STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition :

of :

GABRIEL S. AND FRANCES B. BAUM :

for Redetermination of a Deficiency or for Refund :
of New York State Personal Income Tax under
Article 22 of the Tax Law for the Year 2001. :

In the Matter of the Petition :

of :

CHRISTIAN M. BOEGNER
AND
JOANNA TOWNSHEND :

for Redetermination of a Deficiency or for Refund :
of New York State Personal Income Tax under
Article 22 of the Tax Law for the Year 2001. :

DECISION
DTA NOS. 820837 AND
820838

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on December 20, 2007 in the matter of the petitions of Gabriel S. Baum and Frances B. Baum, and Christian M. Boegner and Joanna Townshend. Petitioners appeared by Hodgson Russ, LLP (Jack Trachtenberg, Esq. and Christopher L. Doyle, Esq., of counsel). The Division of Taxation appeared by Daniel Smirlock, Esq. (Kevin R. Law, Esq., of counsel).

The Division of Taxation filed a brief in support of its exception. Petitioners filed a brief in opposition. The Division of Taxation filed a reply brief. A brief *amicus curiae* in support of petitioners was filed on behalf of Edward Watkins, Kristina W. Watkins and Curtis G. Watkins, II by McDermott, Will & Emery (Peter L. Faber, Esq. and Jeffrey S. Reed, Esq., of counsel). Oral argument, at the request of the Division of Taxation, was held on July 9, 2008 in Troy, New York.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

ISSUES

I. Whether the Division of Taxation (hereinafter the "Division") may properly include, in a nonresident taxpayer's income, the gain from the sale of that taxpayer's shares of a New York S corporation to an acquiring corporation, which sale is deemed, pursuant to an Internal Revenue Code (IRC) § 338(h)(10) election, to be a sale of the S corporation's assets.

II. Whether the Division may disallow a nonresident taxpayer's claimed loss on a deemed liquidation of that taxpayer's New York S corporation's stock, which is treated as a stock sale as the result of such IRC § 338(h)(10) election, on the basis that such loss was not derived from or connected with New York sources because the proceeds of the deemed liquidation resulting in the loss arose from amounts paid for an intangible (stock) not employed in a trade or business in New York State.

III. Whether the Division's disallowance of a nonresident New York S corporation shareholder's claimed loss arising from the deemed liquidation as a result of an IRC § 338(h)(10) election violates the Privileges and Immunities Clause of the United States Constitution.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge. These facts are set forth below.

Petitioners, Christian M. Boegner, Joanna Townshend, Gabriel S. Baum and Frances B. Baum, were nonresidents of New York during the year 2001.[1]

During 2001, petitioners were shareholders of SBS International of New York, Inc. (SBS). SBS was incorporated under the laws of the State of New York on September 1, 1977, and reported taxes on a fiscal year spanning September 1 through August 31.

During the fiscal year ended August 31, 2001, SBS was taxable as an S corporation for federal and New York State tax purposes. During the fiscal year ended August 31, 2001, Christian M. Boegner owned 27.66% of the stock of SBS, and Gabriel S. Baum owned 16.69% of the stock of SBS.

On July 26, 2001, the shareholders of SBS sold all of their shares of stock of the corporation to an unrelated party, the Boeing Company (Boeing). In connection with this stock sale, the shareholders of SBS and Boeing made an election under section 338(h)(10) of the Internal Revenue Code to treat the transaction for federal income tax purposes as if SBS had sold all of its assets to Boeing (the deemed asset sale), followed by a liquidation and distribution of the sales proceeds to the selling shareholders in exchange for the shareholders' stock under section 331 of the Internal Revenue Code (the deemed liquidation).

The deemed asset sale resulted in federal taxable gain to the SBS shareholders of $21,282,038.00. SBS reported this gain on line 4e(2) of Schedule K of its Federal S Corporation Income Tax Return (Form 1120S) for the fiscal year ended July 26, 2001.

[1] Joanna Townshend and Frances B. Baum appear as petitioners in these matters solely by virtue of having filed joint New York State nonresident and part-year resident income tax returns with their respective spouses, Christian M. Boegner and Gabriel S. Baum. All items of income and loss at issue were recognized by Christian M. Boegner and Gabriel S. Baum (in their individual respective share or percentage amounts). Accordingly, unless otherwise indicated or required by context, all plural references to petitioners shall be to the two petitioners Christian M. Boegner and Gabriel S. Baum, and all singular references to petitioner shall be to either petitioner Christian M. Boegner or to petitioner Gabriel S. Baum, as is contextually appropriate.

