STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
JEFFREY M. AND MELISSA LUIZZA	:	DECISION DTA NO. 824932
for Redetermination of a Deficiency or for Refund of New York State Personal Income Tax under Article 22 of the Tax Law and the Administrative Code of the City of New York for the Year 2008.	:	

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on August 21, 2014. Petitioners, Jeffrey M. and Melissa Luizza, appeared by Hodgson Russ LLP (Timothy P. Noonan, Esq., and Joshua K. Lawrence, Esq., of counsel). The Division of Taxation appeared by Amanda Hiller, Esq. (Christopher O'Brien, 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 did not file a reply brief. Oral argument was not requested. Prior to the issuance of a decision in this matter, petitioners requested, and were granted, the opportunity to file a supplemental letter brief. The Division of Taxation filed a response to the supplemental letter brief. Petitioners filed a letter brief in reply. The six-month period for issuance of this decision began on September 29, 2015, the date petitioners' letter brief in reply was received.

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

ISSUE

Whether the Division of Taxation's retroactive application of amendments to Tax Law § 632 (a) (2), which were enacted in 2010, to a transaction that was negotiated and completed between 2007 and 2008, is unconstitutional under the Due Process Clauses of the United States and New York State Constitutions.[1]

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge, with the exception of finding of fact 8, which has been modified to more fully reflect the record. Finding of fact 14 has not been included, as it dealt with the Administrative Law Judge's treatment of petitioners' proposed findings of fact. The Administrative Law Judge's findings of fact and the modified finding of fact are set forth below.

1. Petitioners, Jeffrey and Melissa Luizza, were nonresidents of New York State during 2008, the tax year in issue.[2]

2. Prior to 2008, Mr. Luizza owned 100 percent of the issued and outstanding capital stock of Penn Warranty Corporation (the Company), a corporation doing business partially within New York.

3. On December 14, 2007, Mr. Luizza signed a letter of intent outlining the terms of a proposed sale of the Company to Geminus Capital Partners, LLC, an unaffiliated buyer (the Buyer).

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[1] There were several additional issues raised before the Administrative Law Judge that have not been raised before this Tribunal. Accordingly, such issues are not addressed herein.

[2] Since the subject of this decision is the treatment of income of Mr. Luizza, references to petitioner pertain to Mr. Luizza only unless the context clearly shows otherwise.

4. Originally, the sale of the Company was to be structured as a sale of 100 percent of the Company's stock, along with specified operating liabilities. However, during subsequent negotiations, the Buyer indicated its preference to make an election under section 338 (h) (10) of the Internal Revenue Code (IRC) to allow the sale to be treated, for federal tax purposes, as a deemed sale of the Company's assets to the Buyer, followed by a deemed liquidation of the Company in exchange for its stock. The Company was eligible to make the federal election since it had elected to be treated as an S corporation for federal tax purposes. The Company was also recognized as an S corporation for New York State tax purposes.

5. Mr. Luizza informed the Buyer that he would consent to the IRC § 338 (h) (10) election only to the extent there would be no negative federal or state tax implications for the Company or himself individually. Accordingly, in a February 2008 redraft of the Stock Purchase Agreement, Mr. Luizza's lawyers added the following language in the section related to the IRC § 338 (h) (10) election: "Buyer shall reimburse Seller for all costs and negative tax consequences of the 338 (h) (10) election."

6. Rather than including the foregoing general statement in the stock purchase agreement, the attorney for the Buyer requested, in a February 13, 2008 memorandum to Mr. Luizza, that the tax cost of the IRC § 338 (h) (10) election be addressed up front. To determine the potential for additional taxes, Mr. Luizza and his longtime accountants researched the federal and New York State tax implications of carrying out the proposed sale pursuant to an IRC § 338 (h) (10) election. To do so, the accountants researched and reviewed the applicable New York State Tax Law with regard to nonresident shareholders selling S corporation stock while making an IRC § 338 (h) (10) election. The accountants' review included both an analysis of the New York

State Tax Law and secondary authority available in late 2007 and early 2008.

7. At the time of the transaction, the taxpayers and their representatives had no knowledge and did not believe that Tax Law § 632 (a) (2) would be amended as it was in 2010. Thus, based on the law applicable at the time of the sale of the Company, Mr. Luizza was advised by his tax advisors that there would be no additional New York tax consequences to him as a result of the IRC § 338 (h) (10) election.

8. As a result of the advice he received from his accountants, Mr. Luizza agreed not to require the Buyer to increase the purchase price, nor to require the Buyer to provide indemnity for any additional taxes arising as a result of the election. Mr. Luizza reasonably relied on the New York law applicable at the time of the sale when he agreed to this. In fact, the parties stipulated that "Mr. Luizza reasonably relied on the New York law applicable at the time of the sale when he agreed not to require the Buyer to increase the purchase price nor to provide indemnity for any additional taxes arising as a result of the election."

