STATE OF NEW YORK

TAX APPEALS TRIBUNAL

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| In the Matter of the Petitions<br>of<br>**ALBERT R. LEPAGE, FRANCOISE O. LEPAGE, RONALD A. JALBERT, MARIETTE JALBERT, AND ANDREW P. BAROWSKY**<br>for Redetermination of Deficiencies or for Refunds of New York State Personal Income Tax under Article 22 of the Tax Law for the Years 2010, 2011 and 2012. | : | DECISION<br>DTA NOS. 828035, 828036, 828037 AND 828038 |

Petitioners Albert R. Lepage, Francoise O. Lepage, Ronald A. Jalbert, Mariette P. Jalbert and Andrew P. Barowsky filed an exception to the determination of the Administrative Law Judge issued on December 19, 2019. Petitioners appeared by Jones Day (Dennis Rimkunas, Esq., of counsel). The Division of Taxation appeared by Amanda Hiller, Esq. (Linda Farrington, Esq., of counsel).

Petitioners filed a brief in support of their exception. The Division of Taxation filed a brief in opposition. Petitioners filed a reply brief. An amicus curiae brief in support of petitioners was filed by the Business Council of New York State, Inc. (Timothy P. Noonan, Esq., and Doran J. Gittelman, Esq., of counsel). Oral argument was heard in Albany, New York on October 29, 2020. The parties were permitted to respond to the amicus brief following oral argument. Petitioners chose not to respond. The Division's response was received on November 16, 2020, which date commenced the six-month period for issuance of this decision.

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

## *ISSUES*

I. Whether an eligible S corporation must use its actual federal S corporation tax return or its pro forma federal C corporation tax return to calculate its federal gross income and its investment income for purposes of Tax Law § 660 (i).

II. Whether an eligible S corporation's investment income under Tax Law § 660 (i) includes the gain from a deemed sale of assets made following an election pursuant to Internal Revenue Code (26 USC) § 338 (h) (10).

III. Whether, during the tax year at issue, the respective investment income of Lepage Bakeries, Inc. and Bakeast Holdings, Inc., was more than 50% of their respective federal gross income, thereby mandating New York S corporation elections for those corporations in accordance with Tax Law § 660 (i).

IV. Whether Tax Law § 660 (i) as applied herein violates petitioners' Commerce Clause, Due Process or Equal Protection rights.

V. Whether the Administrative Law Judge's ruling rejecting additional documents offered by petitioners with their reply brief below was proper.

## *FINDINGS OF FACT*

We find the facts as determined by the Administrative Law Judge, except that we have added an additional finding of fact, numbered 74.

1. This matter involves the proper treatment and allocation of the gains from the sale of the stock of Lepage Bakeries, Inc. (Lepage, Inc.), and Bakeast Holdings, Inc. (Bakeast, Inc.), under the Tax Law.

2. Petitioners in this matter are Albert R. Lepage, Francoise O. Lepage, Ronald A. Jalbert, Mariette P. Jalbert and Andrew P. Barowsky.

3. Ronald Jalbert and Mariette Jalbert (Jalberts) are husband and wife, filing joint personal income tax returns for the years at issue.

4. On July 21, 2012, Flowers Foods, Inc. (Flowers, Inc.), acquired 100% of the stock of Lepage, Inc., and Bakeast, Inc., and several other entities not at issue in this matter, from petitioners and another individual, not a party in this matter, for cash and stock of Flowers, Inc. (the sale).

5. A copy of the relevant purchase agreement for the sale was submitted into the record (acquisition agreement).

6. Lepage, Inc., a Delaware corporation, elected to be treated for federal income tax purposes as a subchapter S corporation, effective as of September 26, 1999.

7. Lepage, Inc., was a validly electing S corporation for federal income tax purposes during the 2012 short tax year.

8. Lepage, Inc., never filed a separate New York S corporation election under Tax Law § 660 (a).

9. Bakeast, Inc., a Delaware corporation, elected to be treated for federal income tax purposes as a subchapter S corporation effective as of November 4, 1992.

10. Bakeast, Inc., was a validly electing S corporation for federal income tax purposes during the 2012 short tax year.

11. Bakeast, Inc., never filed a separate New York S corporation election under Tax Law § 660 (a).

12. Valid elections under Internal Revenue Code (IRC [26 USC]) § 338 (h) (10) were made in connection with the sale.

13. Based on the elections under IRC (26 USC) § 338 (h) (10), the acquisition by Flowers, Inc., of the stock of Lepage, Inc., and Bakeast, Inc., was treated as deemed asset sales

by Lepage, Inc., and Bakeast, Inc., followed by a liquidating distribution of the consideration to petitioners.

14. During the relevant period, Lepage, Inc., which was founded in Maine in 1903, was a baking goods company.

15. Lepage, Inc., produced Country Kitchen and Barowsky's breads, rolls, and doughnuts.

16. Lepage, Inc., sold its products throughout New England and New York.

17. Lepage, Inc., filed New York general business corporation franchise tax returns (form CT-3), and reported its income based on its New York business allocation percentage (BAP).

18. For the 2012 short tax year of Lepage, Inc., that ended in connection with the sale, Lepage, Inc., apportioned 11.2327% of its receipts to New York State.

19. At all times during the 2012 tax year prior to the sale, the stock of Lepage, Inc., was owned as follows: Albert Lepage: 33.8%; Andrew Barowsky: 46.1%; Francoise Lepage: 4.4%; Mariette Jalbert: 3.6%; and another individual who is not a party to this proceeding: 12.1%.

20. At all times during the 2012 tax year prior to the sale, the stock of Bakeast, Inc., was owned 50% by Albert Lepage and 50% by Andrew Barowsky.

21. For the audit period, Albert Lepage was a nonresident for New York State income tax purposes, residing in Miami-Dade County, Florida.

22. For the audit period, Francoise Lepage was a nonresident for New York State income tax purposes, residing in Marin County, California.

23. For the audit period, Andrew Barowsky was a nonresident for New York State income tax purposes, residing in Miami-Dade County, Florida.

24. For the audit period, the Jalberts were nonresidents for New York State income tax purposes, residing in Sumter County, Florida.

25. Lepage, Inc., owned a 50% interest in each of: Green Mountain Baking Company, L.P., a Delaware limited partnership (Green Mountain); CK Sales Co., LLC, a Delaware limited liability company (CK Sales); and CK Trucking, LLC, a Delaware limited liability company (CK Trucking).

26. Green Mountain owned and operated a bakery located in Vermont.

27. CK Sales entered into contractual relationships and sold bread products to third party independent distributors.

28. CK Trucking owned, leased and operated tractor trailers and other vehicles that delivered the bread products to third party distribution centers and supermarkets.

29. Bakeast, Inc., filed form CT-3, and reported its income based on its New York BAP.

30. For the 2012 short tax year of Bakeast, Inc., that ended in connection with the sale, Bakeast, Inc., apportioned 2.4451% of its receipts to New York State.