The New York State business allocation percentage (BAP) of SBS at the time of the section 338(h)(10) transaction was 76.1667%.

For the fiscal year ended July 26, 2001, SBS issued a Form K-1 (Shareholder's Share of Income, Credits, Deductions, etc.) to each of its shareholders. Each Form K-1 reported, on line 4e(2), the respective shareholder's pro rata share of gain resulting, for federal income tax purposes, from the deemed asset sale. This amount was calculated by multiplying the total deemed asset sale gain of $21,282,038.00 by the particular shareholder's ownership interest in SBS. Thus, as reported at line 4e(2) on their respective forms K-1, Christian M. Boegner's gain from the deemed asset sale was $5,886,612.00 (i.e., $21,282,038.00 x .2766), and Gabriel S. Baum's gain from the deemed asset sale was $3,551,972.00 (i.e., $21,282,038.00 x .1669).

Christian M. Boegner was deemed to have received cash proceeds in the amount of $4,054,880.00 upon the deemed liquidation of SBS, and Gabriel S. Baum was deemed to have received cash proceeds in the amount of $1,322,025.00 upon the deemed liquidation of SBS.

At the time of the deemed liquidation, Christian M. Boegner's adjusted basis in the stock that he was treated as selling pursuant to the deemed liquidation was $5,767,033.00, and all of that basis was attributable to the $5,886,612.00 of gain that flowed through to Christian M. Boegner from SBS as a result of the deemed asset sale. Likewise, at the time of the deemed liquidation, Gabriel S. Baum's adjusted basis in the stock that he was treated as selling pursuant to the deemed liquidation was $3,687,818.00, and $3,551,972.00 of that basis was attributable to the gain that flowed through to Gabriel S. Baum from SBS as a result of the deemed asset sale. For purposes of this proceeding, it is assumed that the remainder of the basis was not attributable in any way to New York sources.

For the year 2001, Christian M. Boegner filed a Form IT-203 (New York State Nonresident and Part-Year Resident Income Tax Return). On the federal Schedule D (Capital Gains and Losses) attached to this return, Mr. Boegner reported on line 12 the $5,886,612.00 gain from the deemed asset sale, and reported the $1,712,153.00 loss that he recognized for federal income tax purposes upon the deemed liquidation of his SBS stock. The claimed loss was calculated by subtracting Mr. Boegner's $5,767,033.00 adjusted basis in his SBS stock from the $4,054,880.00 of cash proceeds that he was deemed to have received on the deemed liquidation. The net effect of this reporting position for federal income tax purposes was a gain to Mr. Boegner from the stock sale and section 338(h)(10) election in the amount of $4,174,159.00.[2] Christian M. Boegner allocated this amount to New York based upon the 76.1667% BAP of SBS, and therefore treated $3,179,319.00 of his gain as New York source income. This resulted in a reported income percentage (Line 43 to Form IT-203) of 72.77% and a reported total tax due to New York of $163,284.00.

For the year 2001, Gabriel S. Baum filed a Form IT-203 (New York State Nonresident and Part-Year Resident Income Tax Return). On the federal Schedule D (Capital Gains and Losses) attached to this return, Mr. Baum reported on line 12 the $3,551,972.00 gain from the deemed asset sale, and reported the $2,365,793.00 loss that he recognized for federal income tax purposes upon the deemed liquidation of his SBS stock. The claimed loss was calculated by subtracting Mr. Baum's $3,687,818.00 adjusted basis in his SBS stock from the $1,322,025.00.00 of cash proceeds that he was deemed to have received on the deemed liquidation. The net effect of this

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[2] The net gain amount of $4,174,159.00 set forth in the parties' stipulation is $300.00 less than the amount that results from subtracting the claimed loss from the gain on the deemed asset sale (i.e., $5,886,612.00 less $1,712,153.00 equals $4,174,459.00). This small difference is not explained and presumably results from transcription error.

reporting position for federal income tax purposes was a gain to Mr. Baum from the stock sale and section 338(h)(10) election in the amount of $1,186,179.00. Gabriel S. Baum allocated this amount to New York based upon the 76.1667% BAP of SBS, and therefore treated $903,473.00 of his gain as New York source income. This resulted in a reported income percentage (Line 43 to Form IT-203) of 48.65% and a reported total tax due to New York of $30,399.00.

