STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :

of :

MYRON MINTZ :

for Redetermination of a Deficiency or for Refund of New York State Personal Income Tax under Article 22 of the Tax Law for the Years 1999 and 2000. :

DETERMINATION
DTA NOS. 821807 AND 821806

In the Matter of the Petition :

of :

JOANN YEAGER AND JEFFREY D. YEAGER :

for Redetermination of a Deficiency or for Refund of New York State Personal income Tax under Article 22 of the Tax Law for the Years 1998 and 1999 :

Petitioner Myron Mintz filed a petition for redetermination of a deficiency or for refund of New York State personal income tax under Article 22 of the Tax Law for the years 1999 and 2000, and petitioners Joann Yeager and Jeffrey D. Yeager filed a petition for redetermination of a deficiency or for refund of New York State personal income tax under Article 22 of the Tax Law for the years 1998 and 1999.

On December 14, 2007 and January 15, 2008, respectively, petitioners appearing by DLA Piper, US LLP (Ellis L. Reemer, Esq., and Monique A. Ellenbogan, Esq., of counsel), and the

Division of Taxation appearing by Daniel Smirlock, Esq. (Kevin R. Law, Esq., of counsel), waived a hearing and submitted the matters for determination based on documents and briefs to be submitted by December 12, 2008, which date commenced the six-month period for issuance of this determination. After due consideration of the documents and arguments submitted, Dennis M. Galliher, Administrative Law Judge, renders the following determination.

ISSUE

Whether nonresident shareholders of a New York S corporation 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.

FINDINGS OF FACT[1]

1. On June 27, 2005, the Division of Taxation (Division) issued to petitioner Myron Mintz a Notice of Deficiency asserting New York State personal income tax due for the years 1999 and 2000 in the aggregate amount of $578,986.00, plus penalty and interest. On April 10, 2006, the Division issued to petitioners Joann Yeager and Jeffrey Yeager a Notice of Deficiency asserting New York State personal income tax due for the years 1998 and 1999 in the aggregate amount of $71,727.00, plus penalty and interest.[2]

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[1] The parties executed a Stipulation of Facts setting forth, with respect to each petitioner, 13 separately numbered and agreed to facts. In addition, petitioners included in their briefs Proposed Findings of Fact numbered 1 through 13. The proposed findings of fact essentially mirror the stipulated facts, and thus are incorporated in the Findings of Fact set forth herein. It is noted that the stipulated facts and proposed facts numbered 12 and 13 set forth the parties' respective positions in these cases and are therefore presented under the caption "Summary of the Parties' Positions."

[2] Jeffrey Yeager's name appears as a petitioner in these matters solely by virtue of having filed joint income tax returns with his spouse, Joann Yeager. All items of income at issue in this proceeding concerning the Yeagers relate to Joann Yeager in connection with her status as a shareholder in ES Group, Inc. Accordingly, unless otherwise indicated, or required by context, all plural references to petitioners shall be to the two petitioners Myron Mintz and Joann Yeager, and all singular references to petitioner shall be to either petitioner Myron Mintz or to petitioner Joann Yeager, as is contextually appropriate. Further, the Notice of Deficiency issued to the Yeagers

2. During the years in issue, petitioner Myron Mintz was a resident of Florida and a nonresident of New York, and timely filed New York nonresident income tax information forms IT-203. Likewise during the years in issue, petitioner Joann Yeager was a resident of Florida.

3. For all of the relevant periods prior to its liquidation, ES Group, Inc. (ES Group), formerly known as Equisearch Services, Inc., was a New York State Subchapter S corporation. ES Group's New York State franchise tax returns reported a business allocation percentage of 99.4242%, with 100% of its receipts and 100% of its property reported as New York based. Petitioners, together with Charles Ginsberg and Paul Goldstein, were the shareholders of ES Group (the shareholders). Petitioner Myron Mintz owned 54 shares of ES Group, which represented a 27% ownership interest, while petitioner Joann Yeager owned 10 shares of ES Group, which represented a 5% ownership interest.