31. Bakeast's sole assets were the remaining 50% interest in each of Green Mountain, CK Sales and CK Trucking.

32. For the 2012 short tax year, Lepage, Inc., timely filed its form 1120S and its form CT-3.

33. For the 2012 short tax year, Bakeast, Inc., timely filed its form 1120S and its form CT-3.

34. For the 2012 short tax year, Lepage, Inc., reported federal taxable income of $144,982,319.00.

35. For the 2012 short tax year, on its New York form CT-3, Lepage, Inc., reduced its federal taxable income by the gain amount attributed to the deemed assets sale of $160,548,363.00.

36. For the 2012 short tax year, Lepage, Inc., paid New York State corporation franchise tax computed on its entire net income of $2,625.00.

37. For the 2012 short tax year, Bakeast, Inc., reported federal taxable income of $59,112,819.00.

38. For the 2012 short tax year, on form CT-3, Bakeast, Inc., reduced its federal taxable income by the gain amount of $56,086,872.00.

39. For the 2012 short tax year, Bakeast, Inc., paid the New York State corporation franchise tax based on the fixed dollar minimum tax of $5,126.00.

40. For the 2012 tax year, Albert Lepage filed form 1040 and a New York nonresident and part-year resident income tax return (form IT-203) reporting New York source income unrelated to the transaction at issue.

41. For the 2012 tax year, Albert Lepage reported gains from the sale of capital assets, including gains from the deemed sale of assets of Lepage, Inc., and Bakeast, Inc., as a result of the IRC (26 USC) § 338 (h) (10) elections, of $105,234,238.00 on his federal form 1040. Of that amount, $44,861,126.00 was attributable to the gain from the deemed sale of assets by Lepage, Inc., and $25,793,011.00 was attributable to gain from the deemed sale of assets by Bakeast, Inc.

42. For the 2012 tax year, Albert Lepage reported federal taxable income on schedule E of his federal form 1040 in the amount of $10,485,548.00. Of that amount, $4,691,132.00 was attributable to the ordinary business income from Lepage, Inc., and $3,759,532.00 was attributable to the ordinary business income from Bakeast, Inc.

43. For the 2012 tax year, Andrew Barowsky filed form 1040 and a New York nonresident and part-year resident income tax return (form IT-203) reporting New York source income unrelated to the transaction at issue.

44. For the 2012 tax year, Andrew Barowsky reported gains from the sale of capital assets, including a gain from the deemed sale of assets by Lepage, Inc., and Bakeast, Inc., as a result of the IRC (26 USC) § 338 (h) (10) elections, of $128,221,748.00 on his federal form 1040. Of that amount, $61,109,937.00 was attributable to gain from the deemed sale of assets by Lepage, Inc., and $25,793,012.00 was attributable to gain from the deemed sale of assets by Bakeast, Inc.

45. For the 2012 tax year, Andrew Barowsky reported federal taxable income on schedule E of his federal form 1040 in the amount of $17,169,361.00. Of that amount, $6,390,272.00 was attributable to the ordinary business income from Lepage, Inc., and $3,759,533.00 was attributable to the ordinary business income from Bakeast, Inc.

46. For the 2012 tax year, Francoise LePage reported gains from the sale of capital assets, including gains from the deemed sale of assets by Lepage, Inc., as a result of the IRC (26 USC) § 338 (h) (10) elections, of $5,741,974.00 on her federal form 1040.

47. For the 2012 tax year, Francoise Lepage reported federal taxable income on schedule E of her federal form 1040 attributable to the ordinary business income from Lepage, Inc., in the amount of $606,740.00.

48. For the 2012 tax year, the Jalberts reported gain from the sale of capital assets, including gain from the deemed sale of assets by Lepage, Inc., as a result of the IRC (26 USC) 338 (h) (10) elections, of $4,672,516.00 on their joint federal form 1040.

49. For the 2012 tax year, the Jalberts reported federal taxable income on schedule E of their federal form 1040 attributable to the ordinary business income from Lepage, Inc., in the amount of $493,732.00.

50. The Division of Taxation (Division) audited petitioners for their tax years 2010 through 2012.

51. For 2010 tax year, the Division accepted the petitioners' returns as filed.

52. For 2011 tax year, the Division accepted the returns of petitioners Francoise Lepage, Andrew Barowsky, Ronald Jalbert and Mariette Jalbert as filed.

53. A true and correct copy of the stipulation with respect to tax year 2011 for Albert Lepage was submitted into the record. .

54. For tax years 2010 and 2011, the Division accepted Lepage, Inc.'s and Bakeast, Inc.'s New York State forms CT-3 as filed.

55. The parties stipulated that the only outstanding issues relate to tax year 2012.

56. For the tax year 2012, the Division concluded that under New York Tax Law § 660 (i), both Lepage, Inc., and Bakeast, Inc., should have been treated as New York S corporations, not New York C corporations.

57. The Division concluded that for New York corporation franchise, as well as personal income tax purposes, the sale should not be treated as a sale of stock, but rather as a deemed sale of assets by Lepage, Inc., and Bakeast, Inc., in accordance with IRC (26 USC) § 338 (h) (10) and the Treasury regulations promulgated thereunder.

58. The Division issued notice of deficiency L-045526516-2, dated October 12, 2016, asserting the following deficiency with respect to Albert Lepage:

| Tax Year | 2012 | 2011 |
|---|---|---|
| Additional Tax | $549,695.00 | $11,568.00 |
| Interest as of date of Notice | $164,472.31 | $4,631.53 |
| Penalties | $109,719.65 | $2,893.26 |

59. The Division issued notice of deficiency L-045526543-5, dated October 12, 2016, asserting the following deficiency with respect to Andrew Barowsky:

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| Additional Tax for 2012 | $726,058.00 |
| Interest as of date of Notice | $217,241.28 |
| Penalties | $144,922.14 |

60. The Division issued notice of deficiency L-045526633-6, dated October 12, 2016, asserting the following deficiency with respect to Francoise Lepage:

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| Additional Tax for 2012 | $62,818.00 |
| Interest as of date of Notice | $18,796.00 |
| Penalties | $12,537.50 |

61. The Division issued notice of deficiency L-045533086-3, dated October 12, 2016, asserting the following deficiency with respect to the Jalberts:

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| Additional Tax for 2012 | $51,021.00 |
| Interest as of date of Notice | $15,292.79 |

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| Penalties | $10,196.89 |

62. Petitioners timely protested the above notices of deficiency by filing petitions on January 9, 2017, and petitioners subsequently filed amended petitions on March 10, 2017.

63. The Division filed its answers in response to the petitions on March 15, 2017, and answers to the amended petitions on May 3, 2017.

64. The parties agree that in the event the petitioners' protests are unsuccessful and the assessed additional tax amounts in the notices of deficiency are sustained in full, Lepage, Inc., and Bakeast, Inc., should be treated as S corporations for purposes of recalculating their corporate franchise tax under article 9-A for the tax year 2012, as set forth in findings of fact 65 and 66.

65. For the 2012 tax year, Lepage, Inc.'s, payment of $2,625.00 should be applied toward the fixed dollar minimum tax imposed on S corporations in the amount of $1,500.00. The remainder should be treated as an overpayment.

