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Multistate Tax
EXTERNAL ALERT

New York high court on nonresident taxation of gain on sale of S Corp stock

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Overview

The New York State Court of Appeals (Court of Appeals), New York State's highest court, recently ruled in two cases involving the taxation of nonresident shareholders in New York subchapter S corporations. In *Philip Caprio, et al. v. New York State Department of Taxation and Finance, et al.*,[1] the Court of Appeals held that the retroactive application of 2010 amendments to New York Tax Law § 632(a)(2) imposing tax on the 2007 sale of subchapter S corporation stock by nonresident shareholders in a deemed asset sale transaction involving the installment sale method of accounting[2] did not violate the Due Process Clauses of the United States and New York State Constitutions. In *Robert R. Burton et al. v. New York State Department of Taxation and Finance, et al.*,[3] the Court of Appeals held that there was no bar under New York Constitution Article 16, § 3 to the taxation of a nonresident's New York source income earned from the sale of S corporation stock (treated as a deemed asset sale), specifically with regard to amendments to New York Tax Law § 632(a)(2) enacted in 2010. In effect, the two cases address challenges to the retroactive application of the 2010 amendments to New York Tax Law § 632(a)(2) applicable to nonresident shareholders of S corporations,[4] and the constitutionality of the substance of such amendments. [5]

In this Tax Alert we summarize these two recent Court of Appeals decisions and provide some taxpayer considerations.

Background

Both Court of Appeals decisions arise out of legislation enacted in 2010, which was intended to address two decisions issued during 2009 (one by the New York State Tax Appeals Tribunal [Tribunal] and one by the Division of Tax Appeals Administrative Law Judge [ALJ] Unit, each described below) that "erroneously overturned the longstanding policies of department of taxation and finance that nonresident subchapter S shareholders who sell their interest in an S corporation pursuant to an election under section 338(h)(10) or section 453(h)(1)(A) of the Internal Revenue Code, respectively, are taxed in accordance with that election and the transaction is treated as an asset sale producing New York source income."[6]

In *Matter of Gabriel S. Baum,*[7] the Tribunal held that the stock sale in question was in fact a stock sale for New York tax purposes (i.e., nontaxable to nonresidents) notwithstanding an election by subchapter S shareholders under IRC § 338(h)(10) to treat their sale of stock as an asset sale of the S corporation. Likewise, in *Matter of Mintz*,[8] an ALJ held that nonresident shareholders of a New York S corporation did not realize New York source income upon their receipt of payments pursuant to an installment obligation that had previously been received by the S corporation in exchange for its assets and subsequently distributed to such shareholders in exchange for their stock upon the corporation's liquidation.[9]

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[1] 2015 NY Slip Op 05625 (2015). This case can be accessed **here**.
[2] IRC § 453(h)(1)(A).
[3] 2015 NY Slip Op 05624 (2015). This case can be accessed **here**.
[4] The taxpayers in *Caprio* limited their challenge only to the retroactive application of the amendments pertaining to the tax treatment of installment obligations under IRC § 453(h)(1)(A) and not the portion related to IRC § 338(h)(10). 2015 NY Slip Op 05625 (2015), p.4-5.
[5] The taxpayers in *Burton* focus their constitutional challenge to the amendments to the extent that they permit taxation of a nonresident's income derived under an IRC Sec. 338(h)(10) deemed asset sale. 2015 NY Slip Op 05624 (2015), p.5.
[6] L. 2010, ch. 57, Part C, § 1, labeled as "Legislative findings."
[7] New York State Tax Appeals Tribunal, DTA Nos. 820837 and 820838 (Feb. 12, 2009).
[8] New York State Div. of Tax Appeals, ALJ Unit, DTA Nos. 821807 and 821806 (Jun. 4, 2009).
[9] The transaction in question satisfied the requirements under IRC §§ 453(h)(1) and 453B(h).

The Governor's "Memorandum in Support" of the 2010 amendments to New York Tax Law § 632(a)(2) contends that these two 2009 decisions raised concerns about New York's continued conformity to the Internal Revenue Code with regard to the transactions at issue because, prior to them, the New York State Department of Taxation and Finance (Department) generally had taken the position that when shareholders of a New York S corporation sell their interests pursuant to elections under either IRC § 338(h)(10) (deemed asset sale) or IRC § 453(h)(1)(A) (installment sales), New York would conform to that treatment for state personal income tax purposes.[10] The Tribunal's decision in *Baum* and the ALJ's determination in *Mintz* upended this general treatment by re-characterizing what had always been considered to be a sale of New York property (i.e., New York source income for nonresidents), into a sale of an intangible asset, which generally is not subject to New York personal income taxation.[11] In addition, the Tribunal's decision caused some uncertainty for purchasers where an election under IRC § 338(h)(10) was made. That is, because the Tribunal held that the transaction in *Baum* was a stock sale (and not a sale of assets for purposes of New York income taxation), the purchaser may not be entitled to "step up" its basis in the assets for New York purposes, thereby creating inconsistencies with federal income tax law.[12]

The 2010 amendments stated that if an S corporation distributed an installment obligation under IRC § 453 (h)(1)(A) or if the S corporation shareholders made a deemed asset sale election under IRC § 338 (h)(10), "any gain recognized on the receipt of payments from the installment obligation…[or] on the deemed asset sale for federal income tax purposes will be treated as New York source income."[13] The amendments were made retroactive to all taxable years beginning on or after January 1, 2007—which represent those years for which the statute of limitations for seeking a refund (under *Baum* or *Mintz*) or assessing additional tax was still open[14]—thus creating a three-and-a-half year period of retroactivity.