4. On November 25, 1998, ES Group adopted a plan of complete liquidation (the Plan of Liquidation). Thereafter, on December 11, 1998, effective as of December 1, 1998, ES Group entered into an Acquisition Agreement with a newly formed subsidiary of ChoicePoint Services, Inc., known as ES Acquisition, Inc. (ES Acquisition). Pursuant to the Acquisition Agreement, ES Group agreed to sell substantially all of its assets to ES Acquisition in exchange for an installment obligation in the principal amount of $22,000,000.00 (the Installment Obligation).

5. On December 23, 1998, pursuant to the Plan of Liquidation, the shareholders formed a liquidating trust, Equisearch Services, Inc. Liquidation Trust, pursuant to which the shareholders transferred all of their rights in ES Group (including their rights to the Installment Obligation) to the Equisearch Service, Inc. Liquidation Trust.

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included the earlier years 1996 and 1997. The portion of the notice pertaining to such earlier years has been paid in full and is not in dispute in this proceeding.

6. Pursuant to the Plan of Liquidation, ES Group distributed its remaining assets, including the Installment Obligation, in complete liquidation of ES Group to the Equisearch Services, Inc. Liquidation Trust prior to October 31, 1999.

7. The Installment Obligation was paid by a wire transfer in the amount of $22,000,000.00 on January 4, 1999.

8. The transactions described in Findings of Fact 4 through 7 satisfy the requirements set forth in sections 453(h)(1) and 453B(h) of the Internal Revenue Code of 1986 as amended (IRC).

SUMMARY OF THE PARTIES' POSITIONS

9. It is petitioners' position that pursuant to the application of IRC §§ 453(h)(1) and 453B(h), for federal and New York State income tax purposes (i) no gain or loss was recognized by ES Group upon distribution of the Installment Obligation in liquidation to the shareholders, including petitioners; (ii) petitioners did not recognize gain or loss upon the receipt of the Installment Obligation, but only as payments were received on the Installment Obligation; (iii) petitioners' receipt of payments under the Installment Obligation are treated as the receipt of payments for stock in ES Group and; (iv) as such, petitioners who were nonresidents, do not have any New York source income for the tax years because Tax Law § 631(b) and 20 NYCRR 132.5 direct that income derived from the sale of intangible property is sourced to the recipients' state of residence, here Florida.

10. The Division asserts, in contrast, that subsection (h) of IRC § 453B provides that:

> [i]f (1) an installment obligation is distributed by an S corporation in a complete liquidation, and (2) receipt of the obligation is not treated as payment for the stock by reason of Section 453(h)(1), then . . . no gain or loss with respect to the distribution of the obligation shall be recognized by the distributing corporation. Under regulations prescribed by the Secretary, the character of the gain or loss to the shareholder shall be determined in accordance with the principles of section 1366(b).

In turn, subsection (b) of IRC § 1366 provides that:

> [t]he character of any item included in a shareholder's pro rata share . . . shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation.

In this case, the source of the passed-through installment income was from ES Group's assets, a New York S corporation. Thus, the Division maintains that petitioners realized New York source income upon receipt of payments under the Installment Obligation.

CONCLUSIONS OF LAW

A. New York State imposes personal income tax on the income of nonresident individuals to the extent that their income is derived from or connected to New York sources (Tax Law § 601[e]). The income tax is imposed on the nonresidents' "tax base," which is their tax liability calculated as if the nonresident individuals were New York residents, multiplied by the "New York source fraction" (Tax Law § 601[e][1],[2]). The numerator of the fraction is the portion of the individual's adjusted gross income derived from or connected with New York sources, as determined per Tax Law §§ 631 through 639 (Tax Law § 601[e][3]). The denominator of the fraction is the individual's entire New York adjusted gross income, consisting (generally) of the individual's federal adjusted gross income with certain modifications (Tax Law § 601[e][3]; § 612).