66. For 2012 tax year, Bakeast, Inc.'s payment of $5,126.00 should be applied toward the fixed dollar minimum tax imposed on S corporations in the amount of $87.50. The remainder should be treated as an overpayment.

67. The parties agree that, in the event the petitioners' protests are successful and the assessed additional tax amounts in the notices of deficiencies are cancelled, Lepage, Inc., and Bakeast, Inc., will be treated as having no overpayments or underpayments for the 2012 tax year.

68. Albert Lepage failed to file a return with New York State for the tax year 2011. Upon audit, Albert Lepage provided the Division with a pro forma unsigned form IT-203 for the tax year 2011 reporting total tax due in the amount of $11,568.00.

69. The Division accepted Albert Lepage's pro forma return as filed, and both parties agree that Albert Lepage's total tax liability for the 2011 tax year is $11,568.00.

70. Albert Lepage and the Division separately agreed to certain payment terms regarding the tax year 2011 liability.

71. Albert Lepage and the Division agree that the payment terms will fully resolve the portion of the notice of deficiency, assessment ID #L-045526516, attributable to the tax year 2011, and that tax year 2011 is no longer in controversy for Albert Lepage. However, the parties agree that tax year 2012 remains in controversy for Albert Lepage.

72. The acquisition agreement noted that both Lepage, Inc., and Bakeast, Inc., were valid S corporations under various state laws as provided on a list attached to the acquisition agreement. However, the list was not included with the copy of the acquisition agreement the parties submitted into the record.

73. For the tax year 2012, both Lepage, Inc., and Bakeast, Inc., were New York State "eligible S corporations" as defined under Tax Law § 660 (a).

74. Petitioners and the Division agreed to have the present matter determined on submission without the need for a hearing pursuant to 20 NYCRR 3000.12. The Administrative Law Judge then-assigned to this matter set a schedule for the submission of documents and briefs. Approximately two months after their submission of documents in accordance with the schedule, petitioners offered additional documents with their reply brief. In a letter to the parties dated July 16, 2019, the Administrative Law Judge ruled that the documents offered with petitioners' reply brief were not submitted in compliance with the schedule. Those documents were not received in evidence and were returned to petitioners.

***THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE***

The Administrative Law Judge observed that Tax Law § 660 (a) permits a corporation that has elected to be a federal S corporation to also elect to be an S corporation for New York tax purposes. The Administrative Law Judge noted that, while the decision to elect New York S corporation status generally resides with the shareholders of an eligible S corporation, Tax Law § 660 (i) provides that such an election is mandated where an eligible S corporation's investment income in a taxable year exceeds 50% of its federal gross income for that year (the investment ratio test).

The Administrative Law Judge determined that federal gross income as used in Tax Law § 660 (i) refers to income amounts reported on the eligible S corporation's federal S corporation tax return. The Administrative Law Judge rejected petitioner's argument that an eligible S corporation's federal gross income for purposes of the investment ratio test should be determined from the eligible S corporation's pro forma federal C corporation return computations that must be completed in order to file that entity's New York C corporation returns. The Administrative Law Judge concluded that federal gross income should be determined from actual federal forms and calculations and not from state tax forms or computations. The Administrative Law Judge found support for this conclusion in the legislative history of Tax Law § 660 (i) and in the Division's guidance, published at the time of the enactment of Tax Law § 660 (i), that instructed taxpayers to use the eligible S corporation's federal gross income when applying the investment ratio test. The Administrative Law Judge then determined the 2012 federal gross income of Lepage, Inc. and Bakeast, Inc. for purposes of the investment ratio test using amounts reported on each corporation's 2012 federal S corporation tax return.

Next, the Administrative Law Judge analyzed the meaning of investment income as used in Tax Law § 660 (i). The Administrative Law Judge noted that this term is defined in Tax Law § 660 (i) (3) to include, among other items, "gains derived from dealings in property . . . to the extent . . . includible in federal gross income." He observed that the IRC definition of gross income also includes "gains derived from dealings in property" among various items of gross income. He further observed that federal regulations define "gains derived from dealings in property" to include gain realized on the sale or exchange of tangible property and intangible property, such as goodwill. The Administrative Law Judge concluded that gains from the deemed sale of assets fell within the definition of gains derived from dealings in property and thus constituted investment income to Lepage, Inc. and Bakeast, Inc.

Based on his understanding of the meaning of federal gross income and investment income as noted, the Administrative Law Judge determined that both Lepage, Inc. and Bakeast, Inc. had investment income ratios greater than 50% in tax year 2012, and that, accordingly, both corporations were subject to the mandated S corporation election for that year pursuant to Tax Law § 660 (i).

The Administrative Law Judge rejected petitioners' contention that the Legislature intended Tax Law § 660 (i) as a narrow exception designed to combat the specific tax avoidance strategy of resident individuals transferring personal investment assets to C corporations to avoid personal income tax. The Administrative Law Judge found that, although the Division's Commissioner and the Governor's office both expressed an intent to close this particular loophole with the then-proposed Tax Law § 660 (i) legislation, the statutory language was not so narrowly drawn and thus did not support petitioners' proposed interpretation. The Administrative Law Judge also rejected petitioners' contention that a letter written by an auditor

assigned to this matter was evidence that the subject transaction must be treated as a stock sale for Tax Law § 660 (i) purposes. To the contrary, the Administrative Law Judge found that the letter sought to convey the opinion that the gain from the transaction was properly deemed investment income under Tax Law § 660 (i).

The Administrative Law Judge also rejected petitioners' claim that certain guidance published by the Division supported their position (***see*** Department of Taxation and Finance Publication 35 ["New York Tax Treatment of S Corporations and Their Shareholders"] [3/00]) ("Publication 35"). The Administrative Law Judge found that the guidance was published before the enactment of Tax Law § 660 (i) and thus had little relevance to the present matter.

The Administrative Law Judge dismissed petitioners' contention that ***Matter of Baum*** (Tax Appeals Tribunal, February 12, 2009) supported their position. Given his conclusion that the investment income ratio test under Tax Law § 660 (i) required the use of the corporations' federal S corporation tax return information, the Administrative Law Judge determined that ***Baum*** was not relevant to the present matter. The Administrative Law Judge also found, contrary to petitioners' contention, that ***Caprio v New York State Dept. of Taxation & Fin.*** (25 NY3d 744 [2015], ***rearg denied*** 26 NY3d 955 [2015]) diminished the significance of ***Baum***. The Administrative Law Judge determined that ***Caprio*** recognized that the 2010 amendments to Tax Law § 632 (a) (2), whereby gains from a deemed asset sale are expressly considered New York source income to the extent of the corporation's business allocation percentage, clarified the Division's longstanding interpretation of the prior law.

