

Oregon Court Adds New Test for Nonbusiness Income in Liquidating Sale

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Introduction

The Oregon Tax Court has added a new element to the ongoing debate regarding whether a taxpayer's gain from a deemed asset sale governed by section 338(h)(10) of the Internal Revenue Code is apportionable business income or allocable nonbusiness income. In *Centurytel, Inc. v. Department of Revenue*, the court held that the taxpayer's gain on the deemed sale of its assets was apportionable business income because its parent corporation used the sale proceeds in a business that was unitary with the business of the subsidiary, the stock of which was sold.¹ Most of the cases up to now addressing section 338(h)(10) transactions have held that, because the corporation that is deemed to have sold its assets is also deemed to have liquidated into its parent, its gain on the sale is nonbusiness income because the proceeds are distributed to the shareholders and not reinvested in the taxpayer's business. The cases have not considered the use of the funds by the selling shareholder to be relevant. The tax court's decision, although it cites to a novel by Mark Twain and an opera by Beethoven, cites none of the cases from other states dealing with section 338(h)(10) transactions.²

Consequences of a 338(h)(10) Election

Section 338(h)(10) was added to the IRC to level the playing field between asset sales and stock sales regarding the tax basis of the assets of the company being sold.

¹TC 4826 (Aug. 9, 2010). (For the decision, see *Doc 2010-17787* or *2010 STT 154-17*.)

²The opinion also borrows a line from a Gilbert and Sullivan operetta, *HMS Pinafore*, without citation to its source.

A corporate business can be purchased by buying the corporation's stock from the shareholders or by buying its assets from the corporation itself (the corporation is referred to below as the "target corporation"). Purchased assets often have a value that exceeds their tax basis in the target corporation's hands. If a buyer buys a business by buying the stock of the corporation that owns it, the tax basis of the target corporation's assets will ordinarily not change, and future depreciation and amortization deductions attributable to those assets will be based on their historic basis in the target corporation's hands and not on the buyer's cost of buying the business. In other words, the buyer will get no tax benefit from part of its cost. If, instead, the buyer buys the assets from the target corporation, they will acquire a new tax basis equal to the purchase price and the depreciation and amortization deductions available to the buyer will reflect its economic cost and will be greater than they would have been if the buyer had bought the target corporation's stock, assuming that the assets had appreciated in value in the target corporation's hands.

Earlier cases have not considered the use of the funds by the selling shareholder to be relevant.

Before the enactment of section 338, a buyer of corporate stock could obtain a stepped-up basis for the target company's appreciated assets only if it liquidated the target within two years,³ but liquidating the target corporation was not always feasible, particularly if it had unassignable contracts or debt obligations that would be triggered by a liquidation. Section 338 was intended to give the buyer of a corporation's stock the benefit of a stepped-up basis in the target's assets reflecting its purchase price for future depreciation and amortization purposes without liquidating the target. Under section 338(h)(10),

³Prior section 334(b)(2) of the IRC.

if both the buyer and the seller elect, the target is treated as if it sold its assets to a newly created corporation (Newco) with no tax history in a taxable transaction. Even though the assets remain owned by the same corporation as a matter of corporate law, they are treated for income tax purposes as if they had been sold to Newco in a taxable transaction for their fair market values. After the transaction, the continuing target corporation (that is, Newco), now owned by the buyer of its stock, gets a new basis in its assets that is generally equal to their fair market value on the date of the sale of the target's stock. The target is deemed to have sold its assets to an unrelated party in the transaction and recognizes gain or loss on the sale. It is then deemed to have liquidated into its selling parent corporation.⁴ The taxation of the deemed liquidation is governed by sections 332 and 337 of the IRC, under which a liquidation of an 80 percent or more subsidiary is tax free to both the subsidiary and the parent. The target's net operating loss carryovers and other tax attributes pass to the selling parent under section 381 of the code, as they would if the target had actually sold its assets and liquidated. If the two corporations are both domestic corporations, they would typically be filing consolidated federal income tax returns. As a result, the target's gain on the deemed sale of its assets is reported on the consolidated returns filed by the selling parent and the target, and the parent bears the economic burden of the tax.⁵ The actual sale of the target's stock by the parent is ignored for federal income tax purposes.⁶

⁴Except for S corporations, section 338(h)(10) is available only to corporations that are subsidiaries of other corporations, defined generally in terms of 80 percent stock ownership.

