Recent Legislation Ensures New York State Can Tax Gain From I.R.C. §338(h)(10) Transactions Involving S Corporations

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Tax Base

New York recently amended N.Y. Tax Law §632(a)(2) to require that nonresident shareholders of S corporations pay tax on gains from deemed asset sales under I.R.C. §338(h)(10) transactions. The amendment was enacted as part of the New York 2010-2011 budget legislation and is retroactive to Jan. 1, 2007, thus precluding nonresident shareholders from benefiting from a recent taxpayer victory in this area. In this article, authors Russell W. Banigan and Mary Jo Brady discuss the interaction of New York's franchise tax and personal income tax with the federal provisions both before and after the statutory change.

Recent Legislation Ensures New York State Can Tax Gain From I.R.C. §338(h)(10) Transactions Involving S Corporations

BY RUSSELL W. BANIGAN AND MARY JO BRADY[1]

Some of the most interesting tax situations in recent years have involved the extent to which the gains from I.R.C. §338(h)(10) transactions of S corporations are taxable in New York state, both for purposes of the corporation franchise tax and the individual income tax. The New York State Department of Taxation and Finance has attempted, in two separate cases, to impose tax on such gains at the S corporation level during the years in which New York taxed S corporations on an entire net income basis and on the gains realized by nonresident shareholders. In both situations, taxpayers successfully challenged the department. First, one taxpayer did so with respect to the S corporation level tax. Then, building off of that success, another set of taxpayers prevailed with respect to I.R.C. §338(h)(10) gains realized by nonresident shareholders of S corporations. However, the latter victory was short lived due to a recent statutory change enacted as part of the New York 2010-2011 budget legislation. That statutory change is given retroactive effect, so as to preclude nonresident taxpayers from following the successful litigation mentioned above.

In the discussion below, we briefly review the relevant I.R.C. §338(h)(10) provisions. Then we discuss how those provisions interact with the provisions of the New York state franchise tax (Article 9-A) and how that, in turn, impacted the result for nonresidents under the New York state personal income tax (Article 22), both before and after legislation passed in 2010. Lastly,

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we comment on the validity of the retroactive application of the recently adopted law.

I.R.C. §338(h)(10) Rules

In the context of certain qualified stock purchases[2] of a target corporation (''Old Target Corporation''), the purchasing corporation and certain sellers may make a joint election under I.R.C. §338(h)(10) to treat the sale of Old Target Corporation for federal income tax purposes as if Old Target Corporation had sold all of its assets to an unrelated purchaser (''New Target Corporation'') in a single transaction. Such treatment is permitted under any one of the following three situations:

- Old Target Corporation is a member of a consolidated return group with the selling shareholder corporation on the acquisition date;
- Old Target Corporation is a member of an affiliated (but not consolidated) group on the acquisition date with the selling corporation and the purchasing corporation makes a qualified stock purchase from a single member of the affiliated group; or
- The Old Target Corporation is an S corporation immediately before the acquisition date.[3]

For federal income tax purposes, where one of these situations applies and a joint election is filed, the purchase of the stock of Old Target Corporation is ignored and New Target Corporation is treated as having acquired the assets of Old Target Corporation in exchange for consideration that includes the assumption of liabilities. Immediately following the deemed asset sale, Old Target Corporation is treated as having distributed in a liquidating distribution all of its assets (*i.e.*, the proceeds from the deemed asset sale) to the selling consolidated group, selling affiliate, or S corporation shareholders, as the case may be, and then ceasing to exist.[4] Accordingly, the selling shareholder(s) are not viewed for federal income tax purposes as having sold their stock in Old Target Corporation. Rather, they are treated as having exchanged their stock in Old Target Corporation for that corporation's assets (that being the consideration furnished by purchaser) in connection with the deemed liquidation of Old Target Corporation.

