STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions

of

ALBERT R. LEPAGE, FRANCOISE O. LEPAGE, RONALD A. JALBERT, MARIETTE JALBERT, AND ANDREW P. BAROWSKY

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.

DETERMINATION
DTA NOS. 828035, 828036, 828037 AND 828038

Petitioners, Albert R. LePage, Francoise O. LePage, Andrew Barowsky, and, Ronald A. and Mariette P. Jalbert, filed separate petitions for redetermination of deficiencies or for refund of New York State personal income tax under article 22 of the Tax Law for the years 2010, 2011 and 2012. Petitioners, appearing by Jones Day (Dennis Rimkunas, Esq., Antoinette L. Ellison, Esq., and John M. Allan, Esq., of counsel), and the Division of Taxation, appearing by Amanda Hiller, Esq. (Linda Farrington, Esq., of counsel), agreed to have the controversies consolidated and determined on submission without the need for a hearing pursuant to section 3000.12 of the Rules of Practice and Procedure of the Tax Appeals Tribunal. The final brief was to be submitted by June 20, 2019,[1] which date commenced the six-month period for issuance of this determination.[2]

[1] Petitioners reply brief included several additional documents, attached thereto, that petitioners desired the undersigned to consider in the analysis of this matter. The undersigned determined that the submission of additional documents, aside from the actual reply brief, was not in compliance with the original evidence submission schedule and therefore, the additional documents were returned to petitioners (***see Matter of Schoonover***, Tax Appeals Tribunal, August 15, 1991).

[2] On April 8, 2019, petitioners filed a motion for summary determination. The then-assigned Administrative Law Judge, Barbara J. Russo, ruled that the motion would be addressed in the final determination.

After due consideration of the pleadings, affidavits and documents submitted in connection with this matter, Nicholas A. Behuniak, Administrative Law Judge, renders the following determination.

ISSUES

I. To complete the mandated New York S corporation election test required pursuant to Tax Law § 660 (i), must a New York eligible S corporation utilize its actual federal S corporation tax amounts, or New York C corporation pro forma tax amounts.

II. Whether the corporate entities at issue produced enough "investment income" to trigger the mandated New York S corporation election provided in Tax Law § 660 (i).

III. Whether resident and nonresident shareholders of a New York S corporation that made an election pursuant to Internal Revenue Code (26 USC) § 338 (h) (10) to treat the sale of stock as a sale of assets must recognize the proceeds as gains derived from the sale of assets for New York State income tax purposes.

FINDINGS OF FACT

On February, 22, 2019, the parties entered into a stipulation of facts, which contained 77 separately numbered paragraphs. The parties also stipulated to the admission of 24 separate exhibits, one of which included a separate stipulation of facts which contained an additional 7 separately numbered paragraphs. The stipulated facts set forth in the stipulations have been incorporated into the facts below to the extent they are relevant and proper findings.

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 New York Tax Law.

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

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 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) and self-reported New York sourced 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 voluntarily filed a New York nonresident and part-year resident income tax return (form IT-203) and self-reported New York sourced 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:

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:

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:

Additional Tax for 2012	$51,021.00
Interest as of date of Notice	$15,292.79
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 Lapage, Inc., and Bakeast, Inc., were valid S corporations under various state laws as provided on a list attached to the acquisition agreement. However, the attachment, which indicates which states this representation applied to was not included with the copy of the acquisition agreement the parties submitted into the record.

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

CONCLUSIONS OF LAW

A. When the Division issues a notice of deficiency to a taxpayer, a presumption of correctness attaches to the notice, and the burden of proof is on the taxpayer to demonstrate, by clear and convincing evidence, that the asserted deficiency is erroneous (***see Matter of O'Reilly***, Tax Appeals Tribunal, May 17, 2014; ***see also Matter of Leogrande v Tax Appeals Tribunal***,

187 AD2d 768 [3d Dept 1992], ***lv denied*** 81 NY2d 704 [1993]; ***Matter of Tavolacci v State Tax Commn.,*** 77 AD2d 759 [3d Dept 1980]; Tax Law § 689 [e]).