⁵There is a trap here of which state and local tax practitioners should be aware. If, as is often the case, the target and the parent file separate returns in one or more states (as might be the case if they are not engaged in a unitary business or if they do business in states that do not allow combined returns under any circumstances), there is no mechanism for getting the target's gain on the deemed sale of its assets to the selling parent. The liability for tax on the deemed sale will be the target's, and the buyer, as the new owner of the target stock, will bear the economic burden of the tax. See, e.g., *Newell Window Furnishing, Inc. v. Commissioner of Revenue*, 2008 Tenn. App. LEXIS 750 (Tenn. Ct. App. 2008). (For the decision, see *Doc 2008-26453* or *2008 STT 243-20*.) Buyers should insist that the contract of sale require the selling parent to indemnify the buyer or the target for any tax incurred with respect to the deemed sale.

⁶Although the form of the transaction is ignored for income tax purposes, it is respected for many other purposes. For example, no state imposes a sales tax on the sale of assets that is deemed to occur for income tax purposes. For sales tax purposes, the states treat the transaction as the sale of stock that in fact occurs.

UDITPA Principles

The courts, in interpreting the Uniform Division of Income for Tax Purposes Act definition of business income, have agreed that the statute includes what has come to be known as the transactional test, under which gain from the sale of assets will be business income if the sale occurs in the ordinary course of the company's business. The courts have divided on the question of whether the statute contains an additional test, known as the functional test, under which gain on the sale of assets that are used in the corporation's business to produce business income is itself business income. Although there are tax policy considerations that support the application of the functional test (that is, the value of the sold asset is presumably attributable to its ability to produce business income and the gain on the sale is arguably an acceleration of business income to be realized in the future), Prof. Walter Hellerstein has pointed out that the statutory language does not. The UDITPA statute provides that income is business income only if the "acquisition, management, and disposition" of the property are "integral parts of the taxpayer's regular trade or business operations."⁷ Hellerstein says that if the sale is an extraordinary transaction "it is hard to see how the disposition can constitute an integral part of the taxpayer's regular trade or business operations."⁸ Court cases have gone both ways on whether the statute includes a functional test in addition to the transactional test. The legislatures in some states in which the courts have held that there is no functional test have amended the statute by changing the word "and" to "or," thereby adding the functional test to the statute.

Liquidation Exception to the Functional Test

A number of courts have held that, even if the functional test applies, an exception should be made if the sale involves the liquidation of a business and the proceeds are not reinvested in the business.

When sale proceeds are reinvested in the business, one can reasonably argue that the sale should be viewed as part of the company's continuing business operations and that a court that follows the functional test should treat any gain or loss as business income or loss. Not all sales of business assets are part of a continuing business operation, however. Assets may be sold as part of the liquidation of a

⁷UDITPA Section 1(c).

⁸Jerome R. Hellerstein and Walter Hellerstein, I., *State Taxation*, section 9.05(2)(c) 3rd Ed. 1998. See also Peter L. Faber, "When Does the Sale of Corporate Assets Produce Business Income for State Corporate Franchise Tax Purposes?" *The Tax Executive*, May-June 1995, p. 179.

business or of a business operation. The sale proceeds may be distributed to the business's owners and, in effect, removed from the business instead of being reinvested in the business. If the sale represents the liquidation of a business and the sale proceeds are removed from the business by being distributed to the business's owners (the shareholders in the case of a corporation), the transaction seems more in the nature of the liquidation of an investment and not a part of continuing business operations. The liquidation of an investment is the quintessential example of a transaction that produces nonbusiness income. For general federal income tax purposes, the sale of an investment produces capital gain treatment, even if the investment's value is based on its ability to generate ordinary income in the future.