The Administrative Law Judge also dismissed petitioners' constitutional claims. He rejected petitioners' Commerce Clause claim, premised on the nonresident petitioners' lack of nexus to New York. He found, rather, that it is the deemed S corporation's nexus to New York

that is relevant to a Commerce Clause claim and that both corporations here clearly had such nexus. The Administrative Law Judge thus concluded that, as shareholders of S corporations, petitioners were properly subject to New York income tax on their respective shares of corporate income as properly apportioned to New York. The Administrative Law Judge also rejected petitioners' Commerce Clause and Due Process Clause claims premised on the lack of an affirmative election of S corporation status. He noted that many states have laws that require federal S corporations to be treated as S corporations for state tax purposes and further noted that petitioners cite no authority challenging such similar laws. Finally, the Administrative Law Judge dismissed petitioners' Equal Protection Clause argument based on the difference between the mandatory S election for article 9-A business corporations and the absence of a similar mandatory election for article 32 banking corporations. The Administrative Law Judge found that this claim was a facial challenge to the statute and therefore beyond the authority of the Division of Tax Appeals.

***ARGUMENTS ON EXCEPTION***

Petitioners contend that the language of Tax Law § 660 (i) is ambiguous regarding the meaning of "federal gross income," "investment income," and "gains derived from dealings in property" as used therein. Petitioners thus argue that statutory construction principles require that we consider the statute's legislative history to ascertain the meaning of these terms. According to petitioners, such history indicates that Tax Law § 660 (i) was intended to eliminate a specific tax avoidance strategy by which an individual transferred their investment portfolio to a hybrid corporation (i.e., a federal S-New York C corporation) to avoid New York personal income tax. Petitioners note that they did not engage in any such strategy, but simply operated

and sold an active baking business. Petitioners contend that Tax Law § 660 (i) was not intended to apply to their situation.

Petitioners assert that federal gross income as used in Tax Law § 660 (i) refers to the eligible corporation's federal gross income as a C corporation. Petitioners note that hybrid corporations are permitted in New York and assert that C corporation status is the default status for a corporation operating in New York. That is, a corporation is a C corporation unless its shareholders elect or the law requires S status. Hence, according to petitioners, an eligible corporation's federal gross income as a C corporation should determine whether the mandated S election applies. Petitioners also note that federal S-New York C corporations are instructed to make federal C corporation return computations to complete their New York C corporation returns. As they did below, petitioners also assert that the Division's published guidance supports their position.

Petitioners contend that an IRC (26 USC) § 338 (h) (10) election creates a legal fiction of an asset sale for federal tax purposes, in lieu of the non-federal tax reality of a stock sale. Petitioners thus assert that the transaction at issue was a sale of stock under New York law for New York C corporations Lepage, Inc. and Bakeast, Inc. Accordingly, petitioners argue that an IRC (26 USC) § 338 (h) (10) election does not impact the New York tax treatment of hybrid corporations, like Lepage, Inc. and Bakeast, Inc., or their shareholders, like petitioners. Petitioners thus contend that, where the shareholders of such a corporation make such an election, the transaction is properly treated, for New York tax purposes, as a sale of stock by the individual shareholders. Such a stock sale does not appear within the corporations' pro forma

federal C corporation computations filed as part of their New York C corporation returns. Petitioners assert that ***Matter of Baum*** remains relevant and supports this argument.[1]

Petitioners contend that if federal gross income as used in Tax Law § 660 (i) means the subject corporations' gross income as C corporations, then the corporations' investment income ratio will fall well below the 50% level that triggers S corporation status. According to petitioners, therefore, the corporations' hybrid status must be respected.

Petitioners further contend that, regardless of whether the corporations' federal gross income for the investment ratio test is determined by reference to their federal S corporation returns or their hypothetical federal C corporation return information, the corporations' investment income for purposes of the test does not include the gain from the deemed asset sale. Petitioners argue that the determination's definition of investment income is overbroad and incompatible with the asserted loophole-closing intent of Tax Law § 660 (i). Petitioners note that Lepage, Inc. and Bakeast, Inc. were active businesses, not the tax-avoidance vehicles that Tax Law § 660 (i) was assertedly intended to discourage. Petitioners contend that most of the gain from the transaction, attributed to intangible assets and goodwill, is derived from the active operations of the baking business and is not passive investment income. Accordingly, whether the transaction is considered a stock sale or a deemed asset sale, petitioners contend that the companies' investment income was far less than 50% of their federal gross income.

Petitioners also make the same constitutional arguments as raised below. Specifically, petitioners assert that, as nonresidents, they lacked nexus with New York and that, accordingly, New York's assertion of income tax liability against them raises Commerce Clause and Due

[1] Petitioners also cite an Administrative Law Judge determination in support of this argument. As such determinations are not precedential, we have not cited and have not considered that determination in this decision (Tax Law § 2010 [5]).

Process Clause concerns. Petitioners argue that absent an affirmative election, New York's tax jurisdiction does not extend to them as nonresident shareholders of hybrid corporations. Petitioners also argue that it is unconstitutional for Tax Law § 660 (i) to apply to shareholders of article 9-A business corporations, but not to shareholders of article 32 banking corporations. Petitioners do not dispute the Administrative Law Judge's conclusion that there are meaningful differences between business corporations and banking corporations but assert that there is no meaningful difference between shareholders of these two kinds of entities. Petitioners claim a denial of equal protection based on such different treatment.

Petitioners also take exception to the Administrative Law Judge's ruling rejecting the additional documents offered by petitioners with their reply brief below (***see*** finding of fact 74). Petitioners assert that the ruling was improper because the submission schedule did not set a date for the closing of the record. Petitioners' concede that their objection on this point may be moot, as they agree with the Administrative Law Judge's findings of fact and acknowledge his consideration of some of the publicly available proffered documents, such as Publication 35.

The Division asserts that the Administrative Law Judge reasonably concluded that federal gross income as used in Tax Law § 660 (i) refers to actual federal gross income amounts as reported on filed federal S corporation returns. The Division argues that petitioners provided no meaningful support for their contention that the eligible S corporations' pro forma C corporation return information should be used. The Division contends that petitioners' reliance on the Division's guidance is misplaced as such guidance has been rendered irrelevant by subsequent changes in the Tax Law. The Division also contends that the Administrative Law Judge properly referred to federal authority in determining the meaning of investment income and gains derived from dealings in property under Tax Law § 660 (i) (3).

The Division argues that the language of Tax Law § 660 (i) is clear and that a resort to extrinsic aids, such as legislative history, is unnecessary. Nevertheless, the Division contends the legislative history of that provision does not support petitioners' position. The Division acknowledges that such history suggests an intent to address a specific tax avoidance strategy but contends that this does not preclude an intent to mandate an S corporation election under the present circumstances. Moreover, the Division asserts that consideration of the language of Tax Law § 660 (i) in conjunction with Tax Law § 632 (a) (2) shows an intent to subject the transaction at issue to tax in New York.

The Division also contends that petitioners' reliance on ***Matter of Baum*** is misplaced, given subsequent changes in the Tax Law and the subsequent Court of Appeals decision in ***Caprio v New York State Dept. of Taxation & Fin.***

Finally, the Division agrees with the Administrative Law Judge's rejection of petitioners' constitutional claims.