9. The parties executed a final stock purchase agreement on or about March 18, 2008. Following the sale, the Company issued a form K-1 to Mr. Luizza for the fiscal year beginning January 1, 2008 and ending March 18, 2008, reporting a long-term capital gain of $8,158,013.00 recognized on the sale of the Company's stock, with the full amount flowing through to Mr. Luizza based on his 100 percent ownership.

10. Petitioners filed a joint nonresident/part year resident income tax return (form IT-203) for the year 2008. On the return, Mr. Luizza reported the $8,158,013.00 of capital gain from the sale of the stock on Schedule D, but did not include the gain as income attributable to New York sources.

11. In 2010, more than two years after Mr. Luizza completed the sale of the company and after petitioners filed their 2008 New York State return, the New York State Legislature adopted amendments to section 632 (a) (2) of the Tax Law specifying that a nonresident S corporation shareholder's sale of stock pursuant to an IRC § 338 (h) (10) election is not treated as a sale of stock for purposes of New York State income tax; rather, the nonresident recognizes New York source income on gains from the deemed asset sale under the election (the deemed asset sale amendments). The deemed asset sale amendments further provided that such gain may not be offset or increased by any gain or loss recognized on the deemed liquidation occurring pursuant to the section 338 (h) (10) election. The deemed asset sale amendments, by their terms, took effect immediately and were initially applicable to "all tax years for which the statute of limitations for seeking a refund or assessing additional tax are still open." The Legislature subsequently modified the period of retroactivity so as to apply the amended statute to tax years beginning on or after January 1, 2007.

12. In a letter dated December 27, 2011, the Division of Taxation (Division) notified petitioners that they had failed to properly allocate the gain from the sale of the Company to New York on their 2008 income tax return.

13. On March 1, 2012, the Division issued a notice of deficiency to petitioners asserting that personal income tax was due for the year 2008 in the amount of $149,130.00 plus interest for a balance due of $184,997.36.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

The Administrative Law Judge explained that at issue was petitioner's election under IRC § 338 (h) (10) to treat the sale of the Company, for federal tax purposes, as a deemed sale of the

assets of the Company to the Buyer, followed by a deemed liquidation of the Company in exchange for its stock, rather than the sale of the company's stock, which is what actually occurred. The Administrative Law Judge noted that in March of 2008, when petitioner sold the Company, Tax Law § 632 (a) (2) did not address how such an election would impact a nonresident selling stock in an S corporation.

The Administrative Law Judge explained the history regarding this issue by first referencing ***Matter of Baum***, Tax Appeals Tribunal, February 12, 2009, and ***Matter of Mintz***, Division of Tax Appeals, June 4, 2009. The Administrative Law Judge then noted that in response to ***Matter of Baum*** and ***Matter of Mintz***, the Legislature amended Tax Law § 632 (a) (2) so that with regard to nonresident S corporation shareholders, any gain recognized for federal income tax purposes on an IRC § 338 (h) (10) deemed asset sale was "to be treated as New York source income." The Administrative Law Judge pointed to the legislative findings that the Legislature found the amendments to Tax Law § 632 (a) (2) "necessary to correct a decision of the tax appeals tribunal and a determination of the division of tax appeals that erroneously overturned the longstanding policies of department of taxation and finance" (L 2010 ch 57, pt C § 1). The Administrative Law Judge also explained that the deemed asset sale amendments to the statute were applicable to petitioner's 2008 sale of the Company because the 2010 amendments to Tax Law § 632 (a) (2) were made applicable "to taxable years beginning on or after January 1, 2007" (L 2010 ch 57 pt C § 4 amended L 2010 C 312 pt B § 1).

The Administrative Law Judge set forth the general principle that the retroactive application of taxing statutes is looked upon with disfavor by the courts, citing ***James Sq. Assoc. LP v Mullen***, 21 NY3d 233, 246 (2013), and the Appellate Division decision in ***Caprio v New***

York State Dept. of Taxation & Fin., 117 AD3d 168, 174 (2014); ***revd*** 25 NY3d 744 (2015). However, the Administrative Law Judge then explained that retroactive application of taxing statutes has been allowed unless such application is found to be so harsh and oppressive that it passes beyond constitutional boundaries, citing ***Matter of Replan Dev. v Department of Hous. Preserv. & Dev. of City of N.Y.***, 70 NY2d 451, 455 (1987), ***appeal dismissed*** 485 US 950 (1988). The Administrative Law Judge explained that in determining whether those conditional boundaries have been passed, the courts look to three factors: (1) the "taxpayer's forewarning of a change in the legislation and the reasonableness of . . . reliance on the old law," (2) "the length of the retroactive period," and (3) "the public purpose for retroactive application" (***Matter of Replan Dev.***, 70 NY2d at 456; ***James Sq. Assoc.***, 21 NY3d at 246).

