



- D-4 Memorandum dated June 21, 1991 from the Assistant Director of the Corporate Income and Franchise Tax Division to the Audit Unit of the Corporate Income and Franchise Tax Division.
- D-5 Power of Attorney signed by [Taxpayer's Vice President of Finance] on May 25, 2001.
- D-6 Letter dated May 25, 2001 from [Taxpayer's Director of Taxes] to the North Carolina Department of Revenue.
- D-7 Letter dated December 19, 2001 from M. Larry Stanfield to [Taxpayer's Director of Taxes].
- D-8 Letter dated January 11, 2002 from [Taxpayer's Director of Taxes] to Mr. M. Larry Stanfield.
- D-9 Letter dated February 5, 2002 from Bobby L. Weaver, Jr., Administrative Officer, to [Taxpayer's Director of Taxes].
- D-10 Power of Attorney signed by [Taxpayer's Director of Taxes] on May 7, 2002.
- D-11 Letter dated May 8, 2002 from [an attorney] to Mr. Bobby L. Weaver, Jr.
- D-12 Letter dated May 14, 2002 from Bobby L. Weaver, Jr., Administrative Officer, to [an attorney].
- D-13 Letter dated May 28, 2002 from [an attorney] to Mr. Bobby L. Weaver, Jr.
- D-14 Letter dated May 28, 2002 from Bobby L. Weaver, Jr., Administrative Officer, to [an attorney].
- D-15 Letter dated May 30, 2002 from Bobby L. Weaver, Jr., Administrative Officer, to [an attorney].
- D-16 Letter dated May 31, 2002 from Eugene J. Cella, Assistant Secretary of Revenue, to [an attorney].
- D-17 Letter dated June 7, 2002 from Eugene J. Cella, Assistant Secretary of Revenue, to [an attorney].
- D-18 Stock Purchase Agreement Between [Parent] and [an unrelated entity].
- D-19 Letter dated June 12, 2002 from [an attorney] to Eugene J. Cella, Assistant Secretary of Revenue.
- D-20 Letter dated July 10, 2002 from Eugene J. Cella, Assistant Secretary of Revenue, to [an attorney].
- D-21 Letter dated July 18, 2002 from [an attorney] to Eugene J. Cella, Assistant Secretary of Revenue.

- D-22 North Carolina Department of Revenue Corporate Directive (CD-02-03).
- D-23 Memorandum dated August 20, 2002 from Gregory B. Radford, Director of Corporate, Excise and Insurance Tax Division to Eugene J. Cella, Assistant Secretary of Revenue.
- D-24 Letter dated August 20, 2002 from Kay Hobart, Assistant Attorney General, to [Taxpayer's attorney].
- D-25 Memorandum dated August 20, 2002 from [Taxpayer's attorney] to Kay Hobart, Assistant Attorney General.
- D-26 Letter dated August 23, 2002 from Eugene J. Cella, Assistant Secretary of Revenue, to [Taxpayer's attorney].
- D-27 North Carolina Department of Revenue Hearing Brief submitted by the Corporate, Excise and Insurance Tax Division to Eugene J. Cella, Assistant Secretary of Revenue on August 13, 2002.

### **FINDINGS OF FACT**

Based on the foregoing evidence of record, the Assistant Secretary for Administrative Tax Hearings makes the following findings of fact:

1. Taxpayer was incorporated in [another state] on June 29, 1993.
2. Taxpayer qualified to conduct business as a corporation in North Carolina on August 26, 1993.
3. Taxpayer is a manufacturer of [fabrics] sold primarily to domestic apparel producers.
4. Prior to August 26, 1997, Taxpayer was 100% owned by [Affiliate One], and [Affiliate One] was 100% owned by [Affiliate Two].
5. At that time, [Affiliate Two] was wholly owned by [Parent].
6. On August 26, 1997, [Affiliate One] was acquired by [an unrelated entity].
7. [The unrelated entity] acquired all of the capital stock of [Affiliate One] pursuant to the terms of a stock purchase agreement with [Parent] dated July 15, 1997.
8. The cash purchase price paid in the acquisition was \$126 million.
9. For federal income tax purposes, [Parent] (the selling consolidated group) and [unrelated entity] made an election under IRC § 338(h)(10) to treat the stock acquisition as if the assets of [Affiliate One] were sold.
10. Taxpayer reported on its Federal corporate income tax return (Federal Form 1120) a gain of \$60,818,777 resulting from the acquisition of [Affiliate One] stock by [unrelated entity].