B. There is no dispute between the parties that income derived from intangible assets, such as from the sale of shares of stock held by a nonresident and not employed in a business, trade, occupation or profession carried on in New York, is not New York source income and is not subject to New York State personal income tax (Tax Law § 631[b][2]; 20 NYCRR 132.5[a]; 132.8[c]). In this case, however, the Division seeks to impose tax upon the gain petitioners

received via periodic installment obligation payments resulting from ES Group's liquidating distribution to petitioners of an installment obligation it had received upon the sale of its assets in exchange for such installment obligation.

C. Generally, when a corporation liquidates, property distributed to the corporation's shareholders is treated by the shareholders as payment received in exchange for their shares of stock (IRC § 331). In the case of complete liquidations carried out pursuant to a plan which complies with the terms set forth in IRC § 453(h)(1)(A), gain is recognized by the shareholders upon their receipt of the periodic payments due pursuant to the installment obligation rather than upon their receipt of the installment obligation itself (***see In re Lambert***, 1998 WL352173[ED La 1998], ***affd*** 179 F3d 281 [5th Cir 1999]).[3] It is not disputed that the ES Group Plan of Liquidation was carried out according to its terms, and that those terms fell within the provisions of the IRC at sections 453, 453B and 1366(b), which are set forth hereinafter.

D. IRC § 453 provides, in relevant part, as follows:

> (h) Use of Installment Method by Shareholders in Certain Liquidations.
>
> (1) Receipt of Obligations Not Treated as Receipt of Payment.
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> (A) In General.— if, in a liquidation to which section 331 applies, the shareholder receives (in exchange for the shareholder's stock) an installment obligation acquired in respect of a sale or exchange by the corporation during the 12-month period beginning on the date a plan of complete liquidation is adopted and the liquidation is completed during such 12-month period, then, for purposes of this section, the receipt of payments under such obligation (but not the receipt of such obligation) by the shareholder *shall be treated as the receipt of payment for the stock* (emphasis added).

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[3] A clear benefit to the shareholders receiving an installment obligation under these circumstances is that income will be recognized and subject to tax periodically over time, as opposed to all at once and in advance of the series of periodic payments due under the installment obligation.

IRC § 331, as referenced in section 453 above, pertains to the gain or loss to shareholders in corporate liquidations.

E. IRC § 453B provides, in relevant part, as follows:

> (h) Certain Liquidating Distributions by S Corporations.
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> If–
>
> (1) an installment obligation is distributed by an S corporation in a complete liquidation, and
>
> (2) receipt of the obligation is not treated as payment for the stock by reason of section 453(h)(1), then, except for purposes of any tax imposed by subchapter S, no gain or loss with respect to the distribution of the obligation shall be recognized by the distributing corporation. Under regulations prescribed by the Secretary, the character of the gain or loss to the shareholder shall be determined in accordance with the principles of section 1366(b).

F. IRC § 1366(b) provides that "[t]he *character* of any item included in a shareholder's pro rata share . . . shall be determined as if such item were realized directly from the *source* from which realized by the corporation, or incurred in the same manner as incurred by the corporation" (emphasis added).

G. It is, as noted earlier, not disputed that income received by a nonresident of New York State from intangible assets (e.g., income resulting from the sale or exchange of shares of stock) is not New York source income subject to taxation by New York State. However, on the basis of the last provision set forth above (IRC § 1366[b]) the Division posits that the payments received by petitioners pursuant to the installment obligation distributed by the corporation in exchange for petitioners' stock constitute New York source income subject to taxation by New York.