Interplay Between I.R.C. §338(h)(10) And Franchise Tax (Article 9-A)

Prior to a 2003 amendment, a New York S corporation was subject to the franchise tax computed on the higher of the tax on the entire net income allocated to New York or the fixed dollar minimum tax, reduced by the Article 22 tax equivalent.[5] ''Entire net income'' is defined in N.Y. Tax Law §208.9 as follows:

> The term ''entire net income'' means total net income from all sources, which shall be presumably the same as the entire net income . . . (ii) which the taxpayer would have been required to report to the United States Treasury Department if it had *not* made an election under subchapter s of chapter one of the internal revenue code . . . .(emphasis added)

Thus, for years starting prior to 2003, a New York S corporation would have used federal taxable income as if such corporation were a federal C corporation[6] as its starting point in determining entire net income. Accordingly, the federal rules that apply to a federal S corporation, but not to a federal C corporation, would not to be taken into account in determining New York entire net income of a New York S corporation.

The determination of ''entire net income'' was considered in *In re Zweig Total Return Advisors Inc.*,[7] where the issue was whether three related New York S corporations were required to include gains from I.R.C. §338(h)(10) transactions in computing their entire net income for New York corporate franchise tax purposes. In preparing their Article 9-A tax returns for the taxable period ended March 1, 1999, the taxpayers took the position that, based on the requirement of N.Y. Tax Law §208.9(ii) that a federal S corporation is to determine its New York taxable income as if it were a federal C corporation, the taxpayers' I.R.C. §338(h)(10) elections could not be considered as being valid for Article 9-A purposes for the taxable period in question. This was based on federal regulations in effect at the time that provided that a valid I.R.C. §338(h)(10) election could not be made with respect to a federal C corporation that was not part of an affiliated group of corporations (as defined in I.R.C. §1504) or a member of a federal consolidated return group. The federal regulations further provided that if an I.R.C. §338(h)(10) election were invalid, then all of I.R.C. §338 was invalid with respect to that transaction.

There is an apparent dichotomy between the New York franchise tax and personal income tax law with respect to measuring net income of a New York S corporation.

The department raised various arguments, but the administrative law judge ruled in favor of the taxpayers that in computing entire net income for New York corporate franchise tax purposes, New York S corporations were not required to include gains from I.R.C. §338(h)(10) transactions.

[2] A ''qualified stock purchase'' requires that a purchaser, either in a single transaction or series of transactions within a 12-month period, acquire an amount of stock that represents:

- at least 80 percent of the total combined voting power of all classes of the stock of the target corporation entitled to vote; and
- at least 80 percent of the value of the stock of the target corporation, not including nonvoting, nonparticipating, nonconvertible preferred stock. I.R.C. §§338(d)(3), 1504(a)(2).

[3] Treas. Regs. §1.338(h)(10)-1(b)(1)-(b)(5), and -1(c).

[4] Treas. Regs. §§1.338-1(a)(1) and 1.338(h)(10)-1(d)(3)-(d)(4).

[5] N.Y. Tax Law §210.1(g)(1).

[6] I.R.C. §1361(a)(2) defines a federal C corporation as any corporation that is not a federal S corporation.

[7] *In re Zweig Total Return Advisors Inc.*, DTA Nos. 819390, *et seq.* (N.Y. State Div. of Tax App. Dec. 16, 2004).

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New York Personal Income Tax

Article 22 of the New York Tax Law provides that a shareholder of a New York S corporation or a federal S corporation that is not subject to New York taxation must include in his or her New York adjusted gross income (AGI) his or her share of the S corporation's items of income, loss, deduction, and reduction for taxes (for the federal taxes on built-in gains and excess passive income).[8] The starting point for this inclusion is the amount that the shareholder is required to include in his or her federal adjusted gross income. For federal tax purposes, an S corporation recognizes a gain or loss on the deemed asset sale that takes place pursuant to a §338(h)(10) election.

