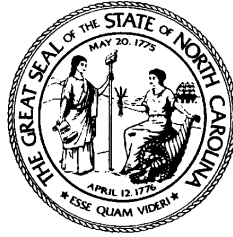


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# North Carolina Department of Revenue

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## **DIRECTIVE**

**Subject:** Internal Revenue Code § 338(h)(10)  
**Tax:** Corporate Income and Franchise Tax  
**Statutes:** G.S. 105-130.2(5c)  
**Issued By:** Corporate Income, Excise, and Insurance Tax Division  
**Date:** May 31, 2002  
**Number:** CD-02-3

This directive announces a change in the Department of Revenue's administrative practice as it relates to North Carolina's recognition and treatment of the gains or losses that result from a taxpayer's election to treat a stock sale as a deemed sale of assets under Internal Revenue Code § 338(h)(10). The change is effective for acquisition dates occurring on or after June 1, 2002.

### **Internal Revenue Code § 338**

A corporation (purchasing corporation) that makes a qualified stock purchase of the stock of another corporation (target) can elect under IRC § 338(g) to treat the stock purchase as a purchase of the target's assets. If the election is made, the target is treated as having sold all of its assets at the close of the acquisition date for a price measured by what the purchasing corporation paid for the target's stock. The target recognizes gain or loss on the deemed sale of the assets. The target then is treated as a new corporation that purchased the assets on the day after the acquisition date. In most cases, this results in a step-up in the basis of the target's assets for federal tax depreciation purposes in accordance with what the purchasing corporation paid for the target's stock.

If the target's stock is sold by a group filing consolidated returns (selling consolidated group) or by an affiliated group filing separate returns (selling affiliated group) or the target is an S corporation, a further election can be made for federal tax purposes. The seller and the purchaser may make a joint election for the target under IRC § 338(h)(10). If a § 338(h)(10) election is made for the target, it must be a simultaneous joint election by both the seller and purchaser. A § 338(h)(10) joint election by the seller and purchaser treats the target as if it sold all of its assets and distributed the proceeds to the seller in complete liquidation while a member of the selling consolidated group or while owned by the selling affiliates or S corporation shareholders. Because the

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target is taxed on the deemed asset sale, the election allows the seller to avoid recognition of any gain on the sale of the target's stock for federal income tax purposes.

### **North Carolina Conforms to Federal Law**

North Carolina generally follows federal law in determining State net income and has previously recognized most provisions of IRC § 338, including the election under § 338(g). Unlike federal law, however, North Carolina law does not permit a corporation to elect to file a consolidated income tax return. G.S. 105-130.14 sets out the prohibition on filing a consolidated return.

When the federal election under IRC § 338(h)(10) was first enacted, it applied only in the context of a consolidated return. North Carolina, therefore, did not recognize the election because it did not allow consolidated returns. Treasury Regulation § 1.338(h)(10)-1, effective for acquisitions occurring on or after January 14, 1992, expanded the scope of the § 338(h)(10) election to apply to corporate members of affiliated groups that file separate returns.

North Carolina will recognize and accept an election made by a taxpayer under IRC and Treasury Regulation § 1.338(h)(10)-1 for income tax purposes for acquisition dates occurring on or after June 1, 2002. If a valid § 338(h)(10) election is made for federal purposes, the taxpayer is bound by that election for State income tax purposes. A separate North Carolina election is not required in addition to the federal election and an election cannot be made for State tax purposes if the election is not made for federal tax purposes. When a valid federal election is made, the North Carolina filing periods are the same as the federal filing periods.

### **Effect on North Carolina Income Tax Returns**

For corporate income tax purposes, any gain from the deemed sale of a target's assets under an IRC § 338(h)(10) election is reportable to North Carolina as apportionable business income under G.S. 105-130.4(a)(1) because the assets deemed sold were integral to the target's trade or business operations. In apportioning the target's income, the gross receipts from the deemed sale are excluded from the numerator and denominator of the sales factor as a "casual sale" under G.S. 105-130.4(a)(8) because the assets were not purchased, produced, or acquired primarily for sale in the target's regular trade or business.

The holding of the North Carolina Court of Appeals in *Lenox, Inc. v. Tolson*, 353 N.C. 659, 548 S.E. 2d 513 (2001), does not apply to a § 338(h)(10) election. In *Lenox*, the Court held that the gain from the sale of assets in a liquidation is nonbusiness income if the liquidation results in the cessation of business and the company distributes all of the proceeds of the liquidation to its shareholders. The *Lenox* case involved an actual liquidation, not a deemed liquidation. In a § 338(h)(10) election, the target continues to operate the same assets and does

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not transfer title to any of its property as a result of the transaction. Thus, the target is not liquidated and it continues its trade or business. As a result, the liquidation test created by the *Lenox* court is not satisfied when a § 338(h)(10) election is made.

If the target is an S-Corporation, the deemed sale of assets by the target is not subject to corporate income tax, but is reportable proportionately by the target's shareholders on their individual income tax returns. The gain or loss from the deemed sale of the target's assets included in taxable income by the target's shareholders increases or decreases each shareholder's basis in the stock of the target in the same manner as for federal income tax purposes. The shareholders must also report a gain or loss as a result of the deemed liquidation of the target. The adjusted basis used in computing the gain or loss on the deemed liquidation is the amount determined after including the gain or loss from the deemed sale of the target's assets.

### **Questions**

If you have questions about this directive, you may call the Corporate, Excise, and Insurance Tax Division of the North Carolina Department of Revenue at (919) 733-8510. You may also write to the Division at P.O. Box 871, Raleigh, N.C. 27602-0871.