STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
JEFFREY M. AND MELISSA LUIZZA	:	DETERMINATION 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.	:	

Petitioners, Jeffrey M. and Melissa Luizza, filed a petition for redetermination of a deficiency or for refund of New York State and New York City personal income taxes under Article 22 of the Tax Law and the Administrative Code of the City of New York.

On August 26, 2013 and May 3, 2013, respectively, petitioners, by Hodgson Russ LLP (Timothy P. Noonan, Esq., of counsel), and the Division of Taxation, by Amanda Hiller, Esq. (Christopher O'Brien, Esq., of counsel), waived a hearing and agreed to submit this matter for determination based on documents and briefs submitted by February 28, 2014, which date began the six-month period for the issuance of this determination. After a review of the evidence and arguments presented, Arthur S. Bray, Administrative Law Judge, renders the following determination.

ISSUES

I. Whether there is a rational basis for the Division of Taxation's assertion that personal income tax is due.

II. Whether the Division of Taxation's retroactive application of amendments to Tax Law

§ 632(a)(2), that were enacted in 2010, to a transaction that was negotiated and completed between 2007 and 2008, deprived petitioner[1] of due process under the United States and New York State constitutions.

III. Whether the doctrine of equitable estoppel bars the Division of Taxation from retroactively applying amendments of the Tax Law that were enacted in 2010 to a transaction negotiated by petitioner in reliance on the Tax Law as it existed in 2007 and 2008.

FINDINGS OF FACT

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

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).

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

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

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 forgoing 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.

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 they filed their 2008 New York State return, the New York State Legislature adopted amendments to section 632(a)(2) of the Tax Law (the amendments) 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 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

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 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.

14. In accordance with State Administrative Procedure Act § 307(1), petitioners' proposed findings of fact have been generally accepted and incorporated herein. However, proposed finding of fact 17 was rejected as argumentative. It is noted that many of the proposed findings of fact correspond with a Stipulation of Facts executed by the parties. Additional findings of fact were also made.

CONCLUSIONS OF LAW

A. As petitioner's representative has pointed out, in order to properly understand the implications of the retroactivity it is necessary to present the law as it existed in 2008 in regard to IRC § 338(h)(10) elections, how the Division of Tax Appeals interpreted that structure and the consequences of the Legislative amendment in 2010. For background, when shareholders of an S corporation sell the corporation's stock they may make an election pursuant to section 338(h)(10) of the Internal Revenue Code 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. In March 2008, when Mr. Luizza sold his company, Tax Law § 632(a)(2) did not address how a section 338(h)(10) election would impact a nonresident selling stock in an S corporation.

In ***Matter of Baum*** (Tax Appeals Tribunal, February 12, 2009) the Tax Appeals Tribunal addressed the question of whether a nonresident taxpayer's income properly includes the gain from the sale of the taxpayer's shares of a New York S corporation to an acquiring corporation when the sale is deemed pursuant to IRC § 338(h)(10) to be the sale of the S corporation's assets. In its decision, the Tribunal reasoned that the substance of the transaction was a sale of stock and 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." (***Id.***) It followed from the forgoing that the gain from the deemed asset sale could not be included in the entire net income of the S corporation, nor could such gain be passed through as New York source income to the shareholders. At the conclusion of its decision, the Tribunal stressed its position that this was a stock sale and that the gain from sale of stock is not New York source income to a nonresident. A few months after the decision in ***Baum*** was issued, an administrative law judge, in ***Matter of Mintz*** (Division of Tax Appeals, June 4, 2009), reached a conclusion that was consistent with ***Baum*** insofar as he determined that payments received by nonresident shareholders under an installment obligation of an S corporation in a liquidation were not New York source income and were not subject to New York State personal income tax since the installment payments were gains from the sale of stock.

In response to the administrative interpretations of the Tax Appeals Tribunal and the Division of Tax Appeals, the Legislature amended Tax Law § 632(a)(2), 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]).

The following Legislative findings are pertinent:

> 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.)

Lastly, to the extent relevant to this matter, the Legislature enacted the following provision concerning the effective date of the legislation:

> This act shall take effect immediately; provided however, that section two of the act [amending Tax Law § 632] shall apply to taxable years beginning on or after January 1, 2007 for which the statute of limitations for seeking a refund or assessing additional tax is still open . . . (L 2010, ch 57, pt C, § 4).