The Division audited petitioners' nonresident returns for the year 2001 and concluded that petitioners had improperly offset their respective gains from the deemed asset sale by their respective losses recognized upon the deemed liquidation of SBS. As a result, the Division disallowed Christian M. Boegner's claimed loss on the deemed liquidation and issued an audit adjustment that allocated 76.1667% of Mr. Boegner's $5,886,612.00 deemed asset sale gain to New York based upon the BAP of SBS. Thus, $4,483,638.10 of such gain was treated as New York source income, resulting in total tax due to New York in the amount of $252,274.48. In the same fashion, the Division disallowed Gabriel M Baum's claimed loss on the deemed liquidation and issued an audit adjustment that allocated 76.1667% of Mr. Baum's $3,551,972.00 deemed asset sale gain to New York based upon the BAP of SBS. Thus, $2,705,419.86 of such gain was treated as New York source income, resulting in total tax due to New York in the amount of $152,140.55.

On July 19, 2004, the Division issued a separate Notice of Deficiency to each petitioner. The notice issued to Christian M. Boegner asserts additional personal income tax due for the year 2001 in the amount of $88,990.48, plus interest in the amount of $12,907.31. The notice issued to Gabriel S. Baum asserts additional personal income tax due for the year 2001 in the amount of $121,741.55, plus interest in the amount of $17,657.58. The additional tax asserted as due per the respective notices results solely from the Division's disallowance of the loss that each petitioner recognized upon the deemed liquidation of SBS.

If Christian B. Boegner had been a resident of New York State during the year of the stock sale and section 338(h)(10) election, his New York State personal income tax liability would have been $224,384.00. If Gabriel S. Baum had been a resident of New York State during the year of the stock sale and section 338(h)(10) election, his New York State personal income tax liability would have been $62,485.00.

As noted in the findings of fact above, Christian M. Boegner and Gabriel S. Baum paid New York State personal income tax for the year 2001 in the respective amounts of $163,284.00 and $30,399.00, based upon the respective reported income percentages (at line 43 of their returns) of 72.77% and 48.65%. In contrast, the Division's notices of deficiency assert additional personal income tax against Christian M. Boegner and Gabriel S. Baum based on income percentages of 112.43% and 245.39%, respectively.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

In his determination, the Administrative Law Judge noted that at issue was whether petitioners' pro rata shares of the gain from the deemed asset sale were properly includible in the numerator of their New York source fractions as New York source income or, rather, whether the gain must be excluded as resulting from the nonresident petitioners' sale of an intangible, i.e., petitioners' shares in SBS.

The Administrative Law Judge stated that a New York subchapter S corporation is subject to tax on the higher of the tax that would be computed by a C corporation on its entire net income base or the fixed dollar minimum reduced by the article 22 tax equivalent, but no less than the fixed dollar amount (***see***, Tax Law § 210[1][g]). The Administrative Law Judge turned to Tax

Law § 208(9) for guidance, as such section addresses the calculation of entire net income with respect to a subchapter S corporation.

The Administrative Law Judge explained that a plain reading of the statute requires that an S corporation compute its entire net income as if it had not made a subchapter S election. In other words, the statute requires SBS to compute its entire net income as if it were a C corporation. The Administrative Law Judge reasoned that the IRC § 338(h)(10) election is not available to a C corporation that is not a member of a selling consolidated or affiliated group of corporations and, as such, SBS would not be able to make a valid section 338(h)(10) election at the State level. Thus, the Administrative Law Judge stated that the gain from the deemed asset sale may not be included in the entire net income of the New York S corporation for purposes of determining its State franchise tax under Article 9-A.

The Administrative Law Judge held that petitioners' gain from the sale of SBS resulted from the sale of their respective stock and, as nonresidents of New York State, petitioners were not required to include such gain as New York source income for income tax purposes.

ARGUMENTS ON EXCEPTION

The Division argues that the Administrative Law Judge erred in his determination. Specifically, the Division points out that the Administrative Law Judge should have started with the shareholder's actual Federal adjusted gross income, which is the starting point for determining New York adjusted gross income. Thus, the Division states that Tax Law § 632 is the controlling section of the statute and that Tax Law § 208(9) has no bearing on whether section 632 can be disregarded.

Additionally, the Division maintains that the only reference in Article 22 to Article 9-A is in how to determine an allocation percentage. The Division relies on Tax Law § 617 in support of its position that a nonresident shareholder of a New York S corporation is taxed on the deemed asset sale gain entering into his Federal adjusted gross income and is sourced to New York according to the corporation's business allocation percentage.