If a corporation sells assets in liquidation of a business and distributes the proceeds to its shareholders (as a current dividend if the corporation remains in existence or in liquidation if the corporation goes out of existence), the proceeds are no longer available for use in the corporation's business. Logic would appear to require that as a matter of policy the gain should be allocated differently from income resulting from general day-to-day business operations. A line of cases has emerged that indicates that sales of assets in liquidation of a business in which the proceeds are distributed to the corporation's shareholders will produce nonbusiness income even though the assets have been used in the seller's business and even though the court generally applies the functional test as well as the transactional test.⁹

The first case that provided a liquidation exception to the functional test was *Laurel Pipe Line Co. v. Commonwealth of Pennsylvania*.¹⁰ The taxpayer had operated two pipelines in Pennsylvania through which it transported refined petroleum products. The corporation sold one of the pipelines and distributed the sale proceeds to its shareholders as a dividend. It continued to operate the other pipeline. None of the sale proceeds were reinvested in the taxpayer's continuing business of operating the remaining pipeline or in any other business operations. The commonwealth court held that the gain was business income under the functional test.¹¹ It said that the sale of the unprofitable pipeline was an integral part of the company's regular business because if the operation had not been sold the company's other business would have suffered fi-

nancially. The court said that whether the sale amounted to a liquidation or a partial liquidation was irrelevant. The Pennsylvania Supreme Court reversed and held that a sale in liquidation of a business could not be viewed as an integral part of the company's regular trade or business operations. The court reasoned that the sale proceeds were not reinvested in the business and therefore they did not contribute to the corporation's continuing operations. They were distributed to the corporation's shareholders and, in effect, removed from the corporation's business.

Later cases in North Carolina,¹² Ohio,¹³ and Illinois¹⁴ have held that the sale of assets followed by the distribution of the sale proceeds to the corporation's shareholders produces nonbusiness income under the functional test. In fact, in one case, the Alabama Supreme Court said that, although it did not believe that there was a separate functional test, it recognized that courts applying the functional test had uniformly held that gain on the sale of a business was nonbusiness income when the sale was in liquidation of the business. The Alabama court observed that "the Department [of Revenue of Alabama] has not directed us to any case holding that gains realized from a complete liquidation and cessation of business operations produced business income."¹⁵ Only California has dissented.¹⁶

Section 338(h)(10) Cases

Because section 338(h)(10) treats a sale of stock as if the target corporation had sold its assets and distributed the proceeds in liquidation, one would think that a state that applied the liquidation exception to the functional test would treat the taxpayer's gain on the deemed sale of its assets as nonbusiness income. After all, the taxpayer (the target corporation in a section 338(h)(10) transaction) sold nothing and would not have any income from the transaction but for the section 338(h)(10) election. The section 338(h)(10) regime contemplates two fictional transactions: the deemed sale of its assets by the target corporation and the deemed

¹²*Lenox Inc. v. Tolson*, 353 N.C. 659, 548 S.E.2d 513 (2001). (For the decision, see *Doc 2001-19945* or *2001 STT 143-19*.)

¹³*Kemppel v. Zaino*, 91 Ohio St.3d 420, 746 N.E.2d 1073 (2001). (For the decision, see *Doc 2001-14889* or *2001 STT 103-21*.)

¹⁴*Blessing/White Inc. v. Zehnder*, 329 Ill. App.3d 714 (Ill. App. Ct. 2002). (For the decision, see *Doc 2002-9071* or *2002 STT 74-13*.)

¹⁵*Uniroyal Tire Co. v. Department of Revenue*, 779 So.2d 227 (2000). (For the decision, see *Doc 2000-21049* or *2000 STT 156-2*.)

¹⁶*Jim Beam Brands Co. v. Franchise Tax Bd.*, 34 Cal.3d 874 (Cal. Ct. App. 2005). (For the decision, see *Doc 2005-13882* or *2005 STT 98-7*.)

⁹For a general discussion, see Peter L. Faber, "Sales in Liquidation Under the Functional Test for Nonbusiness Income," *State Tax Notes*, Feb. 19, 2001, p. 611, *Doc 2001-4984*, or *2001 STT 34-56*.

¹⁰537 Pa. 205, 642 A.2d 472 (1994). (For the decision, see *Doc 94-51043* or *94 STN 107-27*.)

¹¹150 Pa. Commw. 135, 615 A.2d 848 (1992).

distribution of the sale proceeds by the target corporation to its selling parent in complete liquidation. Thus, the target could not be deemed to have realized income from the transaction unless the first part of the legal fiction is accepted. If the first part of the fiction (the deemed sale) is accepted, the second part (the deemed distribution of the sale proceeds in liquidation) should be as well. Otherwise, how could one explain how the sale proceeds from the deemed transactions got to the selling parent, where they in fact ended up? Although the logic would seem to be unassailable, state revenue departments have not uniformly agreed. Some of them have taken the position that, even though an actual sale of assets followed by an actual liquidation would produce nonbusiness income, a fictional sale and liquidation should produce business income.