H. Resolution of this matter turns upon the distinction between the *source* of income and the *character* of income. The impact of IRC § 1366(b) is not to change the *source* from which a

taxpayer's income was derived, and the *source* from which the income was derived in this case was petitioners' stock as surrendered in exchange for the installment obligation and its payments (IRC § 453[h][1][A]). Instead, IRC § 1366(b) serves only to dictate how the *character* of such income is determined. Rather than simply leaving all of the income from the installment payments as capital gain income (i.e., income derived from a sale or exchange of shares of stock), with its *character* being either long-term or short-term depending upon the shareholders' holding period, as would otherwise be the case with a stock sale by shareholders, IRC § 1366(b) requires reporting of the income in the *character* it would have had in the hands of the corporation (i.e., as ordinary income or capital gain income [either long-term or short-term] as the case may be depending upon the *character* of such income as realized by the corporation). Essentially, IRC § 1366(b) requires that the installment payments, to the extent included in a taxpayer's income, be reflected and reported according to their component composition. While IRC § 1366(b) dictates how the *character* of the installment payments is determined, it does not change the *source* from which the taxpayers' income was derived, here their stock in ES Group.

I. Ultimately, the income in question simply does not "make the cut" as New York *source* income, and since there is thus no gain or income for New York purposes there is no reason to apply the principles of IRC § 1366(b) to determine the *character* of the income or gain. As relevant, IRC § 1366(b) impacts and determines the *character* of income or gain received, but only to the extent the income or gain itself is includible in a taxpayer's income in the first instance (i.e., for federal purposes and for New York State resident taxpayer purposes). In short, IRC § 1366(b) would apply if the gain in question were included in petitioners' New York source income. However, since the gain petitioners received (via periodic installment payments) in exchange for their stock in ES Group was gain from the sale of stock held by a nonresident, the

same is not includible as New York source income, is not subject to taxation by New York State, and IRC § 1366(b) simply does not apply or have any impact under these circumstances.[4]

J. Finally, the Division has argued that the reasoning set forth in the determination in ***Matter of Baum*** (Division of Tax Appeals, December 20, 2007), and sustained in the decision in ***Matter of Baum*** (Tax Appeals Tribunal, February 12, 2009) controls the result herein. This argument is rejected. The cases relied upon by the Division involved a different federal provision, IRC § 338(h)(10), an election which by its own terms is available only to a corporation which is a member of a selling consolidated or affiliated group of corporations or an S corporation. Since Tax Law § 208(9)(ii) requires an S corporation to compute its entire net income as if it were a C corporation, and since the underlying corporation in ***Matter of Baum*** (SBS International of New York, Inc.) was not a member of a selling consolidated or affiliated group of corporations, then the IRC § 338(h)(10) election and its result was not available and did not apply for New York purposes. Unlike the situation in ***Matter of Baum***, there is no provision in the IRC limiting the availability of section 453(h)(1), or in the Tax Law causing a bar to the application and result of IRC § 453(h)(1). Thus, it remains that the nonresident petitioners here received payments under the installment obligation in exchange for their stock, and such payments are simply not New York source income.

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[4] The Division's brief referenced in support of its position a California Letter Decision issued by the California Board of Equalization (***Appeal of Mancini***, Case No. 255117, March 9, 2005). Such letter decisions do not carry the weight of precedent and may not be cited as such. Moreover, the primary issue in that case was the timing of the shareholder's recognition of gain on an installment obligation received upon complete liquidation of an S corporation. The Board held that because the S corporation (Hilltopper Publications, Inc.) failed to liquidate and distribute the installment obligation to its shareholders within 12 months of adopting the liquidation plan, the IRC § 453(h)(1) benefit of delaying recognition of gain until and as the installment payments were received was not available to the shareholding taxpayers and they were required to recognize their full distributive share of gain at the time of the distribution (citing IRC §§ 453B[h] & 1366[b]). (***See Appeal of Hilltopper***, Case No. 250265, March 9, 2005; ***see also Appeal of Vodrey***, Case No. 258566, September 1, 2005.)

K. The petitions of Myron Mintz and JoAnn Yeager and Jeffrey D. Yeager, are hereby granted and the Notice of Deficiency dated July 27, 2005 as to petitioner Myron Mintz is canceled, and the Notice of Deficiency dated April 10, 2006 as to petitioners JoAnn Yeager and Jeffrey D. Yeager is cancelled only with respect to the years 1998 and 1999.

DATED: Troy, New York
June 4, 2009

/s/ Dennis M. Galliher
ADMINISTRATIVE LAW JUDGE