The amicus brief concurs with petitioners' assertion that Tax Law § 660 (i) was enacted to thwart the tax avoidance strategy of placing personal investment assets in a hybrid corporation to avoid personal income tax. The amicus brief argues that a proper interpretation of Tax Law § 660 (i) must be consistent with that purpose. The amicus brief also asserts that the determination erroneously uses federal tax concepts to interpret investment income and gains derived from dealings in property in Tax Law § 660 (i). The amicus brief contends that neither the statutory language nor the legislative history supports such an interpretation.

The amicus brief also contends that the determination defines investment income to include income from operational assets held in the ordinary course of business and that this interpretation, if affirmed, will trigger mandated S elections where businesses simply sell or

replace non-inventory assets. The amicus brief argues that such transactions were not the intended targets of the mandated election provision.

***OPINION***

The Division seeks to impose New York personal income tax on a portion of petitioners' shares of the gains from the July 21, 2012 transaction. The Division contends that the transaction triggered mandated S corporation elections for Lepage, Inc. and Bakeast, Inc. under Tax Law § 660 (i) and that a consequence of such mandated elections is additional New York source income for petitioners, all of whom are nonresidents. As the Administrative Law Judge correctly noted, a presumption of correctness attached to the subject notices of deficiency and petitioners bear the burden to prove, by clear and convincing evidence, that the proposed deficiencies are erroneous (***Matter of Greenfeld***, Tax Appeals Tribunal, March 7, 2019).

As nonresidents, petitioners are subject to New York personal income tax on income that is "derived from or connected with New York sources" (Tax Law §§ 601 [e], 631 [a]). Income from intangible personal property is New York source income only to the extent that such income is from property employed in a business, trade, profession, or occupation carried on in New York (Tax Law § 631 [b] [2]). Shares of stock are considered intangible personal property under Tax Law § 631 (b) (2). The shares of stock sold to Flowers, Inc. in the July 21, 2012 transaction were not employed in a business, trade, profession, or occupation carried on in New York. Accordingly, if treated as a sale of stock from the individual shareholders to Flowers, Inc., petitioners' gains from the transaction would not be considered New York source income and thus would not be subject to New York personal income tax (***see*** 20 NYCRR 132.5). Moreover, such a stock sale would not be reflected in the corporations' tax returns. The mandated S election provision thus would not be triggered.

On the other hand, a nonresident's New York source income includes an S corporation shareholder's pro rata share of the S corporation's New York-allocated income, including gain from a deemed asset sale made in connection with an IRC (26 USC) § 338 (h) (10) election (Tax Law § 632 [a] [2]). Hence, a mandated S corporation election for Lepage, Inc. and Bakeast, Inc. means additional tax liability for petitioners.

At all times relevant, Lepage, Inc. and Bakeast, Inc. elected to be taxed as S corporations for federal tax reporting purposes (***see*** IRC [26 USC] §§ 1361-1379). As such, those entities did not pay federal corporate income taxes, but rather passed items of income through to their shareholders, who reported their proportionate share of such items on their federal personal income tax returns (***see*** IRC [26 USC] § 1366).

Like the IRC, the Tax Law permits the shareholders of an eligible S corporation to elect to have the corporation's income and losses taxed at the shareholder level (Tax Law § 660 [a]). An eligible S corporation is a federal S corporation which is subject to tax under article 9-A or 32 of the Tax Law (***id.***). Although Lepage, Inc. and Bakeast, Inc. were eligible S corporations, neither elected S corporation status for New York tax reporting purposes. Instead, each reported and paid franchise tax under article 9-A on their entire net income as allocated to New York as C corporations (***see*** Tax Law former §§ 209, 210). This hybrid federal S-New York C status for tax reporting purposes is permitted under the Tax Law.

The July 21, 2012 transaction was structured as a sale of stock from petitioners, as shareholders, to Flowers, Inc., and was treated as such for all non-tax purposes. As noted, however, the parties made valid IRC (26 USC) § 338 (h) (10) elections in connection with the sale. Accordingly, the transaction was treated as a deemed sale of assets from Lepage, Inc. and Bakeast, Inc. to Flowers, Inc. for federal income tax purposes. Lepage, Inc. and Bakeast, Inc.

thus reported gain on the deemed sale of assets on their federal S corporation returns and such gain flowed through to their shareholders (petitioners), who reported their proportionate shares of such gain on their federal personal income tax returns. The transaction at issue qualified for IRC (26 USC) § 338 (h) (10) treatment because, in addition to other qualifications, Lepage, Inc. and Bakeast, Inc. were federal S corporations (***see*** Treas Reg [26 CFR] 1.338 [h] [10]-1 [c]). The transaction would not have qualified for such treatment if Lepage, Inc. and Bakeast, Inc. were federal C corporations.

Although New York's S corporation regime is generally voluntary (***see*** Tax Law § 660 [a]), an S election is required under the following circumstances:

> "Mandated New York S corporation election. (1) Notwithstanding the provisions in [Tax Law § 660 (a)], in the case of an eligible S corporation for which the election under subsection (a) of this section is not in effect for the current taxable year, the shareholders of an eligible S corporation are deemed to have made that election effective for the eligible S corporation's entire current taxable year, if the eligible S corporation's investment income for the current taxable year is more than fifty percent of its federal gross income for such year provided that this subsection shall not apply to an eligible S corporation that is subject to tax under article thirty-two of this chapter.
>
> (2) For the purposes of this subsection, the term 'eligible S corporation' has the same definition as in subsection (a) of this section.
>
> (3) For the purposes of this subsection, the term 'investment income' means the sum of an eligible S corporation's gross income from interest, dividends, royalties, annuities, rents and gains derived from dealings in property, including the corporation's share of such items from a partnership, estate or trust, to the extent such items would be includable in federal gross income for the taxable year" (Tax Law § 660 [i]).

In summary, under Tax Law § 660 (i) an eligible S corporation subject to tax under article 9-A is deemed to have elected S corporation status for a given taxable year if its investment income for that year is greater than 50% of its federal gross income for that year. As Lepage and Bakeast were eligible S corporations, the dispute in the present matter centers on the

meaning of federal gross income, investment income and gains derived from dealings in property as used in Tax Law § 660 (i).

Pursuant to well-established principles, proper interpretation of a statute focuses on "the precise language of the enactment in an effort to give a correct, fair and practical construction that properly accords with the discernable intention and expression of the Legislature [citation omitted]" (***Matter of 1605 Book Ctr. v Tax Appeals Trib. of State of N.Y.***, 83 NY2d 240, 244, 245 [1994], ***cert denied*** 513 US 811 [1994]). "The best evidence of the Legislature's intent is the text of the statute itself" (***Matter of Stewart's Shops Corp. v New York State Tax Appeals Trib.***, 172 AD3d 1789, 1792 [3rd Dept 2019]). Accordingly, "courts should construe unambiguous language to give effect to its plain meaning" (***Matter of DaimlerChrysler Corp. v Spitzer***, 7 NY3d 653, 660 [2006]).