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Until the recent Oregon case, the courts generally had rejected revenue department arguments that the section 338(h)(10) gain was business income.

The first case so holding was *Canteen Corp. v. Commonwealth*.¹⁷ The taxpayer argued that both halves of the section 338(h)(10) fiction must be accepted or neither must be accepted and that the Pennsylvania Department of Revenue could not have its cake and eat it, too, by accepting that part of the fiction that produced a gain but ignoring that part of the fiction that contemplated a liquidation that converted the gain from business income to nonbusiness income. The taxpayer pointed out that, to the extent that there might be a mismatch between recognized gain and increased basis for depreciation purposes, that mismatch also occurred in the case of an actual sale of assets followed by a liquidation such as that that took place in *Laurel Pipe Line*, and the Pennsylvania courts had found that the liquidating sale of assets in *Laurel Pipe Line* produced nonbusiness income.

The taxpayer also pointed out that the tax departments in New York, Illinois, and Virginia had all held that for state tax purposes the actual distribu-

¹⁷818 A.2d 594 (2003), affirmed, 854 A.2d 440 (Pa. Sup. Ct. 2004). The writer represented the taxpayer in this case. (For the decision, see *Doc 2003-6097* or *2003 STT 47-32*.)

tion of assets in a section 338(h)(10) transaction that were not desired by the buyer was treated for state tax purposes as if the distribution had occurred as part of a liquidation, even though as a matter of corporate law it would be treated as a dividend because the corporation was a continuing legal entity.

The commonwealth court held that all of the section 338(h)(10) legal fiction had to be respected. It said, “The liquidation and distribution, deemed to have occurred as a result of the Section 338(h) election, cannot be recognized by the Commonwealth on the one hand in order to yield a fictitious gain but ignored on the other hand in order to avoid the holding in *Laurel Pipe Line*.” The Pennsylvania Supreme Court affirmed.

Canteen was followed in short order by courts in Illinois¹⁸ and Missouri.¹⁹

The Centurytel Case

In *Centurytel*, the Oregon Tax Court took a new approach to the problem, holding that the target’s gain on the deemed sale of its assets was business income because the selling parent used the sale proceeds in a business that was unitary with the business conducted by the target. In other words, the court said that the use of the sale proceeds by the shareholders was decisive in determining the nature of a corporation’s gain on the sale of its assets.

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The taxpayer was the current parent of a group of corporations that filed a consolidated Oregon corporate excise tax return. The companies were engaged in the telecommunications business in both wireline and wireless operations. The wireless operations were conducted by Centurytel Wireless and its subsidiaries. The wireline operations were conducted by other members of the group. In 2002 the taxpayer sold all of its wireless subsidiary’s stock to an

¹⁸*American States Insurance Co. v. Hamer*, 352 Ill. App.3d 521, 816 N.E.2d 659 (Ill. App. 2004); *NICOR v. Illinois Department of Revenue*, Ill. App. Ct. (2008). (For the decision in *American States*, see *Doc 2004-17964* or *2004 STT 177-15*; for the decision in *NICOR*, see *Doc 2008-26942* or *2008 STT 247-11*.)

¹⁹*ABB C-E Nuclear Power Inc. v. Missouri Director of Revenue*, 215 S.W.3d 85 (Mo. 2007). (For the decision, see *Doc 2007-2579* or *2007 STT 23-12*.)

unrelated buyer. The parties elected under section 338(h)(10) to have the transaction treated as if the subsidiary had sold all its assets and distributed the proceeds to the buyer. The selling parent used part of the proceeds from the stock sale to finance the acquisition of local exchange wireline operations. The rest of the proceeds were used to repay debt that the parent had incurred.

The taxpayer treated the gain on the transaction as nonbusiness income and the Oregon Department of Revenue objected.

The Oregon Tax Court had previously held that the sale of assets constituting a business produces business income, even though it arguably represented the “liquidation” of the business.²⁰ The court in that case said it was irrelevant that the sale was in liquidation of the business followed by the liquidation of the corporation. Thus, it rejected the notion that there was a liquidation exception to the functional test.