So there is an apparent dichotomy between the New York franchise tax and personal income tax law with respect to measuring net income of a New York S corporation. For franchise tax purposes, a New York S corporation is to determine its entire net income as if it had not made the federal S corporation election. For individual tax purposes, the New York S corporation shareholder starts with its federal AGI, which includes the flow-through income of the S corporation. So it was not entirely clear whether the result in *Zweig* would apply for Article 22 purposes.[9]

A recent Tax Appeals Tribunal case, *In re Gabriel S. and Frances B. Baum*,[10] clarified this point. The tribunal ruled that since a New York S corporation could not make a valid I.R.C. §338(h)(10) election for Article 9-A purposes, the I.R.C. §338(h)(10) election would not be valid for Article 22 purposes either:

> From a plain reading of [Tax Law §208.9(ii)], it is clear that S corporations must compute their income for New York tax purposes as if the section 338(h)(10) election had not been made. Thus, the fictitious deemed asset sale and the deemed distribution in complete liquidation is not applicable to the sale of [stock] for New York purposes. As such, the gain from the deemed asset sale may not be included in the entire net income of [the target company] for purposes of determining its New York State franchise tax under Article 9-A, *nor may the same be passed through, pro rata, as New York source income to the shareholders of [the target company]*. (emphasis added)

The tribunal's holding in *Baum* ... raised the question of whether New York would reverse its position and challenge whether such basis adjustments should be recognized for New York income tax purposes.

Since the tribunal held that the I.R.C. §338(h)(10) transaction in *Baum* was a simple stock sale for New York purposes, the nonresident shareholders were treated as merely selling shares of stock in an S corporation, and, under normal New York sourcing rules, the gain from selling stock is not New York source income to a nonresident shareholder.[11]

In addition to establishing a lack of conformity for the sellers between the federal and state tax treatment of the same transaction, the tribunal's decision also caused uncertainty for purchasers where an election under I.R.C. §338(h)(10) was made. It has been our experience that New York state has routinely respected the basis adjustments for the assets that a New Target Corporation is considered to have as a result of its deemed asset purchases from an Old Target Corporation under an I.R.C. §338(h)(10) election. The tribunal's holding in *Baum* that the transaction is a stock sale and not a sale of assets for essentially all purposes of New York income taxation raised the question of whether New York would reverse its position and challenge whether such basis adjustments should be recognized for New York income tax purposes.[12] Indeed, this action was suggested in the Governor's Memorandum in Support for a technical correction to the statute, wherein the governor stated the following: ''[the Tribunal's ruling] would create unwarranted inconsistencies with Federal tax law and would add additional cost and complexity because the purchaser would be required to maintain separate book-keeping procedures for any New York assets purchased in a I.R.C. §338(h)(10) transaction.''[13]

A secondary issue in *Baum* was whether, for New York purposes, the loss on the deemed surrender of a shareholder's stock of the S corporation could offset the I.R.C. §338(h)(10) gain recognized by such shareholder. That issue was rendered moot by the tribunal's ruling that the I.R.C. §338(h)(10) election was invalid for Article 22 purposes.

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[8] N.Y. Tax Law §632(a)(2).

[9] This disparity is illustrated in *In re Petition of Curcio*, DTA No. 818849 * (N.Y. Div. Tax App. April 4, 2003). In *Curcio*, a New York S corporation was able to exclude school bus income from its Article 9-A entire net income. The New York S corporation's shareholders, however, were not permitted to exclude the school bus income passed through to them from their Article 22 taxable income.

[10] *In re Gabriel S. and Frances B. Baum*, DTA Nos. 820837 and 820838 (N.Y. Div. Tax App. Feb. 12, 2009).

[11] N.Y. Tax Law §631(b)(2).

[12] It should be noted that the New York City Department of Finance's current policy is not to include I.R.C. §338(h)(10) gains in the entire net income of a federal S corporation, but not recognize any basis adjustments as a result of that election. New York City Rule §11-27(j).