B. In general, corporations are formed and incorporated under the respective business corporation laws of their home state of incorporation. There are no special rules for forming a corporation that subsequently will make an S election. Both Lepage, Inc., and Bakeast, Inc., were incorporated under the laws of the state of Deleware.

C. Corporations are separate legal entities from their shareholders; however, for tax purposes, shareholders of certain corporations are allowed to elect to have the income of their corporations taxed as though those corporations were flow-through entities.

> "Subchapter S of the Internal Revenue Code, 26 U.S.C. §§ 1361–1379, permits certain corporations to elect to be taxed in a similar, but not identical, fashion as partnerships. ***See*** 3 Boris I. Bittker and Lawrence Lokken, ***Federal Taxation of Income, Estates and Gifts*** ¶ 95.6.1 (2d ed.1991) (highlighting major distinctions). A subchapter S corporation generally does not pay taxes as an entity. 26 U.S.C. § 1363(a). Instead, the corporation's profits and losses pass through directly to its shareholders on a pro rata basis and are then reported on the shareholders' individual tax returns. 26 U.S.C. § 1366(a). This conduit approach allows shareholders to avoid double taxation on corporate earnings. Tax integrity, meanwhile, is preserved by requiring shareholders to treat all income and deductions as if 'realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation.' 26 U.S.C. § 1366(b). In other words, 'the items attain no greater dignity from being passed through the corporation.' Boris I. Bittker and James S. Eustice, ***Federal Income Taxation of Corporations and Shareholders,*** ¶ 6.06[2][c] (6th ed.1998)" (***see Gitlitz v C.I.R.***, 182 F3d 1143, 1146 [10th Cir 1999], ***revd***, 531 US 206, 121 S Ct 701, 148 L Ed 2d 613 [2001], and ***vacated***, 6 Fed Appx 770 [10th Cir 2001]).

D. In general, to be eligible to make an S corporation election, a domestic corporation must have only one class of stock and no more than 100 shareholders. In addition, the shareholders must all be either individuals who are U.S. citizens or resident aliens, estates, or certain types of trusts (***see*** IRC [26 USC] § 1361). The election is made by filing federal form

2553 (***see*** John C. Healy and Michael S. Schadewald, ***2019 Multistate Corporate Tax Guide***, Volume 1 Corporate Income Tax, [Wolters Kluwer, CCH Publications] at 6001). Federal S corporation status may be elected only with the consent of all shareholders of the corporation at the time the election is filed (***id***. citing IRC [26 USC] § 1362 [a] [2]).

E. States generally conform to the federal pass-through treatment of S corporations, but only if the corporation has filed a valid S corporation election for federal tax purposes ***(see 2019 Multistate Corporate Tax Guide*** at 6001). Although most states provide that the filing of a federal S corporation election automatically qualifies the corporation as an S corporation for state tax purposes, a handful of states require taxpayers to comply with additional special procedures in order to make a valid S corporation election (***id.*** at 6021-6025, S Corporations [Part 3] table). Maryland, New Jersey and New York are the states that require a separate state S corporation election in addition to the federal election ***(id***.).

The Sale of Shareholder's Stock with an IRC (26 USC) § 338 (h) (10) Election

F. In general, upon the sale of a shareholder's S corporation stock, the selling shareholder(s) recognizes capital gain or loss on the sale (Treas Reg [26 CFR] § 1.1367-1). In a transaction involving IRC (26 USC) § 338 (a), there is the sale of stock of a corporation; however, for tax purposes a legal fiction is created. The purchaser, in a qualified stock purchase, may make an election whereby the target corporation (old target) is treated as having sold all of its assets as of a certain date, and then treated as a new corporation that purchased all of the assets as of a certain date. As a result of the election, the old target recognizes gain or loss on the difference between the fair market value of the assets and the adjusted basis of the assets. The selling shareholders recognize gain or loss on the disposition of their stock.