The tax court in *Centurytel* said, however, that even:

If one [i.e., a liquidation exception] were to be recognized, the case law from other jurisdictions recognizing such an exception indicates that the exception does not apply where the seller continues in business and uses the proceeds of a liquidating sale in business. The court finds that the business in which this taxpayer is involved is the communication of voice and data. The consolidated group did not cease that business but rather redirected assets into certain aspects of that business. Further, taxpayer here used the proceeds of sale to continue and expand aspects of its already existing operations, the income from which it has treated as subject to taxation on an apportioned basis by Oregon.²¹

Thus, the court defined the taxpayer for purposes of the liquidation exception as including the selling corporation’s entire unitary business group.

The tax court then dismissed the constitutional arguments that had been advanced by the taxpayer. It held that there was no violation of the due process clause of the U.S. Constitution because the assets that had been sold had been used by the taxpayer in a unitary business that was conducted both within and outside Oregon. It also concluded that there was no violation of the commerce clause.

The court took a dramatically different approach from that taken by other courts in looking to the activities of the seller’s consolidated group in ana-

lyzing the application of the liquidation exception. In effect, this represented an expansion of the *Finnigan* doctrine, in which a combined return unitary group is treated as a single taxpayer for some purposes, to a new area.

This decision represented an expansion of the Finnigan doctrine, in which a combined return unitary group is treated as a single taxpayer for some purposes, to a new area.

The tax court did not cite any of the other cases applying the liquidation exception in support of its view that the use of the sale proceeds by the seller’s shareholder in a unitary business could make the exception inapplicable. The courts have generally viewed the sole inquiry as being whether the taxpayer, defined as the corporation that sold the assets or was deemed to have sold the assets in a section 338(h)(10) transaction, used the proceeds in its business. If the taxpayer distributed the proceeds to its shareholders, it was deemed to have liquidated. The use of the proceeds by the shareholders was generally not mentioned. That was true, even though a number of the cases involved corporate parents that were likely engaged in a unitary business with the selling corporation, although the opinions do not make that clear.

Cases in Other States and Use of Proceeds

The taxpayer in *Laurel Pipe Line* distributed the proceeds of the sale of the sold pipeline to its “stockholders.” The opinion does not indicate who the stockholders were, but presumably the reference in the plural indicates that the seller was not the subsidiary of another corporation. Although the corporation was not liquidated, “the sale of the pipeline was a liquidation of a separate and distinct aspect of its business” and that was enough for the court to conclude that nonbusiness income treatment was appropriate. At the time, Pennsylvania was a separate return state so even if the stockholders had been corporations, they would not have been filing consolidated returns with the seller. The court made no mention of the use to which the corporation’s shareholders put the proceeds.

Lenox Inc. v. Tolson involved a sale of assets by a wholly owned subsidiary of another corporation. The court said the sale amounted to the liquidation and cessation of a line of business and hence was a liquidating sale producing nonbusiness income. There was no mention of the use of the sale proceeds by the corporation’s parent after they were distributed to it or of whether the parent and the subsidiary were engaged in a unitary business. The

²⁰*Crystal Communications, Inc. v. Department of Revenue*, TC 4769 (July 19, 2010). (For the decision, see *Doc 2010-16129* or *2010 STT 139-18*.)

²¹Slip. Opinion, p. 5.

seller's business was described in the opinion, but the parent's business was not, so it would not be possible to make a unitary business determination based on the facts as described in the opinion. But it is obvious that either the issue was not presented or the court did not regard it as being relevant.

In *Canteen Corp. v. Commonwealth*, a section 338(h)(10) case, the use of the proceeds by the selling parent never came up.²² Although the opinion does not mention the circumstances of the sale, the record in the case indicates that it involved a decision by the parent to divest itself of one of its businesses. The Pennsylvania DOR did not argue that the business conducted by the target corporation and deemed to have been sold was part of a unitary business with the business conducted by the parent. The court apparently did not regard the use of the proceeds by the parent as being relevant to its inquiry. The question was not raised at the oral arguments in the case and is not discussed in the opinions.