The Administrative Law Judge found that the stipulated facts established that petitioner had neither any knowledge nor reason to believe that there would be a change in the statute two years after he sold the Company. Furthermore, the Administrative Law Judge found that the prevailing law was that petitioner had correctly reported the transaction and that he was advised the same by his tax advisors. The Administrative Law Judge also noted that the record reflected that petitioner was induced to forgo any requests for the Buyer to cover the higher tax costs that would have been associated with the tax consequences of reporting the transaction for New York purposes as a deemed asset sale rather than a stock sale.

With regard to whether the approximately two and one-half year retroactive period was excessive, the Administrative Law Judge noted that there was no bright line in the case law for when such a period was excessive, but that longer periods were allowed when the legislation at issue was intended to correct an error. The Administrative Law Judge concluded that the

retroactive period here was excessive based upon the Appellate Division's holding in ***Caprio*** that the 2010 amendments to the statute were not meant to correct an existing statute, but rather to create a new exception to the statutory rule "that gains from a nonresident's sale of stock (not used in a New York business) are not subject to New York taxation" (***Caprio v New York State Dept. of Taxation & Fin.***, 117 AD3d at 177 [2014]).

On the question of whether there was a public purpose for the deemed asset sale amendments, the Administrative Law Judge found that there was not. In reaching this determination, the Administrative Law Judge, again relying on the Appellate Division decision in ***Caprio***, specifically found that the legislation was not corrective in nature as it did not seek to correct previous legislation and was actually intended to raise tax revenues by over $30 million over the course of the fiscal year. The Administrative Law Judge noted that the courts have found that raising revenue is not a compelling reason to apply taxing statutes retroactively.

Thus, the Administrative Law Judge concluded that the application of the deemed asset sale amendments to petitioner was a violation of due process.

SUMMARY OF THE PARTIES' POSITIONS ON EXCEPTION

The Division asserts that retroactive application of taxing statutes does not necessarily violate principles of due process and, indeed, retroactive tax legislation has been repeatedly upheld by the United States Supreme Court, citing ***United States v Carlton***, 512 US 26, 30 (1994). Furthermore, the Division argues that it need only show that the retroactive application of the statute is "justified by a rational legislative purpose;" that the purpose of the Legislature in applying the statute retroactively was "neither illegitimate nor arbitrary;" and that the period of retroactivity was modest (***Carlton***, 512 US at 30-33 [citations omitted]). The Division asserts

that detrimental reliance by a taxpayer on the law at the time of the transaction at issue, without more, does not establish a violation of due process. The Division explains that this is because "[T]ax legislation is not a promise, and a taxpayer has no vested right" in the tax laws (***id.*** at 33).

The Division asserts that, partially in response to this Tribunal's decision in ***Matter of Baum***, Tax Appeals Tribunal, February 12, 2009,[3] the New York State Legislature amended Tax Law § 632 (a) (2) in 2010 to provide that transactions, such as the one at issue, would be treated as asset sales resulting in New York source income. The Division points to the legislative findings accompanying the amendment, which stated, as relevant to the current matter, that the amendment was "necessary to correct a decision of the tax appeals tribunal . . . 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) . . . are taxed in accordance with that election and the transaction is treated as an asset sale producing New York source income. Section two of this act is intended to clarify the concept of federal conformity in the personal income tax and is necessary to prevent confusion in the preparation of returns, unintended refunds, and protracted litigation of issues that have been properly administered up to now" (L 2010 ch 57 part C § 1).

The Division argues that the facts of this case must result in the conclusion that there is no due process violation based upon a review of the factors considered in ***Replan*** and set forth recently by the Court of Appeals in ***James Sq. Assoc. LP v Mullen***. Specifically, the Division asserts that as the Legislature specifically stated that the 2010 amendments were to correct an

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[3] The Division actually refers to the determination of the Administrative Law Judge in ***Matter of Baum***, Division of Tax Appeals, December 20, 2007, but it is clear that the Division meant to refer to the 2009 Tribunal decision.

erroneous determination of the Division of Tax Appeals and an erroneous decision of this Tribunal, and to "clarify the concept of federal conformity," the Division's position with respect to IRC § 338 (h) (10) is reasonable. The Division also asserts that a three-year retroactive application of a taxing statute is reasonable in situations where the legislation at issue was meant to correct errors and did not result in the imposition of a new tax. The Division argues that corrective legislation meant to clarify New York policy regarding federal conformity as it relates to IRC § 338 (h) (10) is legislation adopted for a proper public purpose, in light of the fact that the Division cannot appeal a decision of this Tribunal.

Essentially, the Division urges in its original brief that the Appellate Division decision in ***Caprio*** was incorrect and that the Court of Appeals decision, when issued, should control.

Petitioners argue that the facts of this case necessarily result in the conclusion that petitioner's right to due process under the United States and New York State Constitutions was violated by the retroactive application of the deemed asset sale amendments based upon a review of the factors considered in ***Replan*** and set forth recently by the Court of Appeals in ***James Sq. Assoc. LP v Mullen***.