11. Taxpayer's return does not indicate whether there was an IRC § 338(g) or IRC § 338(h)(10) election.
12. Taxpayer was not liquidated.
13. Taxpayer did not cease operating a separate and distinct line of business.
14. After the IRC § 338 election, Taxpayer continued to operate the same assets in the same line of business as before the deemed asset sale.
15. Taxpayer did not distribute any proceeds to its shareholders.
16. On May 26, 1998, Taxpayer filed its North Carolina Corporate Income Tax Return for the abbreviated fiscal year ending August 26, 1997, after having timely applied for an extension of time for filing the return on November 15, 1997.
17. Taxpayer's original North Carolina Corporate Income Tax Return reported business income subject to apportionment of \$65,378,352 and an apportionment factor of 50.3303%.
18. Taxpayer reported the gain from the deemed sale of its assets as business income on its original North Carolina Corporate Income Tax Return.
19. Taxpayer's tax liability for the period was \$2,095,567.
20. On May 25, 2001, Taxpayer filed an amended North Carolina Corporate Income Tax Return for the short-period beginning September 29, 1996 through August 26, 1997.
21. On the amended return, Taxpayer stated that the return was filed to correct an error on the North Carolina Corporate Income Tax Return only, and that there was no change to the federal corporation income tax return.
22. Taxpayer subtracted the \$60,818,777 gain from its federal taxable income on its amended return.
23. The amended return showed an overpayment of corporate income tax of \$2,097,425 for the period.
24. The amended return was examined by an auditor, who denied Taxpayer's request for a refund in a letter dated December 19, 2001.
25. Taxpayer protested the auditor's denial of the refund in its letter dated January 11, 2002 and requested a hearing.
26. The administrative hearing was held on August 13, 2002.
27. Taxpayer submitted no documentation or evidence at the hearing in support of its claim for a refund.

#### **CONCLUSIONS OF LAW**

Based on the foregoing findings of fact, the Assistant Secretary makes the following conclusions of law:

1. The Taxpayer, by conducting business activities in North Carolina, is subject to income taxation in this State in accordance with G.S. 105-130 *et. seq.*
2. Under G.S. 105-130.3, the income tax is imposed on the State net income of every C corporation doing business in this State at seven and seventy-five one-hundredths percent (7.75%) of the corporation's State net income.
3. "State net income" is defined as a taxpayer's federal taxable income as determined under the Internal Revenue Code, adjusted as provided in G.S. 105-130.5.
4. Pursuant to IRC § 338, a corporation (purchasing corporation) that makes a "qualified stock purchase" of the stock of another corporation (target) can elect to have the stock purchase treated as a purchase of the target's assets. The target recognizes gain or loss on the deemed sale of assets.
5. The gain from the deemed asset sale is properly includable in Taxpayer's federal taxable income under IRC § 338.
6. G.S. 105-130.5 contains no provision to deduct a gain that is included in federal taxable income as a result an IRC § 338 election.
7. G.S. 105-130.4(a)(1) defines "business income" as "income arising from transactions and activity in the regular course of the corporation's trade or business and includes income from tangible and intangible property if the acquisition, management, and/or disposition of the property constitute integral parts of the corporation's regular trade or business operations."
8. "Nonbusiness income" is defined as all income other than business income. G.S. 105-130.4(a)(5)
9. The assets deemed sold were integral to Taxpayer's trade or business.
10. The income at issue constitutes business income.
11. In *Lenox, Inc. v. Tolson*, 353 N.C. 659, 548 S.E. 2d 513 (2001), the North Carolina Supreme Court recognized an exception to the general rule that the sale of assets integral to a taxpayer's trade or business produces business income.
12. The exception is applicable when the sale is a liquidation and results in the cessation of a separate and distinct line of business and the company distributes all of the proceeds of the liquidation to its shareholders.
13. When all of these facts exist, the income is nonbusiness income.
14. *Lenox* involved an actual liquidation, not a deemed liquidation.
15. Under an IRC § 338 election, the target does not liquidate; does not cease to operate a separate and distinct line of business; continues to operate the same assets as it had

prior to the deemed asset sale; and does not distribute any proceeds to its shareholders.

16. Therefore, the exception in *Lenox* does not apply to a deemed liquidation resulting from an IRC § 338 election.
17. The denial of the refund requested on the amended return was proper under the laws and the facts.

### **DECISION**

The evidence presented in the hearing shows that [Parent] (the selling consolidated group) and [the unrelated entity] jointly filed an election with the IRS to have the sale of [Affiliate One's] stock treated as a sale of [Affiliate One's] assets for federal tax purposes pursuant to IRC § 338(h)(10). Also, as indicated on Taxpayer's return filed with the State, the group made a further election to treat the sale of Taxpayer's stock (which [Affiliate One] would have been deemed to have sold under its election) as a deemed sale of Taxpayer's assets which resulted in a recognized gain for Taxpayer for federal tax purposes. Taxpayer included this gain on its separate Federal 1120 corporate tax return filed with the IRS, and Taxpayer also included the gain from the deemed asset sale on its North Carolina Corporate Income and Franchise Tax Return. Taxpayer subsequently filed an amended North Carolina return, seeking a refund, based on its removal of the gain from the deemed asset sale from its federal taxable income. Taxpayer did not file an amended federal return or amend its federal taxable income to remove the gain.