[13] 2010-11 New York State Executive Budget, Revenue Article VII Legislation, Memorandum in Support p.13, available at http://publications.budget.state.ny.us/eBudget1011/fy1011artVIIbills/REVENUE_ArticleVII_MS.pdf.

2010 Amendments to New York Personal Income Tax Law

Recent amendments to the tax law negate the holding in *Baum*. The Governor's Memorandum in Support (pertaining to the state's 2010-2011 budget legislation) referred to *Baum* as being:

> inconsistent with the longstanding policy of both the Internal Revenue Service and the Department of Taxation and Finance (Department) to treat [IRC §338(h)(10) transactions] as asset sales when the taxpayer so elects. . . .The Department has always taken the position that when shareholders of a S corporation make an election under IRC §338(h)(10), that election is also made for New York State personal income tax purposes.[14]

On Aug. 11, 2010, the New York governor signed Assembly Bill 9710-D,[15] which included an amendment to N.Y. Tax Law §632(a)(2). The new law explicitly provides that a nonresident shareholder is subject to tax on his/her share of the I.R.C. §338(h)(10) gain, regardless of whether such gain is included in the entire net income of the New York S corporation. The gain is sourced under the existing allocation rules applicable to sourcing New York S corporation income.[16]

Furthermore, the new law provides that any gain or loss on the deemed liquidation of the S corporation stock will not increase or offset the nonresident's I.R.C. §338(h)(10) gain. These changes are effective for taxable years beginning on or after Jan. 1, 2007, for which the statute of limitations for refund or assessment is still open. When there is a failure to file a return or a report of a federal audit adjustment, the filing of a false or fraudulent return with the intent to evade tax (as defined in N.Y. Tax Law §683(c)(1)), or a substantial omission of income (as defined in N.Y. Tax Law §683(d)), these changes will apply to all taxable years open to the assessment of additional tax.[17]

Validity of the Retroactive Effective Date of the New Law

There is a question as to whether a tax law enacted in 2010 should have retroactive effect to 2007. In fact, enacting retroactive legislation in this manner is a growing trend as states struggle to balance their budgets. While retroactive legislation would appear to be prohibited by provisions in the U.S. Constitution proscribing Congress and the states from passing ex post facto laws,[18] the U.S. Supreme Court has ruled that such prohibitions apply only to criminal statutes.[19] Thus, when opposing unfavorable retroactive legislation, taxpayers often assert a violation of the Due Process Clause of the U.S. Constitution.[20]

The seminal case outlining Due Process Clause limitations regarding retroactive tax statutes is *United States v. Carlton*.[21] In that case, the U.S. Supreme Court examined whether the retroactive application of a federal estate tax statute, without notice and causing loss to the taxpayer, would violate due process. The court concluded that the requirements of Due Process Clause were met because:

- Congress' purpose in enacting the amendment was neither illegitimate nor arbitrary, and
- Congress acted promptly and established only a modest period of retroactivity.[22]

The court focused on the curative nature of the statutory amendment and the fact that Congress did not contemplate the broad applicability of the statute when it was originally enacted. The revenue loss to the fisc as a result of the enacted statute was over twenty times greater than forecasted because of an unanticipated use of the statute.[23]

The U.S. Supreme Court referenced its earlier ruling in *Welch v. Henry*,[24] where the court also upheld retroactive tax legislation against a Due Process Clausechallenge. In *Welch*, the court upheld a Wisconsin income tax adopted in 1935 on dividends received in 1933. The court acknowledged that because of the practicalities of producing national legislation, it was customary Congressional practice to enact legislation retroactive for short periods, including the year preceding enactment. The *Carlton* opinion noted approvingly that the retroactive application of the amended statute extended only slightly greater than one year.[25]