Petitioners assert that the law at the time that petitioner negotiated the sale of the Company in 2007 and then completed the sale in 2008 was such that the deemed sale of assets under the IRC § 338 (h) (10) election was not recognized for the purposes of calculating petitioner's New York income. Furthermore, petitioners note that there was no way petitioner could have known of the impending 2010 statutory changes two years earlier. Therefore, petitioners argue that petitioner had no forewarning and thus reasonably relied upon the law as it existed in 2007 and 2008. Petitioners note that they suffered severe consequences, as the facts show that at the time

of the transaction, petitioner could have requested that the Buyer cover the additional state tax consequences of the IRC § 338 (h) (10) election, but that two years later at the time of the 2010 amendments, it was too late. Petitioners assert that the Division has failed throughout the instant matter to address petitioner's reliance on the law prior to the deemed asset sale amendments and that such failure undermines all aspects of the Division's due process analysis.

Finally, petitioners assert that there is no public purpose espoused by the Division other than the purpose of correcting a decision of this Tribunal. Petitioners argue that the deemed asset sale amendments cannot be construed as corrective amendments to the law, in that this Tribunal's 2009 decision in ***Matter of Baum*** finally and irrevocably settled the construction of the Tax Law prior to the 2010 amendments (Tax Law § 2016). Petitioners add that while the Legislature can change the law going forward, it cannot retroactively change the construction given to the Tax Law to something other than the construction it would ordinarily receive (***Matter of Roosevelt Raceway v Monaghan***, 9 NY2d 293, 304 [1961]). Petitioners also assert that the Division's argument that because it cannot appeal adverse decisions of this Tribunal, the ability of the Legislature to retroactively reverse any Tribunal decision that it, or the Division, disfavors, must be preserved, is contrary to the Legislature's purpose in creating this Tribunal. Specifically, petitioners point out that Tax Law § 2016 provides that decisions of this Tribunal "finally and irrevocably decide all the issues which were raised in proceedings before the division of tax appeals," with the only exception being an appeal initiated by a taxpayer. Thus, petitioners argue that to allow the Division and the Legislature to retroactively undo any decision of this Tribunal would be to make such decisions worthless as precedent. Additionally, petitioners assert that the Division of Tax Appeals, though an independent body, was established

as part of the Department of Taxation and Finance and, therefore, the Division may not appeal Tribunal decisions, which are effectively final decisions of Department of Taxation and Finance policy.

Petitioners, in their brief in opposition to the Division's exception and their supplemental brief, argue that the Court of Appeals decision in ***Caprio*** should not control the decision in this case. Petitioners explain that it was the installment obligation amendments that were at issue in ***Caprio***, not the deemed asset sale amendments at issue here. Petitioners argue that this is a critical difference in that the installment obligation amendments were enacted in response to the non-precedential Administrative Law Judge determination in ***Mintz***, while the deemed asset sale amendments were enacted in response to the precedential decision of this Tribunal in ***Baum***. Furthermore, petitioners explain that under IRC § 453 (h) (1) (A), an S corporation can sell actual assets (as opposed to a deemed asset sale) and yet avoid flow-through income to its shareholders in the year of sale by accepting an installment payment obligation rather than cash and then distributing the obligation to shareholders in exchange for stock (taxable as income from an intangible when payments are actually made). There is no election pursuant to this provision; if federal requirements are met, the treatment is statutory. Petitioners explain that, in contrast, an IRC § 338 (h) (10) election remains in substance a sale of S corporation stock. The federal election allows the transaction to be characterized, for federal tax purposes, as two fictional transactions, a deemed sale of the S corporation's assets, followed by a deemed liquidation of the S corporation in exchange for its stock. Petitioners further explain that the purpose is to achieve a very specific tax goal: a stepped-up basis in the assets, which benefits the purchaser, not the seller.

Additionally, petitioners argue that the facts in ***Caprio*** differ from the facts in the instant case, in that: (1) there were questions as to whether the plaintiffs in ***Caprio*** could have reasonably relied upon the prior law, as compared to the instant case, where it was stipulated that petitioner reasonably relied upon prior law; and (2) the Division in ***Caprio*** presented evidence of its longstanding policy regarding the taxation of nonresidents on IRC § 453 (h) (1) (A) installment obligations, as compared to the instant case, where the Division presented no evidence, much less any evidence on a longstanding policy regarding the taxation of nonresidents on IRC § 338 (h) (10) deemed asset sales.

Finally, petitioners argue that the question of whether the retroactive application of a taxing statute has been constitutionally applied to a transaction, "must involve a balancing of the equities" in each case (***Holly S. Clarendon Trust v State Tax Common.***, 43 NY2d 933, 934 [1978], ***cert denied*** 439 US 831 [1978]) and in this case, the predominant factor of reasonable reliance on prior law was stipulated to by the parties (***see Matter of Chrysler Props. v Morris***, 23 NY2d 515, 521 [1969]). Petitioners assert that even absent the stipulation in this matter, reasonable reliance has been shown. Petitioner here, unlike the plaintiffs in ***Caprio***, sought out professional tax advice. Petitioner here, unlike the plaintiffs in ***Caprio***, established that he would have structured the transaction differently in order to recoup any state tax consequences of the IRC § 338 (h) (10) election requested by the Buyer, had there been a forewarning of the change that would occur in the law over two years later.