There are two issues presented in this case. The first issue is whether a recognized gain resulting from an Internal Revenue Code § 338 election can be deducted from federal taxable income in the determination of State net income. The second issue is whether the IRC § 338 gain is properly classified as business or nonbusiness income under G.S. 105-130.4(a)(1) if it is included in the determination of State net income.

#### **I. A Recognized Gain Resulting From An Internal Revenue Code § 338(h)(10) Election Is Included In The Determination Of State Net Income.**

Taxpayer first argues that it should be entitled to deduct the amount of the gain resulting from the IRC § 338(h)(10) election from its federal taxable income. The Division argues that Taxpayer may not deduct the gain from its federal taxable income because there is no statutory provision allowing for the deduction. I find that the statutes do not permit Taxpayer to deduct the gain from its federal taxable income. The income from the deemed asset sale was properly included in Taxpayer's federal taxable income. There is no mechanism by which this income can be deducted from federal taxable income for North Carolina tax purposes unless there is a specific provision for its removal under G.S. 105-130.5. "State net income" is defined as a taxpayer's federal taxable income as determined under the Internal Revenue Code, adjusted as provided in G.S. 105-130.5 (G.S. 105-130.2(5c)). None of the adjustments provided under G.S. 105-130.5 (nor any other provision in North Carolina's corporate income tax law) addresses IRC § 338 elections. Because there is no provision permitting Taxpayer to deduct the income at issue from its federal taxable income, it is properly includable in its North Carolina state net income. Therefore, I find that Taxpayer's amended return improperly deducted this income from its federal taxable income without statutory authority.

I do not accept Taxpayer's argument that the gain should be excluded from federal taxable income because North Carolina did not recognize a portion of the IRC § 338(h)(10) election during the period at issue. North Carolina recognizes the deemed sale of assets associated with the IRC § 338 election. At the time Taxpayer's North Carolina Corporate Income and Franchise Tax Return was filed, however, North Carolina did not recognize the federal nonrecognition of the seller's gain or loss on the sale of target's stock under IRC § 338(h)(10) on the seller's separate return filed with this State. Whether or not North Carolina recognized that aspect of the IRC § 338(h)(10) makes no difference in Taxpayer's liability in this case, however, because Taxpayer was required to recognize and report the gain from the deemed sale of its assets on its federal and state tax returns regardless of the treatment of the stock sale on the seller's return.

**II. The Gain Resulting From An Internal Revenue Code § 338(h)(10) Election Is Business Income.**

The Taxpayer argued for the first time at the administrative hearing that in the event that the gain is not excludable from state income as an adjustment under G.S. 105-130.5, it should be excluded from the North Carolina taxable income as nonbusiness income. The Taxpayer submitted no evidence to support its claim.

During the period at issue, “business income” was defined as “income arising from transactions and activity in the regular course of the taxpayer’s trade or business and includes income from tangible and intangible property if the acquisition, management, and/or disposition of the property constitute integral parts of the taxpayer’s regular trade or business operations.” G.S. 105-130.4(a)(1). “Nonbusiness income” was defined to include all income other than business income. G.S. 105-130.4(a)(5). Here, the income from the deemed sale of assets is business income because the assets deemed sold were an integral part of the target’s trade or business operations.

Although the North Carolina Supreme Court held in *Lenox* that the gain from the sale of assets in liquidation is nonbusiness income if the liquidation results in the cessation of a separate and distinct line of business and the company distributes all of the proceeds of the liquidation to its shareholders, those facts are not present here. The *Lenox* case involved an actual liquidation, not a deemed liquidation. Here, Taxpayer did not liquidate, nor did it cease to operate a separate and distinct line of business, nor did it distribute the proceeds from the sale to its shareholders. Thus, *Lenox* is not applicable.

My finding that the gain is apportionable business income is not unprecedented. A Pennsylvania court reached a similar conclusion in *Canteen Corporation v. Commonwealth of Pennsylvania*, 792 A.2d 14 (Pa. Cmwlth. 2002).

**CONCLUSION**

Based on the above findings of fact and conclusions of law, I hold that the gain derived from the deemed asset sale is properly included in Taxpayer's North Carolina State net income as apportionable business income. The Division's denial of the refund requested on the amended return was therefore proper and in accordance with the North Carolina Revenue Laws.

Made and entered this 14<sup>th</sup> day of November, 2002.

Signature \_\_\_\_\_

Eugene J. Cella  
Assistant Secretary of Revenue