In *Caprio*, the taxpayers argued that the three-and-a-half-year retroactive application of the 2010 amendments to Tax Law § 632(a)(2) (L 2010, ch 57, Part C) was unconstitutional, as applied to them, under the Due Process Clauses of the United States and New York State Constitutions. The taxpayers challenged the amendments insofar as they retroactively imposed a tax on the 2007 sale of the stock of their subchapter S corporation in an IRC § 338(h)(10) deemed asset sale, for which they utilized the IRC § 453(h)(1)(A) installment method for federal income tax purposes. The lower court (i.e., the New York Supreme Court) had determined that the amendments were curative and that the taxpayers failed to show reasonable reliance on pre-amendment law; therefore, the retroactive application of the statute was not harsh and oppressive.[15] The New York Supreme Court, Appellate Division, then reversed this determination, finding that the taxpayers reasonably relied on pre-amendment tax law and that the retroactivity period was excessive because the amendments were neither curative nor supported by compelling public purpose.[16]

In *Burton*, the taxpayers sold their S corporation stock in a transaction that had been treated as a deemed asset sale under IRC § 338(h)(10). The taxpayers paid the tax due after an audit and submitted refund claims, which were rejected. The lower court (i.e., the New York Supreme Court) ruled that the statute was constitutional and granted summary judgment to the Department;[17] the taxpayer appealed that ruling directly to the Court of Appeals.[18]

The recent Court of Appeals rulings

In *Caprio*, the Court of Appeals applied the "balancing of the equities test" set forth in other previous Court of Appeals decisions addressing whether retroactive tax legislation was constitutional[19] and reversed the New York Supreme Court, Appellate Division, holding that the retroactivity period of the 2010 amendments to Tax Law §

[10] See Memorandum In Support, 2010-11 New York State Executive Budget Revenue Article VII Legislation, p. 12-13, which can be accessed **here**.
[11] *Id*.
[12] *Id*.
[13] L. 2010, ch. 57, Part C, § 2.
[14] L. 2010, ch. 57, Part C, § 4, amended L. 2010, ch. 312, Part B, § 1.
[15] 37 Misc. 3d 964 (Sup. Ct., N.Y. Cty. 2012).
[16] 117 AD3d 168 (App. Div. 1st Dept. 2014).
[17] *Burton v. New York State Dept. of Tax'n and Fin.*, 43 Misc. 3d 316, 319 (Sup. Ct., Albany Cty. 2014).
[18] C.P.L.R. 5601(b)(2).
[19] *James Sq. Assoc. LP v. Mullen,* 21 NY3d 233, 246 (2013); *Matter of Replan Dev. V. Department of Hous. Preserv. & Dev. of City of N.Y.,* 70 NY2d 451, 456 (1987), *appeal dismissed* 485 US 950 (1988).

632(a)(2) was constitutional. The balancing of the equities test involves evaluating (i) the taxpayer's reasonable reliance on the old law, (ii) the length of the retroactivity period, and (iii) the public purpose for the retroactive application.[20] The Court of Appeals focused heavily on the first prong of this test and the taxpayer's failure to establish that *Mintz* and *Baum* correctly reflected New York's pre-amendment policy regarding taxation of gain derived from installment obligations issued in connection with a deemed asset sale. The Court of Appeals concluded that "given the Legislature's curative purposes, the extension of retroactive application of the statute to only those tax years for which taxpayers could seek a refund (under the "erroneously"[21] decided *Baum* and *Mintz* cases), and the lack of justifiable reliance by plaintiffs on prior law, the retroactivity period here is not excessive, arbitrary or irrational."[22] Referring repeatedly throughout its opinion to the "legislative findings,"[23] the Court of Appeals reasoned that "this Court has long stated that 'when the Legislature … tell[s] us what is meant by a previous act, its subsequent statement of earlier intent is entitled to very great weight'."[24]

In *Burton*, the Court of Appeals examined whether based on New York Constitution Article 16, § 3, the 2010 amendments to New York Tax Law § 632(a)(2) are unconstitutional to the extent such amendments permit taxation of nonresidents' income derived from a stock sale where IRC § 338(h)(10) is elected (i.e., a deemed asset sale). The Court of Appeals concluded that such amendments did not violate proscriptions contained in New York Constitution Article 16, § 3 (i.e., the pass-through IRC § 338(h)(10) gain was not an ad valorem tax on intangible property or an excise tax levied solely because of ownership or possession). The Court of Appeals' ruling was largely based on the plain language of the text and statements made by the 1938 and 1967 Constitutional Convention Committee and Commissions revealing the limited intent of Article 16, § 3.

Considerations

In *Caprio*, the Court of Appeals appears to have given significant weight to the stated intent of the New York Legislature in enacting the 2010 amendments to New York Tax Law § 632(a)(2) to correct an administrative error and to prevent a revenue loss. As such, taxpayers should be aware that New York courts may focus on statements of "legislative findings" when evaluating the factors in the balancing of the equities test.

Taxpayers should also be aware that the *Burton* case may now end any contentions that New York Constitution Article 16, § 3 supports attempts by nonresidents to avoid paying tax on IRC § 338(h)(10) gains recognized on the sale of S corporation stock.

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[20] *Id.*
[21] L. 2010, ch. 5, Part C, § 1.
[22] 2015 NY Slip Op 05625 (2015), p. 21-22.
[23] *Id.* See note 6 and accompanying text.
[24] 2015 NY Slip Op 05625 (2015), p. 16, citing *Matter of Chatlos v. McGoldrick*, 302 NY 380, 388 (1951).

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