In its letter brief filed in response to petitioners' supplemental brief addressing the Court of Appeals decision in ***Caprio***, the Division argues that such decision controls the outcome of this case. Specifically, the Division argues that there is no meaningful difference between the

deemed asset sale amendments and the installment obligation amendments. The Division asserts that the Court of Appeals' analysis of the retroactive period was based upon a balancing of equities test, not on a specific tax provision, and, in any event, all of the 2010 amendments to Tax Law § 632 (a) (2) were intended as corrective measures. Thus, the fact that the Court of Appeals in ***Caprio*** did not have a deemed asset sale before it, does not prevent the extension of its reasoning regarding the installment obligation to the sale in this case.

The Division argues that petitioners are incorrect in their assertion that ***Caprio*** gave a greater weight to the reliance factor of the ***Replan*** balancing test than the other two factors. Furthermore, the Division asserts that though it stipulated that petitioner's reliance on his tax professionals' interpretation of the law at the time the deal was struck was reasonable, it does not necessarily follow that such reliance was reasonable under the ***Replan*** balancing test. The Division argues that, in any event, reasonable reliance alone "is insufficient to establish a constitutional violation" (***United States v Carlton***, 512 US at 32-33).

Finally, the Division argues that the second and third prongs of the ***Replan*** test have been met, in that the retroactive period was reasonable and there was a valid public purpose to the retroactive application of the statute. The Division asserts that the ***Caprio*** court made sufficient findings to enable this Tribunal to determine that there was a policy with regard to deemed asset sales, i.e., the legislative findings**.**

OPINION

History

Petitioner, a nonresident, owned 100 percent of the issued and outstanding stock of the Company. For federal tax purposes, the Company had elected to be treated as an S corporation

and was recognized as such by New York State. Generally, an S corporation does not pay income tax at the corporate level, but passes its income and deductions through to its shareholders, who report the same on their personal income tax returns.

Petitioner decided to sell the Company to the Buyer, an unrelated company. The sale as originally structured was to include the sale of 100 percent of the Company's stock along with certain operating liabilities.

However, the Buyer proposed that a federal election under IRC § 338 (h) (10) be made in order to treat the sale of the Company for tax purposes as a deemed asset sale rather than a sale of stock. Generally speaking, such a treatment on the federal level would be advantageous to the purchaser because of a stepped-up basis in the assets purchased, but disadvantageous to the seller due to possible additional federal tax liability as a result of being taxed at a higher rate on a gain from the sale of assets than it would have been on a gain from the sale of stock (***see Caprio***, 117 AD3d at 747). Based upon these likely results, petitioner proposed, in response to the Buyer's request that the parties agree to make an IRC § 338 (h) (10) election, that the Buyer agree to reimburse the Seller for any tax consequences associated with such election. However, the Buyer preferred to address any such costs as part of the sale and, accordingly, petitioner researched the possible federal and state tax implications of such an election. Petitioner determined that there would be no negative New York tax implications because, under New York law, the transaction would be respected as a stock sale and, as such, would be excluded from petitioner's New York source income as income from a nonresident's sale of an intangible (i.e., the shares of the stock). Based upon this determination, petitioner did not request any adjustments in the price to be paid for the Company's stock to compensate for any additional New York tax liabilities resulting from

the IRC § 338 (h) (10) election. Furthermore, petitioners filed their 2008 nonresident income tax return based upon this determination; i.e., that the gain was not includable as income attributable to New York sources.

There is no question that under the law currently in effect in New York, petitioners' interpretation of the relevant statutes would be incorrect (Tax Law § 632 [a] [2]). In order to answer the question at issue herein, whether the application of the deemed sale amendments to that statute may be applied retroactively to tax years beginning on or after 2007, consistently with the Due Process Clauses of the United States and New York Constitutions, it is necessary to review the history of those amendments and court decisions subsequent to those amendments.

As noted by the Administrative Law Judge, the decision referred to in the legislative findings was ***Matter of Baum***, wherein this Tribunal, in similar circumstances, held that the substance of such a transaction was the sale of stock, and furthermore, that the plain reading of Tax Law § 208 (9) supported the conclusion 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, this Tribunal concluded that as gains from the sale of stock are not New York source income to a nonresident, the gain at issue could not be included in the New York entire net income of the S corporation, or be passed through to the shareholders. The Administrative Law Judge herein also noted that several months later, an Administrative Law Judge in ***Matter of Mintz***, reached a conclusion that was consistent with ***Baum***, to the extent that it held installment payments received by nonresident shareholders under an installment obligation of an S corporation in a liquidation were payments from the sale of stock.