B. At the outset, petitioners argue that since the Division did not submit any evidence into the record, the Division cannot establish a rational basis for the assertion that additional tax is due. This argument is without merit. A presumption of correctness applies to a notice of deficiency that is properly issued under the Tax Law (***Matter of Tavolacci v. State Tax Commn.***, 77 AD2d 759 [1980]). However, under some circumstances, there must be an initial showing that the notice has a rational basis before the presumption of correctness arises (***Matter of Fortunato***, Tax Appeals Tribunal, February 22, 1990). In this instance, the facts alleged in the petition, which were admitted in the answer, and those facts stipulated by the parties clearly establish a rational basis for the notice.[2] Namely, petitioners allegedly failed to properly allocate the gain from the sale of the Company to New York on their 2008 income tax return. This position, in turn, was obviously based upon the change in the Tax Law. It follows that the Division had a rational basis for the notice and petitioners' argument is rejected.

C. The next question is whether the application of Tax Law § 632(a)(2) to petitioners, under the circumstances presented here, violates petitioners' right to due process. In general, retroactive application of a statute has been viewed by the courts with disfavor and distrust (***James Sq. Assoc. LP v. Mullen***, 21 NY3d 233, 246 [2013]; ***Caprio v. New York State Dept of***

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[2] In accordance with the provisions of Administrative Procedure Act § 306(4), official notice was taken of the answer of the Division.

Taxation and Fin., 117 AD3d 168[2014]). Nevertheless, retroactivity has been permitted with respect to tax statutes unless the nature of the tax and the attendant circumstances render the imposition of the law so harsh and oppressive as to pass beyond constitutional boundaries (***Matter of Replan Dev. v. Department of Hous. Preserv. & Dev. Of City of N.Y.***, 70 NY2d 451, 455 [1987] ***lv dismissed***, 485 US 950 [1988]).[3] In ***James Sq.***, the Court of Appeals, following ***Replan***, set forth the following three factors that are to be considered in determining whether a retroactive tax transgresses constitutional limitations: (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" (***id***.).

D. The first factor listed above has been described as the "predominant" factor (***Matter of Replan Dev.***, 70 NY2d at 456). Here, the stipulated facts clearly establish that neither petitioner nor his representative had any knowledge or reason to believe in 2008 that there would be a change in the taxation of S corporations two years later.

The record further establishes that petitioner was harmed by his reliance upon the law as it existed in 2008. It should be borne in mind that, at the time of the sale, the prevailing authority from the Tribunal was that the transaction was not subject to tax by New York. Further, petitioner was advised by his tax advisors that there would be no additional New York tax consequences as a result of the IRC § 338(h)(10) election. However, as a result of the retroactive change in the law, petitioner did not have an opportunity to adjust his negotiating position to account for the change in the law (***see James Sq.***, 21 NY3d at 248). Specifically, petitioner was

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[3] Since the nature of the challenge pertains to the constitutionality of the statute as applied, the issue may be resolved in this forum (***see Matter of Brussel***, Tax Appeals Tribunal, June 25, 1992; ***Matter of Fourth Day Enters.***, Tax Appeals Tribunal, October 27, 1988).

induced to forgo seeking a higher purchase price or requiring the Buyer to provide indemnity for any additional taxes arising from the election. Accordingly, it is found that petitioner had no forewarning of the change in the legislation and that he reasonably relied upon his advisors as to the state of the prior law.

E. The second factor is the length of the retroactive period. The difficulty posed by an excessive period of retroactivity is that it deprives taxpayers of piece of mind regarding transactions that may have been forgotten (***Raplan***, 70 NY2d at 456). Clearly, a review of the cases cited by the parties supports the conclusion that there is no bright line of when the length of retroactivity becomes excessive. In ***James Sq.*** a retroactive period of 16 months was considered excessive. On the other hand, a one-year period of retroactivity was conceded by the petitioner in ***Raplan*** to not be excessive. An additional consideration, noted by the Division, is that when the legislation is intended to correct an error, longer periods of retroactivity have been upheld (***James Sq.***, 21 NY3d at 249).

At the outset, one is presented with the question of measuring the length of the retroactive period in this case. In my view, the period should be measured, at a minimum, from the execution of the final Stock Purchase Agreement, on or about March 18, 2008, to the effective date of the enactment of the legislation providing for a retroactive effective date, August 11, 2010. This results in a retroactive period of approximately two and one-half years.[4]

In support of its position that the retroactive period is not excessive, the Division points out that the 2010 amendments were intended to "correct" the erroneous determinations of the

[4] Since the course of the negotiations would have been different if petitioner had been aware that the law would change in the future, one could argue that the period of retroactivity commenced when the parties began their negotiations for the sale of the business.