Federal gross income is not defined in Tax Law § 660 (i). Tax Law § 607 (a) provides, however, that "[a]ny term used in [article 22] shall have the same meaning as when used in a comparable context in the laws of the United States relating to federal income taxes, unless a different meaning is clearly required." IRC (26 USC) § 61 (a), broadly defines "gross income" as "all income from whatever source derived" and provides a non-exclusive list of the various sources of gross income included in the definition.

A fundamental principle of statutory construction is that "the language of a statute is generally construed according to its natural and most obvious sense, without resorting to artificial or forced construction." (McKinney's Cons Laws of NY, Book 1, Statutes § 94). The natural and most obvious meaning of federal gross income as used in Tax Law § 660 (i) is plainly gross income under federal law, i.e., IRC (26 USC) § 61 (a).

Petitioners' argument regarding federal gross income as used in Tax Law § 660 (i) is not with equating its meaning with IRC (26 USC) § 61 (a). Rather, petitioners contend that this term refers to the eligible S corporation's federal gross income computed *as if* it was a federal C corporation. As noted, petitioners argue that C status is the default for New York corporate tax reporting, and accordingly contend that a corporation should be considered a C corporation to determine whether it is subject to a mandated S election pursuant to Tax Law § 660 (i).

We disagree. The language of Tax Law § 660 (i) controls whether a mandated S election is required in a given circumstance, not the general notion of a corporation's default reporting status. Petitioners' proposed interpretation of that provision is inconsistent with that statutory language. As noted, Tax Law § 660 (i) applies to eligible S corporations, entities that *are* federal S corporations. Hence, the most natural meaning of "its federal gross income" as used in Tax Law § 660 (i) (1) is the sum of the eligible S corporation's actual items of federal gross income as reported on its actual federal S corporation return (***see*** McKinney's Cons Laws of NY, Book 1, Statutes § 94). Petitioners' proposition that the federal S-New York C entities within the statute's purview (i.e., eligible S corporations) should calculate their federal gross income as if such entities were federal C corporations effectively adds words to the statute. There is no "as if" language in Tax Law § 660 (i). The absence of any such language contrasts with Tax Law § 208 (9) (ii), which defines entire net income for federal S corporations as the "entire taxable income . . . which the taxpayer would have been required to report to the [IRS] if it had not made an [S corporation] election" (***see*** Tax Law former § 208 [9] [a]-[q]). The legislature has thus specifically directed an S corporation to make tax calculations as if it was a federal C corporation

when such a direction accords with its intent. The absence of any similar language in Tax Law § 660 (i) weighs against petitioners' proposed interpretation.

Another basic rule of statutory construction is that "a statute or legislative act is to be construed as a whole, and all parts of an act are to be read and construed together to determine the legislative intent" (McKinney's Cons Law of NY, Book 1, Statutes § 97). Here, such a holistic approach directs us to interpret investment income and gains derived from dealings in property as used in Tax Law § 660 (i) consistently with our straightforward interpretation of federal gross income. As noted, Tax Law § 660 (i) (3) defines investment income as "the sum of the eligible S corporation's gross income from interest, dividends, royalties, annuities, rents, and gains derived from dealings in property . . . *to the extent such items would be included in federal gross income for the taxable year*" (Tax Law § 660 [i] [3] [emphasis added]). Investment income is thus a component of federal gross income. Accordingly, it must have the same source as federal gross income. As discussed above, that source is the eligible S corporation's federal S corporation tax return. Additionally, investment income is specifically defined in terms of six of the examples of items of gross income listed in the Code (***see*** IRC [26 USC] § 61 [a] [3-7 and 9]). Of these, only one, gains derived from dealings in property, is at issue here. The determination below was ultimately premised on the Administrative Law Judge's finding that the gains from the deemed asset sale were properly categorized as such gains. Gains derived from dealings in property is not defined in the Tax Law and may, at first, seem ambiguous. Treasury regulations more clearly define this term as "gain realized on the sale or exchange of property . . . includ[ing] tangible items, such as a building, and intangible items, such as goodwill" (Treas Reg [26 CFR] § 1.61-6 [a]). Considering that investment income in Tax Law § 660 (i) is defined in terms of federal gross income and that gains derived from dealings in

property is part of that federal definition, and given the federal conformity rule of Tax Law § 607 (a), we find that the federal definition of gains derived from dealings in property must apply here.

We disagree with the amicus brief's assertion that the foregoing interpretation of Tax Law § 660 (i) improperly uses federal tax concepts to define the disputed statutory language. To the contrary, we think that the statutory language requires the use of such concepts. Moreover, considering that gains derived from dealings in property had a meaning established by federal regulation (Treas Reg [26 CFR] § 1.61-6 [a]), we reject petitioners' contention that investment income in Tax Law § 660 (i) must refer only to passive investments and may not include goodwill. If the legislature intended to restrict the definition of investment income to passive investments, such intent would be reflected in the statutory language.

As noted, petitioners also assert that various extrinsic aids to construction, including legislative history, show that federal gross income as used in Tax Law § 660 (i) refers to the eligible S corporation's federal gross income as a C corporation. Although we find that the language of Tax Law § 660 (i) is clear, such a finding is not necessarily conclusive. "Sound principles of statutory interpretation generally require examination of a statute's legislative history and context to determine its meaning and scope" (***New York State Bankers Assn. v Albright***, 38 NY2d 430, 434 [1975]). We are also mindful, however, that while legislative history may be relevant and should be considered to ascertain legislative intent, "[a]s a general rule unambiguous language of a statute is alone determinative" (***Riley v County of Broome***, 95 NY2d 455, 463 [2000]).

Petitioners cite an April 9, 2007 letter from the Acting Commissioner of the Department of Taxation and Finance to the Governor commenting on the then-proposed Tax Law § 660 (i).

The letter states that the proposed law "will close a loophole and impact a small number of Federal S corporations that have chosen to remain New York C corporations primarily to avoid New York State personal income tax liability." The letter describes a tax avoidance strategy employed by resident taxpayers by which personal investment assets are transferred to a federal S-New York C corporation. For New York tax purposes, income from those assets is not passed through to the shareholder but is taxed at the entity level. The resident individual would thus avoid New York personal income tax on the investment income so long as the corporation did not distribute the income. At the time, article 9-A allocated such investment income to New York using an investment allocation percentage, which was itself premised on the allocation percentage of the issuer of the stock, bond or other security (***see*** Tax Law former § 210 [3] [b]; 20 NYCRR 4-7.2). Assuming a typical, low investment allocation percentage, only a small portion of the investment income would be subject to tax under article 9-A. The letter also notes that this strategy could be employed by a resident individual planning to move out-of-state. In such a scenario, investment income and investment assets would not be distributed until the individual becomes a nonresident. At that point, the distribution would not be subject to New York personal income tax. The letter notes that the proposed law "will correct this loophole by mandating that this group of Federal S corporations file as a New York S corporation, rather than a New York C corporation."

Petitioners also cite the Governor's Executive Budget Proposal for fiscal year 2007-2008, dated January 31, 2007, which similarly notes that the proposed law would "close a loophole that allows resident individuals to place assets into New York C corporations and avoid the personal income tax."