Tax Law § 632 (a) (2) was amended in 2010 to address the issue of nonresident

S corporation shareholders' treatment of income related to IRC §§ 338 (h) (10) and 453 (h) (1) (A), the federal provisions that were the subject of ***Baum*** and ***Mintz***, to provide as follows:

> "In determining New York source income of a nonresident shareholder of an S corporation where the election provided for in subsection (a) of section six hundred sixty of this article is in effect, there shall be included only the portion derived from or connected with New York sources of such shareholder's pro rata share of items of S corporation income, loss and deduction entering into his federal adjusted gross income, increased by reductions for taxes described in paragraph two and three of subsection (f) of section thirteen hundred sixty-six of the internal revenue code, as such portion shall be determined under regulations of the commissioner consistent with the applicable methods and rules for allocation under article nine-A or thirty-two of this chapter, *regardless of whether or not such item or reduction is included in entire net income under article nine-A or thirty-two for the tax year. . . . In addition, if the shareholders of the S corporation have made an election under section 338(h)(10) of the Internal Revenue Code, then any gain recognized on the deemed asset sale for federal income tax purposes will be treated as New York source income allocated in a manner consistent with the applicable methods and rules for allocation under article nine-A or thirty-two of this chapter in the year that the shareholder made the section 338(h)(10) election. For purposes of a section 338(h)(10) election, when a nonresident shareholder exchanges his or her S corporation stock as part of the deemed liquidation, any gain or loss recognized shall be treated as the disposition of an intangible asset and will not increase or offset any gain recognized on the deemed asset sale as a result of the section 338(h)(10) election"* (***see*** L 2010 ch 57 pt B, § 2) [language added by the amendment in 2010 is italicized]).
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> The Legislative findings accompanying the adoption of those amendments provided:
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> "Legislative findings. The Legislature finds that it is necessary to correct a decision of the tax appeals tribunal and a determination of the division of tax appeals that erroneously overturned the longstanding policies of the 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. Section two of this act is intended to clarify the concept of federal conformity in the personal income tax and is necessary to prevent confusion in the preparation of returns, unintended refunds, and protracted

> litigation of issues that have been properly administered up to now" (L 2010 ch 57 pt C § 1).

Issue in Caprio

Prior to the issuance of the determination in the instant matter, the Appellate Division, 3rd Department issued a decision in a parallel case, that was initiated by an action for declaratory judgment filed in Supreme Court, New York County, rather than a petition filed with the Division of Tax Appeals (***Caprio v New York State Dept. of Taxation & Fin.***, 37 Misc.3d 964, 966 [2012]; ***revd*** 117 AD3d 168, 174 [2014]; ***revd*** 25 NY3d 744 [2015] ***rearg denied*** 26 NY3d 955 [2015]). ***Caprio*** also dealt with the constitutionality of the retroactive application of Chapter 57, part B, § 2 of the Laws of 2010. The plaintiffs in ***Caprio*** were also S corporation shareholders and sold all of their shares in the S corporation at issue. Although the plaintiffs in ***Caprio*** did not challenge the deemed sale amendments, but only the installment obligation amendments, the transaction at issue in ***Caprio*** involved both IRC § 338 (h) (10) and IRC § 453 (h) (1) (A). The Supreme Court had originally found that the plaintiffs had failed to prove that the retroactive application of the 2010 amendments as to them was unconstitutional. The Appellate Division, in its decision in ***Caprio***, reversed the Supreme Court, finding that the retroactive application as to plaintiffs of the 2010 amendments constituted a violation of due process. As it dealt with the same legislation and legislative history as the present case, the Administrative Law Judge relied, in part, on the Appellate Division decision in reaching his determination.

After the Division filed its exception in this matter, but prior to the issuance of a decision by this Tribunal, the Court of Appeals issued its decision in ***Caprio***, reversing the Appellate

Division and finding that the retroactive application as to plaintiffs of the 2010 amendments was valid under the Due Process Clauses of the United States and New York Constitutions.

Accordingly, the first issue to be addressed is whether this Tribunal must hold that the retroactive application of the 2010 amendments as applied to petitioners herein is constitutional based on the Court of Appeals decision in ***Caprio***, or whether petitioners have been able to sufficiently distinguish the facts and circumstances herein so as to support a finding that the retroactive application of the 2010 amendments as applied to petitioners constitutes a violation of the Due Process Clauses of the United States and New York Constitutions. While we are not without serious concerns as to the ramifications of this decision, we find that the holding in ***Caprio*** does control our decision in this matter.

