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Section 338(h)(10) Elections for S Corporations:
Traps for Nonresident Shareholders Under a Changing State Law Landscape

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Taxpayers and advisors should give careful consideration to the changing landscape of state taxes in the context of elections under 26 U.S.C. § 338(h)(10) (hereafter I.R.C. § 338(h)(10)), a common tax-planning technique for taxable stock acquisitions. Elections under I.R.C. § 338(h)(10) have a history of creating troublesome results for taxpayers in the state tax context, such as concerns relating to the proper classification of gains as apportionable or allocable income[1] or distortion of the sales factor in the state's corporate income tax apportionment formula.[2] The latest state tax development concerning elections under I.R.C. § 338(h)(10) is the creation of special income sourcing rules that are applicable to nonresident S Corporation shareholders.

While I.R.C. § 338(h)(10) elections typically provide federal tax benefits for the purchaser of an S Corporation, and can often be accomplished with no (or limited) negative tax consequences for the selling shareholders, recent law changes in various states are producing adverse state tax effects for selling shareholders. Thus, clients and advisors alike should carefully consider state tax implications associated with any I.R.C. § 338(h)(10) planning involving S Corporations.

New York is the latest jurisdiction to change its sourcing rules for nonresident shareholders of an S Corporation, with the result of capturing taxable gain at the shareholder level with respect to an I.R.C. § 338(h)(10) election made for an S Corporation that has nexus with the state of New York. New York's change to New York Tax Law § 632 (hereafter Tax Law § 632) can trigger an unexpected New York state tax liability for an out-of-state shareholder who otherwise has no nexus with New York.

The amendments to Tax Law § 632 were passed with retroactive effect. As such, the amended statute is effective August 4, 2010, and affects all tax years beginning on or after January 1, 2007. Tax Law § 632 will apply if (1) a nonresident is a shareholder in an S Corporation, (2) the S Corporation has elected to be treated as a New York S Corporation, and (3) the S Corporation has elected under I.R.C. § 338(h)(10)

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1 *See* Ind. Dep't of Revenue, Letter of Findings No. 98-0523 (Nov. 1, 2002) (stating that income received by a company in an I.R.C. § 338(h)(10) stock sale was business income for purposes of Indiana corporate income tax); *but see Canteen Corp. v. Pennsylvania*, No. 856 F.R. 1997 (Pa. Commw. Ct. Mar. 6, 2003) (holding that gains on the deemed asset sale under I.R.C. § 338(h)(10) are treated as nonbusiness income).

2 *See Combustion Eng'g Inc. v. Massachusetts Comm'r of Revenue*, No. F228740 (Mass. App. Tax Bd. Mar. 29, 2000) (holding that a deemed sale of assets under I.R.C. § 338(h)(10) is still a sale of stock and therefore not includable in the Massachusetts sales factor).

to recognize gain on appreciated assets. Once these conditions are met, Tax Law § 632 requires that any gain recognized on the deemed asset sale for federal purposes will be treated as New York source income for the nonresident shareholders of the S Corporation. The amount of gain to be included in New York source income is determined by applying the applicable allocation percentage under Article 9-A of the New York tax provisions to the gain recognized from the deemed asset sale.

According to the New York Department of Taxation and Finance, taxpayers who are affected by Tax Law § 632, and who have already filed a return for the affected year, must file an amended return.[3] However, no penalties will be assessed for any underpayment of tax attributable to this amendment.[4]

New York is not alone in its effort to tax nonresident shareholders of S Corporations in the context of I.R.C. § 338(h)(10) elections. For example, the Court of Civil Appeals of Alabama recently concluded that the taxable gain allocated to a nonresident shareholder in an S Corporation from an election under I.R.C. § 338(h)(10) was taxable in Alabama.[5] In contrast, the Supreme Court of Georgia recently concluded that income to a nonresident shareholder in an S Corporation from an election under I.R.C. § 338(h)(10) does not constitute Georgia taxable income.[6] Due to the varying treatment that exists for state tax purposes, the state tax consequences of an election under I.R.C. § 338(h)(10) should be carefully analyzed before any such election is made with respect to an S Corporation.

If you have any questions concerning the state tax treatment of an election under I.R.C. § 338(h)(10), or would like more information on any of the issues discussed in this LawFlash, please contact any of the following Morgan Lewis attorneys:

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3 "Amendments to the Treatment of Certain S Corporation Income by Nonresident Taxpayers," New York State Department of Taxation and Finance Advisory Opinion, TSB-M-10(10)I (August 31, 2010).

4 *Id*.

5 *Prince v. State Dep't of Revenue*, Docket No. 2080634 (Ala. Civ. App. May 7, 2010).

6 *Tarwick Constr. Co., Inc. v. Georgia Dep't of Revenue*, 286 Ga. 597 (2010).

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