Tax Appeals Tribunal and the administrative law judge in the ***Baum*** and ***Mintz*** cases, respectively. The Division also submits that the amendments were intended to "clarify the concept of federal conformity" with regard to "the longstanding policy" of the Internal Revenue Service and the Division with which the ***Baum*** and ***Mintz*** cases were inconsistent. The Division posits that its position with respect to IRC § 338(h)(10) is rational and consistent with the position taken by other states, citing ***Newell Window Furnishing, Inc. v. Johnson*** (311 SW3d 441, 445 [Tenn Ct App 2008]).

Fortunately, guidance on the issue of whether the retroactive period is excessive is provided by ***Caprio*** since it reviewed the same legislative amendment that is at issue in this proceeding. Specifically, the Court rejected the suggestion that the 2010 amendment was a curative measure for the following reason:

> Tellingly, defendants point to no legislative history that indicates that the legislature was correcting any specific error in the existing law, as opposed to amending the law to account for the Tax Department's purported policy. Thus . . . the legislative history does not support a view that the 2010 amendment was a curative measure. Plaintiffs . . . persuasively argue that the 2010 amendment created an exception to the general rule, set forth in Tax Law § 631(b)(2), that gains from a nonresident's sale of stock (not used in a New York business) are not subject to New York taxation. Under the 2010 amendment, the particular stock sale engaged in here is now unquestionably subject to New York taxation and thus can fairly be considered a new tax. Because the 2010 amendment cannot be reasonably viewed as merely correcting a legislative error, the longer period of retroactivity urged by defendants is not warranted, and on balance, the second ***James Sq.*** factor weighs against defendants (***Caprio***, 117 AD3d at 177).

The ***Caprio*** court mentioned other factors that raise additional doubt regarding the merit of the Division's position. The court noted that the only evidence before it that New York previously imposed tax on the gain from an IRC § 338(h)(10) deemed asset sale by a nonresident was a 2002 PowerPoint presentation made to the Division's auditors stating this position.

Moreover, even if such a policy were in effect, the record before the ***Caprio*** court contained no evidence that the Division made any effort to advise taxpayers of this policy.

The considerations that were articulated by the Court in ***Caprio*** are persuasive here. As was the situation before the ***Caprio*** court, there is very little evidence in this case of a longstanding policy of the Division. The Division has attempted to fill this gap with a reference to a prior determination by an administrative law judge. However, this argument is flawed because such determinations may not be considered as precedent (Tax Law § 2010[5]).

On the basis of the forgoing, it is concluded that the Division's suggestion that a longer period of retroactivity is permissible because the 2010 amendment is curative is found to be without merit. The remaining considerations that were relied upon in ***Caprio*** also support petitioner's position that the second test is satisfied. Although the period of retroactivity is not as long as that presented in ***Caprio***, the period is significantly longer than that presented in ***James Sq.*** and also long enough for petitioner to have gained a reasonable expectation that he could rely upon the existing tax scheme thereby satisfying the ***James Sq.*** test. Thus, it is concluded that the second ***James Sq.*** factor, the length of the retroactive period, also supports petitioner's position.

F. The last factor considered by ***James Sq.*** is the public purpose for the retroactive application for the 2010 amendment. In essence, the Division argues that retroactivity has a valid public purpose because the 2010 amendment was enacted to correct the mistakes of the Tribunal and the Division of Tax Appeals. However, as set forth above, the decision in ***Caprio*** clearly establishes that, despite the Legislative findings, the amendment may not be viewed as corrective legislation. Rather the legislative history led the ***Caprio*** court to believe that the purpose of the retroactivity was to raise tax revenues by $30 million over the course of the fiscal year. Relying

upon ***James Sq.***, the ***Caprio*** court noted that raising revenue is not a compelling reason for retroactivity and is insufficient to warrant retroactivity when considerations would support doing otherwise. Accordingly, it is concluded that petitioner has satisfied the last factor.

G. In sum, since the Division has not offered a convincing reason for the retroactive application of the 2010 amendment of Tax Law § 632(a)(2) and petitioner has shown that the three factors set forth in ***Replan*** have been satisfied, the application of the amendment to petitioner resulted in a violation of due process. The resolution of the second issue raised by petitioner renders the remaining issue academic and will not be addressed.

H. The petition of Jeffrey and Melissa Luizza is granted and the Notice of Deficiency, dated March 1, 2012, is cancelled.

DATED: Albany, New York
August 21, 2014

/s/ Arthur S. Bray
ADMINISTRATIVE LAW JUDGE