Carlton, as well as *Welch*, was favorably cited by the New York Court of Appeals in *In re Varrington Corp. v. New York City*,[26] where the New York City Department of Finance retroactively applied an amended regulation to recover refunds of New York City corporate taxes paid to a foreign corporation that was a limited partner in a New York limited partnership. In *Varrington*, a longstanding New York City tax policy had been temporarily altered and then reverted to its settled application with retroactive effect. After the first alteration to the city's rules, the taxpayer in *Varrington* filed amended returns and received a refund of its New York City tax payments. After the second amendment to the city's rules, the Department of Finance sought to recover the taxes that were previously refunded to the taxpayer in *Varrington*. The court of appeals found no detrimental reliance by *Varrington* and stated that:

> [s]ince tax legislation is not a governmental promise, Varrington has no vested or actionable right in these circumstances to the benefit of a tax statute or regulation. Varrington, therefore, cannot claim that it was unjustifiably prejudiced by the retroactive applica-

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[14] *Id.* at 12. *See also* A9710-D, Part C, §1.

[15] A.B. 9710-D was recorded as Chapter 57, Laws of 2010.

[16] N.Y. Tax Law §632(a)(2), as amended by A9710-D, Part C, §2.

[17] A.B. 9710-D, Part C, §4, as amended by A11678, Part B, §1.

[18] U.S. Const. art. I, §§9-10.

[19] *Calder v. Bull*, 3 U.S. 386, 390 (1798).

[20] The Due Process Clause in the Fifth Amendment of the Constitution is invoked when the legal issue pertains to federal law, while the Due Process Clause in the 14th Amendment is invoked when the legal issue pertains to state law.

[21] 512 U.S. 26 (1994).

[22] *Id.* at 29.

[23] *Id.* at 32.

[24] *Welch v. Henry* 305 U.S. 134 (1938).

[25] *Carlton*, 512 U.S. at 33.

[26] 85 N.Y.2d 28 (N.Y. 1995).

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tion of the regulation in the detrimental reliance sense.[27]

There is a question as to whether a tax law enacted in 2010 should have retroactive effect to 2007. In fact, enacting retroactive legislation in this manner is a growing trend as states struggle to balance their budgets.

Carlton has also been cited in a number of recent state cases upholding retroactive state tax legislation. In *Johnson Controls Inc. v. Miller*,[28] the taxpayer challenged Kentucky's legislation that retroactively barred refund claims filed six years previously by corporate taxpayers filing combined (and not separate) Kentucky corporate tax returns. Relying on *Carlton*, the Kentucky Supreme Court upheld the retroactive application of the legislation. In analyzing *Carlton*'s modest-period-of-retroactivity requirement, the Kentucky Supreme Court stated that ''[t]his requires analysis of the facts and circumstances of each case, rather than applying a specified modesty period. The pertinent question is whether the period of retroactivity is one that makes sense in supporting the legitimate governmental purpose.''[29]

In another recent state case, *General Motors Corp. v. Michigan Dept. of Revenue*,[30] the Michigan Court of Appeals affirmed that statutory amendments could operate retroactively for up to 10 years[31] to preclude a taxpayer from obtaining a use tax refund of approximately $117 million. *General Motors Corp.* side-steps *Carlton*'s modesty limitation citing the Kentucky Supreme Court in *Johnson Controls*: ''what is 'modest' or acceptable for Due Process purposes depends on the facts of the case, including notice, settled expectations, detrimental reliance, etc.''[32] In further support of its ruling that retroactive application of the statute did not exceed the modesty limitation of the Due Process Clause in *Carlton*, the Michigan Court of Appeals noted that its ruling was consistent with the rulings of other state courts and federal courts, upholding tax legislation retroactive for up to seven years.[33]

Carlton, however, has been used on occasion to strike down retroactive state tax legislation based on due process considerations. In *City of Modesto v. National Med Inc.*,[34] the California Court of Appeal rejected a retroactive application by Modesto, Calif., of amendments to its business license tax ordinance. The city had amended its business license tax ordinance to cure constitutional defects; thus the amendments were clearly legitimate. However, citing the second prong of the due process test enunciated in *Carlton*, the appeals court found that the city did not act promptly in adopting legislation after the need for amendment was identified and that an eight-year period of retroactivity was not acceptable in California.[35]