Similarly, in *ABB C-E Nuclear Power, Inc. v. Missouri Director of Revenue*, the Missouri Supreme Court, in finding nonbusiness income in a section 338(h)(10) transaction, did not refer to the selling parent's use of the proceeds. The court noted that the parent was not present in Missouri and presumably was not taxable there, so any use that it had made of the proceeds would presumably not have been done in Missouri. In any event, the opinion treated the deemed liquidation of the subsidiary as a liquidation of the selling corporation and assumed that that was the end of its inquiry. No reference is made to whether the parent and the subsidiary were conducting a unitary business or of what use the parent made of the sale proceeds.

In *NICOR v. Illinois Department of Revenue*, the court did not mention the use of the sale proceeds by the selling parent corporation in a section 338(h)(10) transaction.²³ The deemed liquidation of the subsidiary being sold apparently put an end to the inquiry in the court's view.

One case in which the use of proceeds was mentioned was *National Holdings, Inc. v. Zehnder*.²⁴ There, two subsidiaries sold their assets and distributed the proceeds to their corporate parent. The parent then transferred the sale proceeds to another of its subsidiaries, which invested them in marketable securities and did not use them in any business. The Illinois Department of Revenue argued that the proceeds had been reinvested in the parent's ongoing business and, hence, that the liquidation excep-

tion should not apply. The court, in holding that the liquidation exception did apply, noted that the proceeds were not in fact used in the parent's business but rather were invested in marketable securities and not used in any business. The court did not have to address the question of whether a reinvestment in the parent's business would have negated the application of the liquidation exception.

In *American States Insurance Co. v. Hamer*, the court, in finding that the liquidation exception applied, noted that the sale proceeds were not reinvested in the business operations of either the deemed seller of the assets (the transaction was a 338(h)(10) transaction) or its parent.²⁵ Because there had been no reinvestment of the sale proceeds in any business, the court did not address the question of whether that would have been relevant.

The other 338(h)(10) cases involved corporations that were owned by individual shareholders, so presumably the unitary business question would not have been present.

If the corporations are not filing combined returns, it seems hard to defend not treating them as separate corporations for purposes of the liquidation exception, even if they are engaged in a unitary business.

In *McKesson Water Products Co. v. Director, Division of Taxation*, the New Jersey Tax Court viewed the issue as being whether the income was operational and not from investments.²⁶ The statutory language was similar to the UDITPA language. Again, there was no discussion of the parent's use of the sale proceeds. The liquidation exception was deemed to apply if the deemed seller of assets, the target corporation, was liquidated or deemed to be liquidated, and that was the end of the inquiry.

Conclusion

The Oregon Tax Court's decision that the liquidation exception does not apply if the selling parent in a section 338(h)(10) transaction uses the sale proceeds in a business that was unitary with the business conducted by the target corporation adds a new element to the law in this area. Other than some of the Illinois cases, which found that the proceeds were not in fact used in such a unitary business and, hence, did not have to address the

²²818 A.2d 594 (2003), affirmed, 854 A.2d 440 (Pa. Sup. Ct. 2004).

²³Ill. App. Ct., 1st Dist. (2008).

²⁴369 Ill. App. 3d 977, 874 N.E. 2d 91 (2007). (For the decision, see *Doc 2007-2528* or *2007 STT 22-12*.)

²⁵352 Ill. App. 3d 521, 816 N.E. 2d 659 (2004).

²⁶23 N.J. Tax 449 (N.J. Tax Ct. 2007). (For the decision, see *Doc 2007-19370* or *2007 STT 164-17*.)

issue, none of the other liquidation cases even mentioned the use of the sale proceeds by the corporation's shareholder. We can expect, however, that the argument will be raised in future cases. It is particularly likely to be raised in cases in which the target corporation and the selling parent file combined returns in the state.

The issue is part of the broader issue of when corporations engaged in a unitary business will be deemed to be separate corporations. The answer to that question may depend on the context in which the question arises. There is no reason to assume that the answer should be the same in all legal contexts.

If the corporations are not filing combined returns, it seems hard to defend not treating them as separate corporations for purposes of the liquidation exception, even if they are engaged in a unitary business. The point is that, for the taxpayer, the business is liquidated (or deemed to be liquidated under the section 338(h)(10) fiction). When the corporations are filing combined returns, the issue is a close one. States generally regard members of a combined reporting group as being separate corporations for computational purposes. Nevertheless, they are treated as a single corporation for other purposes. How the *Joyce-Finnigan* issue will be resolved in this context remains to be seen. ☆