In response, petitioners state that the Administrative Law Judge properly held that the gain was not included in petitioners' income as income from New York sources. Petitioners also focus on Tax Law § 632 as a starting point. Specifically, petitioners emphasize subsection (a)(2) of section 632 which limits the amount of flow-through income a nonresident shareholder of an S corporation must treat as New York sourced. Petitioners point out that such section imposes upon the Commissioner the duty to promulgate apportionment regulations as guidance as to how the New York source portion of such S corporation income is to be determined. However, petitioners state that the Commissioner has failed to promulgate regulations consistent with the Article 9-A's apportionment and allocation rules.

Petitioners argue that under Article 9-A, income is allocated to New York by applying allocation percentages to entire net income. Thus, in defining entire net income, petitioners point out that Tax Law § 208(9)(ii) states that it is the income that the S corporation would have been required to report at the federal level if the valid section 338(h)(10) election had not been made. Petitioners agree with the Administrative Law Judge that in reading both Tax Law § 632(a)(2) and Tax Law § 208(9)(ii), the deemed asset sale did not occur and SBS did not recognize gain to be apportioned using SBS's business allocation percentage. Thus, petitioners argue that the Administrative Law Judge properly held that the gain was from petitioners' sales of stock in the S corporation, and since petitioners were nonresidents of New York, such gain was not included in petitioners' New York source income.

OPINION

We affirm the determination of the Administrative Law Judge.

In reviewing the record of this matter, it is important to note that the transaction at issue is a sale of stock. It was the valid election made by petitioners under IRC § 338(h)(10) that is confusing the appearance of the transaction. As noted by the Administrative Law Judge, there was no sale of the S corporation's assets. The question is whether such an election, available under the federal rules and allowing for a transaction to be treated in a fictitious manner so as to allow calculations providing for an advantageous federal tax result, can change the nature and source of the income, gain, loss or deduction resulting from what actually occurred, a stock sale by a nonresident. We find that it cannot.

When a valid section 338(h)(10) election is made, the target corporation recognizes gain or loss as if it sold all of its assets in a single transaction at the close of the acquisition date to itself as a separate corporation and then distributed the deemed sale proceeds in complete liquidation (Treas. Reg. §§ 1.338[h][10]-1[d][3], 1.338[h][10]-1[d][4]). The gain or loss on the deemed asset sale is included in the tax return of the selling consolidated or affiliated group or of the S corporation shareholders, but no gain or loss is recognized on the sale of the target stock.

The federal election was designed to provide very specific and limited federal tax consequences. Such election does not affect the substance of the transaction which, in this case, is a stock sale. Thus, the question before us is whether the resulting deemed federal transactions from the valid election cause petitioners' sales of their shares of stock to be taxable in New York.

A New York subchapter S corporation is subject to tax on the higher of the tax that would be computed by a C corporation on its entire net income base or the fixed dollar minimum reduced by the "article twenty-two tax equivalent" but not less than the fixed dollar amount (Tax

Law § 210[1][g]). Tax Law § 208(9) impacts the calculation of entire net income with regard to a subchapter S corporation by providing, in relevant part, as follows:

> The term "entire net income" means total net income from all sources, which shall be presumably the same as entire taxable income (but not alternative minimum taxable income),
>
> (i) which the taxpayer is required to report to the United State treasury department, or
>
> (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*, or
>
> (iii) which the taxpayer, in the case of a corporation which is exempt from federal income tax (other than the tax on unrelated business taxable income imposed under section 511 of the internal revenue code) but which is subject to tax under this article, would have been required to report to the United States treasury department but for such exemptions . . . . (emphasis added).

From a plain reading of the above-quoted statute, 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 SBS to Boeing for New York purposes. As such, the gain from the deemed asset sale may not be included in the entire net income of SBS 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 SBS.

As stated at the outset, this is a simple stock sale. Thus, petitioners' gain from the sale of stock in SBS is not included as New York source income to them, since they are nonresident individuals. This conclusion renders moot the remaining issues.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of the Division of Taxation is denied;

2. The determination of the Administrative Law Judge is sustained;

3. The petitions of Gabriel S. and Frances B. Baum, and Christian M. Boegner and Joanna Townshend, are hereby granted; and

4. The notices of deficiency dated July 19, 2004 are cancelled and the Division is directed to refund to petitioners the amounts specified and agreed to in the findings of fact together with such interest as may be due thereon.

DATED: Troy, New York
February 12, 2009

/s/ Charles H. Nesbitt
Charles H. Nesbitt
President

/s/ Carroll R. Jenkins
Carroll R. Jenkins
Commissioner