Similarly, in *Tesoro Refining and Marketing Co. v. Washington Dept. of Revenue*,[36] the Washington Court of Appeals rejected as a violation of due process an amendment to a statute retroactive to the 24-year period since the statute's enactment. The amendment was intended to directly target a taxpayer whose trial (an appeal for refund) was set to begin the day after enactment. Citing *Carlton*, the Washington Court of Appeals disagreed with the Department of Revenue's argument that the amendment was a ''clarifying amendment'' since it was in direct conflict with the reasonable expectation of qualifying taxpayers.[37] The court of appeals

[27] *Id.* at 33.

[28] *Johnson Controls Inc. v. Miller*, 296 S.W.3d 392 (Ky. 2009), *cert denied*, 2010 U.S. LEXIS 4206 (May 24, 2010).

[29] *Id.* at 399.

[30] *General Motors Corp. v. Michigan Dept. of Revenue*, 2010 Mich. App. LEXIS 2050 (Oct. 28, 2010).

[31] The nominal period of time to which the amendment applied was five years and all periods open under the statute of limitations. The taxpayer had waived the statute and so an additional earlier five-year period was still open and, thus, subject to the amendment.

[32] *Johnson Controls*, 296 S.W.3d at 399.

[33] *General Motors Corp.* at 30, n.3, citing *GMAC LLC*, 286 Mich. App. at 378 (seven-year retroactive application of an amendment to Mich. Comp. L. §205.54i affirmed); *Enterprise Leasing Co. of Phoenix v. Arizona Dept. of Rev.*, 221 Ariz. 123; 211 P.3d 1 (Ariz. Ct. App. 2008) (six-year period of retroactivity amending pollution control tax credit excluding property attached to motor vehicles); *King v. Campbell Co.*, 217 S.W.3d 862 (Ky. Ct. App., 2006) (upholding 2005 legislation denying refunds of county taxes overpaid since 1986 under 2004 judicial decision); *Miller v. Johnson Controls Inc.*, 296 S.W.3d 392 (Ky. 2009) (discussed above); *Zaber v. City of Dubuque*, 2010 Iowa Sup. LEXIS 47 (Iowa 2010) (legislation ratifying illegal city cable television franchise fees retroactively applied five-and-one-half-years); *Canisius College v. United States*, 799 F.2d 18 (2nd Cir. 1986) (tax legislation retroactive four years ratifying IRS revenue ruling of doubtful validity); *Licari v. Commissioner*, 946 F.2d 690, 695 (9th Cir. 1991) (four-year retroactive application of enhanced tax penalty approved as ''a rational means by which to guard the public fisc by reimbursing the government for heavy burden of investigative and prosecutorial costs incident to ferreting out tax underpayment''); *Tate & Lyle Inc. v. Commissioner of Internal Revenue*, 87 F.3d 99 (3d Cir. 1996) (upholding six-year retroactive application of tax regulation requiring the taxpayer to use a cash method of accounting); *Montana Rail Link Inc. v. United States*, 76 F.3d 991 (9th Cir. 1996) (approving four-year retroactive application of a tax statute).

[34] *City of Modesto v. National Med Inc.*, 27 Cal. Rptr. 3d 215 (Cal. Ct. App. 2005).

[35] See also *Rivers v. South Carolina*, 490 S.E.2d 261 (S.C. 1997) (favorably citing Justice O'Connor's concurrence in *Carlton* and holding that a retroactivity period of two to three years was ''simply excessive'').

[36] *Tesoro Refining and Marketing Co. v. Washington Dept. of Revenue*, 2010 Wash. App. LEXIS 2815 (Wash. Ct. App. Dec. 21, 2010.)