Although the activity described in the former Acting Commissioner's letter and the Executive Budget Proposal would likely trigger a mandated S election under our construction of Tax Law § 660 (i), the statutory language, as we have construed it, may be broader than those documents appear to suggest. However, the definition of investment income in Tax Law § 660 (i) (3) makes clear that the legislature intended to cast a wider net for the mandated S election than simply the kind of mischief described in the letter and the budget proposal. If the legislature simply wanted to dissuade individuals from moving investment assets into New York C corporations, it could have fashioned a definition of investment income more closely tied to that objective. One such definition was already in place. Specifically, when Tax Law § 660 (i) was enacted in 2007, investment income under article 9-A was defined, generally, as income from stocks, bonds, and other corporate and governmental securities (***see*** Tax Law former § 208 [5], [6]). This definition, along with the investment allocation percentage in Tax Law former § 210 (3) (b), permitted taxpayers to shelter their investment income in the manner described in the Acting Commissioner's letter. As noted previously, the legislature also could have defined investment income in Tax Law § 660 (i) (3) in terms of passive investment activity, if such activity was its intended target. That the legislature chose a broader definition of investment income than such readily available alternatives, either of which would have remedied the specific problem outlined in both the letter and the budget proposal diminishes the significance of such documents as indicia of legislative intent.

Petitioners also observe that instructions published by the Division for the 2012 tax year direct hybrid corporations to determine their entire net income as if they were C corporations (***see*** CT-3/4-I [Instructions for Forms CT-4, CT-3, and CT-3-ATT] [2012]). Petitioners assert that this instruction supports their contention that federal gross income in Tax Law § 660 (i)

refers to the eligible S corporation's federal gross income as if it were a federal C corporation. We disagree. While the Division's instructions in themselves have no legal effect, (20 NYCRR 2375.8 [c]), this instruction accurately reflects the previously cited statutory definition of entire net income (***see*** Tax Law § 208 [9] [ii]). As noted, Tax Law § 660 (i), which refers to federal gross income and not entire net income, does not contain any similar "as if" language. The cited instruction thus does not support petitioners' argument. To the contrary, to the extent that the instructions also direct the shareholders of a hybrid corporation to determine whether the entity is subject to the mandated S election, they distinguish between entire net income under Tax Law § 208 (9) (ii) and federal gross income under Tax Law § 660 (i) (***see*** CT-3/4-I).

Petitioners contend that certain other published guidance of the Division supports their argument that the corporations must be treated as C corporations in applying the test for S status under Tax Law § 660 (i). As they did below, petitioners quote the following from the Division's Publication 35: "If the separate New York election is not made, the corporation is treated as a C corporation for New York State tax purposes." Petitioners also cite a TSB memorandum which states that, in the context of an IRC (26 USC) § 338 (h) (10) election, a corporation's pro forma federal form 1120 is the starting point in preparing its New York return (***see*** TSB-M-91[4]C [Revisions to New York State's Treatment of Elections Under Section 338 (h) (10) of the Internal Revenue Code] [April 17, 1991]).[2] Additionally, petitioners cite an advisory opinion addressing the New York tax consequences of a section 338 (h) (10) transaction where the target is an S corporation (***see Arnold Haskell, CPA*** [TSB-A-97(5)C] [February 6, 1997]). The advisory opinion states that the "starting point for computing entire net income, whether a New

[2] The TSB-M does not address section 338 (h) (10) elections by S corporations.

York C corporation or a New York S corporation, is [the corporation's] federal taxable income as if [it] had not made the election to be treated as a federal S corporation" (***id.***).

The guidance does not support petitioners' argument. While indicative of the Division's position on various issues, publications, technical memos, and advisory opinions (other than for the requesting party) have no legal effect (***see*** 20 NYCRR 2375.5, 2375.6 [c], 2375.9 [c]). Even if they did, the Division's regulations make clear that subsequent changes in the law may affect their validity (***id.***). Here, the law changed in 2007 with the enactment of Tax Law § 660 (i), long after the publication of the cited guidance (***see*** L 2007, c 60). The guidance thus provides no insight regarding the mandated S election provision.

Petitioners also contend that ***Matter of Baum*** supports their argument that the transaction may not be treated as a deemed sale of assets for New York tax purposes, including the mandated S election. ***Baum*** addresses the New York personal income tax consequences of a transaction similar to the one at issue here, i.e., a sale of stock by nonresident shareholders of a federal S corporation treated as a deemed asset sale for federal tax purposes pursuant to valid section 338 (h) (10) elections. Unlike the present matter, the target corporation in ***Baum*** affirmatively elected New York S corporation status. In 2001, the tax year at issue in ***Baum***, S corporations were required to compute their entire net income to determine their article 9-A tax liability (***see*** Tax Law former § 210 [1] [g]). As during the year at issue in the present matter, an S corporation's entire net income was defined as the "entire taxable income . . . which the taxpayer would have been required to report to the [IRS] if it had not made an [S corporation] election" (Tax Law § 208 [9] [ii]). The Tribunal in ***Baum*** reasoned that, since S corporations must compute their entire net income as if the S election had not been made, it was as if the section 338 (h) (10) election had not been made and, thus, as if the deemed asset sale did not

occur. Accordingly, the Tribunal found that the gain from the sale of stock was not included in the corporation's entire net income and thus could not be passed through as New York source income to the shareholders.

Petitioners' reliance on ***Baum*** leans heavily on language in that decision emphasizing the substance of the transaction as a stock sale and the deemed asset sale as "fictitious." As shown above, however, the outcome in ***Baum*** ultimately rests on the statutory definition of entire net income in Tax Law § 208 (9) (ii). In contrast, the outcome of the present matter rests on the meaning of federal gross income, investment income and gains derived from dealings in property in the context of Tax Law § 660 (i). Given these differences, ***Baum*** is distinguishable.[3]

As petitioners correctly observe, the foregoing interpretation of Tax Law § 660 (i) suggests that a hybrid corporation's deemed sale of assets pursuant to a 338 (h) (10) election will always trigger a mandated S corporation election. Contrary to petitioners' contention, however, such an interpretation does not portend the end of New York's generally voluntary S corporation election regime for such hybrid entities, since gross profits from inventory sales and compensation from services are not included in investment income. Moreover, the legislature has made clear its intention to subject a nonresident to New York personal income tax on gain from a 338 (h) (10) deemed asset sale by its amendment to Tax Law § 632 (a) (2) (***see*** L 2010, ch 57). We thus reject petitioners' contention our interpretation will lead to absurd or objectionable results.

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[3] In response to ***Baum***, the legislature amended Tax Law § 632 (a) (2) to expressly provide that a nonresident's New York source income includes an S corporation shareholder's pro rata share of the New York-allocated gain recognized on a 338 (h) (10) deemed asset sale. In legislative findings accompanying the adoption of this amendment, the legislature indicated that ***Baum*** "erroneously overturned the longstanding policies of the [Division]" (L 2010 ch 57 pt C, § 1).

Petitioners also make constitutional claims. With respect to such claims, our authority is limited to as-applied challenges; facial constitutionality is presumed at the administrative level (***Matter of Eisenstein***, Tax Appeals Tribunal, March 27, 2003).