The issue of the retroactive application of the deemed asset sale amendments did not appear to be before the court in ***Caprio*** (***see*** 25 NY3d at 748). Indeed, the court noted "that in their submissions before Supreme Court, plaintiffs limited their challenge to the retroactive application of the amendments pertaining to the tax treatment of installment obligations" and "expressly acknowledged that they 'did not challenge those portions of the 2010 Amendments related to' deemed asset sales, 'which have no bearing on [plaintiffs'] claims and [were] not even identified in the Verified Complaint'" (***id.***). The court then explained that this acknowledgment, and the fact that plaintiffs conceded the constitutionality of the prospective application of the statute "distinguishes this case from ***Burton v New York State Dept. of Taxation & Fin.***, [decided herewith], in which the plaintiffs challenge the prospective application of the amendments to transactions in which an election has been made under section 338 (h) (10)" (***id.*** citations omitted). While this language appears to limit the application of ***Caprio*** to the issue of

the retroactive application of the installment obligation amendments, the court explains that the plaintiffs in ***Caprio*** utilized both IRC § 338 (h) (10) and IRC § 453 (h) (10 (A) in reporting their sale of all the shares of their company (***Caprio***, 25 NY3d at 747-48). Furthermore, the court, throughout its decision, continually refers to: (1) both the deemed asset sale and the installment obligation when discussing the plaintiffs' treatment of the sale at issue; (2) the 2010 amendments to the statute including the Legislative findings accompanying the statute, rather than only the installment sale amendments; and (3) this Tribunal's decision in ***Baum*** dealing with a deemed asset sale election, as well as the determination of the Administrative Law Judge in ***Mintz*** dealin g with an installment sale (***Caprio***). The final judgment of the court, "that the retroactive application as to plaintiffs of the 2010 amendment to Tax Law § 632 (a) (2) is valid under the Due Process Clauses of the United States and New York Constitutions," did not differentiate between the deemed asset sale amendments and the installment obligation amendments. Finally, in ***Burton***, the case decided with ***Caprio***, the court noted that "[D]uring the pendency of the matter before the Supreme Court plaintiffs abandoned their challenge to the retroactive application of Tax Law § 632 (a) (2). [W]e reject just such a challenge and *uphold the retroactivity of the statute* in ***Caprio v New York State Dept. of Taxation & Fin.***,[decided herewith]" (***Burton v New York State Dept. of Taxation & Fin.***, 25 NY3d 732, 743, footnote 1 [2015] [emphasis added] [citation omitted]). Thus, the Court of Appeals made clear its intention to uphold the retroactivity of the entirety of the 2010 amendments, the deemed asset sale amendments as well as the installment obligation amendments. Thus, petitioners' argument that the present case may be distinguished from ***Caprio*** based upon the fact that the issue in ***Caprio***

was the retroactive application of the installment obligation amendments, while the issue herein is the retroactive application of the deemed asset sale amendments, must fail.

That having been said, petitioners are still entitled to prove that their case can be distinguished from ***Caprio*** based upon differences in the facts and circumstances in each case. Unfortunately for petitioners, the broad reach of the language in ***Caprio*** leaves little room for factually distinguishing their case.

Balancing of Equities Test

It is agreed, by the courts, the Administrative Law Judge and the parties, that in determining whether the retroactive application of a taxing statute violates the Due Process Clauses of the United States and New York Constitutions, the courts look to three factors: (1) "the taxpayer's forewarning of a change in the legislation and the reasonableness of . . . reliance on the old law," (2) "the length of the retroactive period," and (3) "the public purpose for the retroactive application" (***Matter of Replan Dev.***, 70 NY2d at 456; ***James Sq. Assoc.***, 21 NY3d at 246). We now turn to such an analysis in the present case.

Forewarning of change in the law and reasonable reliance on the old law

Petitioners assert that the law, at the time the sale of the Company was negotiated and concluded, was such that the deemed sale of assets pursuant to an IRC § 338 (h) (10) election did not change the nature of the transaction, that of a stock sale. We obviously agree (***see Matter of Baum*** ["S corporations must compute their income for New York tax purposes as if the section 338 (h) (10) election had not been made"]). However, petitioners are required to show not just what the law was, but also that petitioner had no forewarning that changes might be made in the relevant law and that petitioner's reliance on the then-existing law was reasonable. Petitioners

note that first and foremost, the Division stipulated that "Mr. Luizza reasonably relied on the New York law applicable at the time of the sale when he agreed not to require the Buyer to increase the purchase price nor to provide indemnity for any additional taxes arising as a result of the election." Furthermore, petitioners assert that even without the stipulation, they have shown that petitioner reasonably relied upon the law in effect at the time of the negotiations for, and eventually, the sale of, the Company. It is true that unlike plaintiffs in ***Caprio***, petitioner sought out and relied upon professional advice regarding the New York tax implications of an IRC § 338 (h) (10) election. It is also true that unlike plaintiffs in ***Caprio***, petitioners have shown that the purchase price of the stock would have been adjusted to account for additional New York tax liabilities had there been a forewarning of the change in the law that took place two years after the sale of the Company. Finally, it is true that petitioners have shown that petitioner reasonably relied upon prior law to petitioners' detriment.