[37] *Id.* at 20.

further contrasted the facts of this case with *Carlton*, stated that ''[t]here is no colorable argument to suggest a legislative act creating a 24-year retroactive tax period is 'prompt' or 'established a modest period of retroactivity.' ''[38]

A taxpayer challenging the anti-*Baum* amendments on the basis of due process may face an uphill battle.

Perhaps anticipating backlash to the retroactive application to the newly amended law negating the *Baum* case, the New York Legislature prefaced the text of A.B. 9710-D with language evoking Justice Blackmun's opinion in *Carlton* regarding the curative nature of the statutory amendment. The ''legislative findings'' section of A.B. 9710-D states that the new law ''is necessary to correct [court] decision[s] . . . that erroneously overturned the longstanding policies of department of taxation and finance.''[39] This would appear to make the change somewhat akin to the situation in *Varrington*,[40] where a longstanding policy was temporarily changed, then changed back to its original form.

This type of argument supporting a retroactive amendment to a tax statute was also successful in *Trinova Corp. v. Michigan*,[41] where the state enacted retroactive legislation that added two tests to determine whether its apportionment formula fairly represented a taxpayer's business activity in Michigan. The Michigan Court of Appeals reasoned that the retroactive legislation was appropriate because varying interpretations of the statute had created uncertainty. The court also stated that ''[t]he general rule that a statute is presumed to operate prospectively does not apply to statutes remedial or procedural in nature.''[42] It seems, then, as though the possible infringement of due process rights as the result of the retroactive application of the anti-*Baum* amendments might be balanced, in the words of the New York Legislature, by the need to clarify the statute and to prevent ''confusion in the preparation of returns, unintended refunds, and protracted litigation of issues that have been properly administered up to now.''[43] Since the U.S. Supreme Court's precedent in this area has been used more often to support than to strike down retroactive state tax legislation and because of New York precedent supporting remedial retroactive state tax legislation, a taxpayer challenging the anti-*Baum* amendments on the basis of due process may face an uphill battle.

Conclusion

The taxpayer victory in *Baum* was short-lived due to retroactive changes made to the New York state tax law, as noted above. Undoubtedly, there have been taxpayers that relied upon *Baum* in negotiating the terms of I.R.C. §338(h)(10) transactions that happened between the date of the New York State Tax Appeals Tribunal's decision in that matter (Feb. 12, 2009) and the enactment of New York A.B. 9710-D on Aug. 11, 2010. There are also taxpayers that have entered into I.R.C. §338(h)(10) transactions for taxable years beginning on or after Jan. 1, 2007, but prior to the tribunal's decision in *Baum*, that had filed refund claims in response to that case.

It would appear that the second group of taxpayers—those that did not rely upon *Baum*, but filed refund claims in reaction to it—fall within the parameters of the New York Court of Appeals decision in *Varrington*, and therefore may anticipate potential difficulty challenging the anti-*Baum* provision of A.B. 9710-D. In contrast, the first group of taxpayers may be distinguished from *Varrington* since they can claim reliance on *Baum* when negotiating their contracts to sell their S corporations. However, the period of Feb. 12, 2009 to Aug. 11, 2010, would seem well within the concept of a ''modest period of retroactive application,'' as established in *Carlton*.

For nonresident shareholders of New York S corporations that will be sold in I.R.C. §338(h)(10) transactions, the New York statutory arguments for avoiding New York state taxation of the gain to the shareholders appear to have been foreclosed by the anti-*Baum* provision of A.B. 9710-D.

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[38] *Id.* at 22.
[39] A.B. 9710, Part C, §1.
[40] *See above*, note 27.
[41] *Trinova Corp. v. Michigan*, 421 N.W.2d 258 (Mich. Ct. App. 1988), *aff'd,* 433 Mich. 141 (Mich. 1989), *aff'd,* 498 U.S. 358 (1991).
[42] *Id.* at 262.
[43] A.B. 9710-D, Part C, §1.

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