ii) files a consolidated return.

To the extent provided in regulations, such term also includes any affiliated group of corporations which includes the target corporation (whether or not such group files a consolidated return).

(C) Information required to be furnished to the Secretary.--Under regulations, where an election is made under subparagraph (A), the purchasing corporation and the common parent of the selling consolidated group shall, at such times and in such manner as may be provided in regulations, furnish to the Secretary the following information:

(i) The amount allocated under subsection (b)(5) to goodwill or going concern value.

(ii) Any modification of the amount described in clause (i).

(iii) Any other information as the Secretary deems necessary to carry out the provisions of this paragraph.

(11) Elective formula for determining fair market value.--For purposes of subsection (a)(1), fair market value may be determined on the basis of a formula provided in regulations prescribed by the Secretary which takes into account liabilities and other relevant items.

[**(12) Repealed.** Pub.L. 99-514, Title VI, § 631(e)(5), Oct. 22, 1986, 100 Stat. 2273]

(13) Tax on deemed sale not taken into account for estimated tax purposes.--For purposes of section 6655, tax attributable to the sale described in subsection (a)(1) shall not be taken into account. The preceding sentence shall not apply with respect to a qualified stock purchase for which an election is made under paragraph (10).

[**(14) Repealed.** Pub.L. 108-27, Title III, § 302(e)(4)(B)(i), May 28, 2003, 117 Stat. 763]

(15) Combined deemed sale return.--Under regulations prescribed by the Secretary, a combined deemed sale return may be filed by all target corporations acquired by a purchasing corporation on the same acquisition date if such target corporations were members of the same selling consolidated group (as defined in subparagraph (B) of paragraph (10)).

(16) Coordination with foreign tax credit provisions.--Except as provided in regulations, this section shall not apply for purposes of determining the source or character of any item for purposes of subpart A of part III of subchapter N of this chapter (relating to foreign tax credit). The preceding sentence shall not apply to any gain to the extent such gain is includible in gross income as a dividend under section 1248 (determined without regard to any deemed sale under this section by a foreign corporation).

(i) Regulations.--The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including--

(1) regulations to ensure that the purpose of this section to require consistency of treatment of stock and asset sales and purchases may not be circumvented through the use of any provision of law or regulations (including the consolidated return regulations) and

(2) regulations providing for the coordination of the provisions of this section with the provision of this title relating to foreign corporations and their shareholders."