Petitioners assert that, as nonresidents, they lacked nexus with New York and that, accordingly, New York's assertion of income tax liability against them raises Commerce Clause and Due Process Clause concerns. Petitioners argue that without an affirmative election, New York's tax jurisdiction does not extend to them as nonresident shareholders of hybrid corporations. As petitioners correctly note, this position, if correct, would not invalidate Tax Law § 660 (i) in its entirety, but would only preclude the taxation of nonresidents by application of that provision. Hence, this is an as-applied challenge, which we may address.

We agree with the Administrative Law Judge's analysis on this issue and reject petitioners' contention. As noted in the determination, ***Matter of Shell Gas*** (Tax Appeals Tribunal, September 23, 2010) addressed the issue of whether two corporations had sufficient nexus with New York to be subject to tax under article 9-A where their only connection was through ownership interests in a limited liability company that did business in New York. In response to an argument asserting insufficient nexus similar to petitioners' assertion in the present matter, this Tribunal responded:

> "This argument is without merit because it focuses upon the lack of direct nexus between petitioners and New York. The ***Allied-Signal NYC*** case [***Matter of Allied Signal, Inc. v Commissioner of Fin.***, 79 NY2d 71 (1991)] stands for the principle that the State's power to tax need not be based on the taxpayer's own activities in the State. In order to justify the imposition of tax, the relevant inquiry is whether New York has given something for which it may impose a tax in return. Here, New York has satisfied this standard because it has accorded privileges and immunities that led to [the limited liability company's] which inured to the benefit of its shareholders, including petitioners."

Here, there is no question that Lepage, Inc. and Bakeast, Inc. did business in New York and were subject to tax under article 9-A. Under the rule enunciated above, the corporations' connection to New York satisfies Commerce Clause and Due Process Clause requirements with respect to New York's taxation of petitioners' share of corporate income attributable to New York sources. Contrary to petitioners' contention, ***Matter of Shell*** is not distinguishable because the present matter involves personal income tax and not franchise tax. The same principle applies.

As the Administrative Law Judge correctly found, petitioners' Equal Protection Clause argument based on the application of Tax Law § 660 (i) to article 9-A business corporations but not article 32 banking corporations is a challenge to the facial validity of the statute. Accordingly, we have no authority to rule on that claim.

In accordance with the foregoing discussion, we adopt the Administrative Law Judge's conclusions with respect to Lepage, Inc.'s and Bakeast, Inc.'s 2012 federal gross income and investment income for purposes of the mandated S corporation election under Tax Law § 660 (i). Petitioners do not dispute that the amounts as determined by the Administrative Law Judge accurately reflect the corporations' 2012 federal S corporation tax returns. These amounts appear below.

Lepage, Inc.'s 2012 Federal Gross Income:

| Type of Income | Amount |
|---|---|
| Gross Profit | $46,473,825.00 |
| 4797 Gain | $29,699,596.00 |
| Interest | $9,927.00 |
| Dividends | $18,882.00 |

| | |
|---|---|
| Long Term Capital Gains[4] | $137,197,971.00 |
| Pro Rata Share of Partnership Income | $3,659,476.00 |
| Federal Gross Income | $217,059,677.00 |

Lepage, Inc.'s 2012 Investment Income:

| Type of Income | Amount |
|---|---|
| 4797 Gain | $29,699,596.00 |
| Interest | $9,927.00 |
| Dividends | $18,882.00 |
| Long Term Capital Gains | $137,197,971.00 |
| Rental Income from CK Trucking | $866,024.00 |
| Lepage, Inc.'s Investment Income | $167,792,400.00 |

Lepage, Inc.'s total investment income of $167,792,400.00 is about 77% of its federal gross income of $217,059,677.00. This exceeds the 50% threshold in Tax Law § 660 (i). The shareholders of Lepage, Inc. are thus properly deemed to have made an election under Tax Law § 660 (a) to be treated as a New York S corporation for the 2012 tax year.

Bakeast, Inc.'s, 2012 Federal Gross Income:

| Type of Income | Amount |
|---|---|
| 4797 Gain | $4,608,706.00 |
| Interest | $7,731.00 |

[4] Long-term capital gains include $130,371,061.00 in gains from the sale of intangibles and goodwill attributable to the deemed sale of assets to Flowers, Inc.

| | |
|---|---|
| Long Term Capital Gains[5] | $56,194,729.00 |
| Pro Rata Share of Partnership Income | $4,865,448.00 |
| Federal Gross Income | $65,676,614.00 |

Bakeast, Inc.'s 2012 Investment Income:

| Type of Income | Amount |
|---|---|
| 4797 Gain | $4,608,706.00 |
| Interest | $7,731.00 |
| Long Term Capital Gain | $56,194,729.00 |
| Rental Income From CK Trucking | $866,024.00 |
| Bakeast Inc.'s Investment Income | $61,677,190.00 |

Bakeast, Inc.'s total investment income of $61,677,190.00 is about 94% of its federal gross income of $65,676,614.00. This exceeds the 50% threshold in Tax Law § 660 (i). The shareholders of Bakeast, Inc. are thus properly deemed to have made an election under Tax Law § 660 (a) to be treated as a New York S corporation for the 2012 tax year.

Having determined that Lepage, Inc. and Bakeast, Inc. were subject to mandated S corporation elections, petitioners' liability as S corporation shareholders follows accordingly (***see*** Tax Law § 632 [a] [2]). Petitioners' do not challenge the Division's computations of tax due.

Finally, while we agree with petitioners that this issue is largely moot, we affirm the Administrative Law Judge's ruling on petitioners' offer of documents with their reply brief in

[5] Long-term capital gains includes $51,474,382.00 in gains from the sale of intangibles and goodwill attributable to the deemed sale of assets to Flowers, Inc.

order to provide instruction on this point. The submission schedule clearly states the due date for petitioners' documents. The Administrative Law Judge's rejection of petitioners' attempted late submission was consistent with our rules pertaining to submitted cases (20 NYCRR 3000.12 [b] [2] ["*In accordance with the schedule established,* the petitioner may submit additional documents . . . " (emphasis added)]) and within the Administrative Law Judge's authority to "regulate the course of the hearings . . . and fix the time for filing of legal memoranda and other documents" (20 NYCRR 3000.15 [c] [3]).

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Albert R. Lepage, Francoise O. Lepage, Ronald A. Jalbert, Mariette P. Jalbert and Andrew P. Barowsky is denied;

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

3. The petitions of Albert R. Lepage, Francoise O. Lepage, Ronald A. Jalbert, Mariette P. Jalbert and Andrew P. Barowsky are denied; and

4. The notices of deficiency, dated October 12, 2016 are sustained, except that the notice of deficiency issued to petitioner Albert R. Lepage is subject to the terms set forth in findings of fact 69 through 71.

DATED: Albany, New York
May 17, 2021

/s/ Dierdre K. Scozzafava
Dierdre K. Scozzafava
Commissioner

/s/ Anthony Giardina
Anthony Giardina
Commissioner