However, ***Caprio*** still requires us to conclude that petitioner's reliance on the law cannot be held to be reasonable despite the stipulation signed by both parties and the additional facts that petitioners have proven. This is because, according to ***Caprio***, petitioner should have been aware, at the time he negotiated and concluded the sale of the Company, of the long standing policies of the Division. In particular, the Court of Appeals in ***Caprio*** found that: "Acceptance of plaintiffs' interpretation of the pre-amendment law would require that we discredit the legislative findings articulated in the amended statute that long-standing policies of DTF required taxpayers to pay proportionate state income taxes on deemed asset sale gains" (***Caprio***, 25 NY3d at 754). The court went on to conclude that it would "give due consideration" to the Legislative findings, particularly in light of the Division's additional evidence of its long-standing policy,

"an unrefuted affidavit of a DTF tax auditor detailing this State's taxation policy" (***Caprio***, 117 NY3d at 755). Petitioners argue that the Division in this case submitted no evidence concerning any long-standing policy it had regarding its treatment of IRC § 338 (h) (10) elections as they relate to nonresident S corporation shareholders. However, we read ***Caprio*** as holding that the Legislative findings alone require a conclusion that the Division's long-standing policy differed from petitioner's interpretation of the law, making petitioner's reliance on his interpretation unreasonable and defeating petitioners' argument that petitioner had no way of foreseeing the change made by the 2010 amendments.

Length of retroactive period

Although there is no bright line delineating when a period of retroactivity of a taxing statute becomes unconstitutional, it remains an issue to be reviewed based upon the facts and circumstances of each case. In this case, the retroactive period was approximately two and one-half to three years, depending upon whether it is measured from the time of the negotiations regarding petitioner's sale of the Company, or the time of the execution of the final stock purchase agreement. ***Caprio*** concluded that as the 2010 amendments were curative or corrective in nature, and the retroactive period was reasonable in that it only applied to tax years that remained open under the statute of limitations, this factor also weighed in favor of a finding of the constitutionality of the retroactive application as to plaintiffs of the 2010 amendments. As this finding is dependent upon a finding as to whether the purpose of the 2010 amendments was curative or corrective in nature, and we determine below that under ***Caprio*** that is the case, it follows that the retroactive period is not unreasonable.

Public purpose for retroactive application

Petitioners argue that the only public purpose espoused by the Division in support of the retroactive application of the deemed asset sale amendments is that they are meant to cure or correct a decision of this Tribunal. Petitioners posit that a review of this factor of the balancing of equities test also distinguishes this case from ***Caprio***. The crux of petitioners' argument is that while the Legislature may cure or correct a non-precedential determination of an administrative law judge that was not appealed to this Tribunal, a decision of this Tribunal is a final, irrevocable and precedential decision, unless the taxpayer petitions for judicial review (Tax Law §§ 2010 [5], 2016). Thus, petitioners argue that as the actual issue before the ***Caprio*** court was the retroactive application as to plaintiffs of the installment obligation amendments, and such amendments were the result of ***Matter of Mintz***, a non-precedential determination of an administrative law judge, and the actual issue in the present case is the retroactive application of the deemed asset sale amendments, and such amendments were the result of ***Matter of Baum***, a final decision of this Tribunal, different results are mandated. The logic of petitioners' argument is clear, that the Legislature cannot cure or correct a decision of this Tribunal that is final and irrevocable, thus, no matter what the legislative findings say in regard to ***Matter of Baum***, the deemed asset sale amendments cannot be curative or corrective. The Division argues that because it cannot appeal adverse decisions of this Tribunal, the ability of the Legislature to retroactively reverse a Tribunal decision that it, or the Division, disfavors, must be preserved. Petitioner counters that such an argument is contrary to the Legislature's purpose in establishing this Tribunal.

Obviously, the Legislature can override any decision of this Tribunal prospectively, as it can with any decision of the courts of this state. The issue is whether it can retroactively correct

a final decision of this Tribunal. While we do not know whether any arguments regarding the finality of Tribunal decisions were before the Court of Appeals in ***Caprio***, we do know that throughout the decision, reference is made to the legislative findings regarding ***Matter of Baum*** and the retroactive application of the deemed asset sale amendments. Furthermore, the conclusion reached is that "the curative, rational public purposes set forth in the legislative findings are compelling and, thus, this factor also supports upholding the retroactive application of the statute" (***Caprio***, 25 NY3d at 758 [citations omitted]). There is no indication in this conclusion, and every indication to the contrary in the ***Caprio*** decision, that the deemed sale amendments adopted by the Legislature in response to this Tribunal's final decision in ***Matter of Baum***, were meant to be excluded from this conclusion.

Accordingly, it ORDERED, ADJUDGED and DECREED that:

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

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

3. The petition of Jeffrey M. and Melissa Luizza is denied; and

4. The notice of deficiency dated March 1, 2012, is sustained.

DATED: Albany, New York
March 29, 2016

/s/ Roberta Moseley Nero
Roberta Moseley Nero
President

/s/ Charles H. Nesbitt
Charles H. Nesbitt
Commissioner

/s/ James H. Tully, Jr.
James H. Tully, Jr.
Commissioner