If an election is made under IRC (26 USC) § 338 (a), the seller and the purchaser of the target stock may make an additional election under Tax Law § 338 (h). IRC (26 USC) § 338 (h) (10) permits an election to treat a qualified stock purchase of S corporation stock by another corporation (but not by individuals) as an asset sale and purchase (***see*** IRC [26 USC] § 338 [h] [10]; Treas Reg [26 CFR] 1.338 [h] [10] - 1 [c] [1]). All of the shareholders of the S corporation, including any shareholders who have not sold their stock, and the acquiring corporation must consent to the election (***see*** Treas Reg [26 CFR] 1.338 [h] [10] - 1 [c] [3]).

When an IRC (26 USC) § 338 (h) (10) election is made, the shareholders of the subchapter S corporation treat the stock sale as a sale of assets by the corporation. The S corporation recognizes gains and losses on the deemed sale of its assets (***see*** Treas Reg [26 CFR] § 1.338-4). The tax attributes of the deemed asset sale flow through to its shareholders on the federal level (***see*** IRC [26 USC] § 1366), and the State level if the corporation is a New York S corporation (***see*** Tax Law § 660).

New York S Corporation Election

G. As noted, in general, New York does not require federal S corporations to file as New York S corporations; rather New York permits federal S corporations to be treated as New York S corporations for tax purposes via voluntary shareholder elections, or in the absence of making the election to file as C corporations.

Specifically, Tax Law § 660 (a) provided New York corporations the option to elect to be New York S corporations. Tax Law § 660 (a) provided in relevant part:

> “(a) Election. If a corporation is an eligible S corporation, the shareholders of the corporation may elect in the manner set forth in subsection (b) of this section to take into account, to the extent provided for in this article (or in article thirteen of this chapter, in the case of a shareholder which is a taxpayer under such article),

> the S corporation items of income, loss, deduction and reductions for taxes described in paragraphs two and three of subsection (f) of section thirteen hundred sixty-six of the internal revenue code which are taken into account for federal income tax purposes for the taxable year. No election under this subsection shall be effective unless all shareholders of the corporation have so elected. An eligible S corporation is (i) an S corporation which is subject to tax under article nine-A or thirty-two of this chapter..." (former Tax Law § 660 [a]).

H. For many years, in New York State the decision to remain taxable as a C corporation was completely up to the shareholders. However, in 2007 the New York Legislature passed Tax Law § 660 (i) which mandated that certain federal S corporations be treated as New York S corporations regardless of whether the shareholders elected to be treated as such (2007 Sess. Law News of N.Y. Ch. 60 [S. 2110 -C] 230th Legislature Part L §1). In relevant part, Tax Law § 660 (i) provides:

> "(i) Mandated New York S corporation election. (1) Notwithstanding the provisions in subsection (a) of this section, 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]).

I. Petitioners advance that Lepage, Inc., and Bakeast, Inc., are New York C corporations and that application of the required Tax Law § 660 (i) test that compares an eligible S

corporation's "investment income" to its "federal gross income" (the Investment Income Ratio Test), does not trigger a mandatory switch requiring them to file as New York S corporations. Petitioners support their position by asserting that since Lepage, Inc., and Bakeast, Inc., did not elect to be New York S corporations, they are by default New York C corporations and the Investment Income Ratio Test is applied upon each corporation's tax numbers as derived from pro forma New York C corporation returns. These pro forma New York C corporation returns calculate what the corporations' return numbers would be if, rather than being federal S corporations, Lepage, Inc., and Bakeast, Inc., were in essence federal C corporations. The Division asserts that the Investment Income Ratio Test should be calculated using the companies' actual federal S corporation tax return numbers.

J. The starting point of the analysis is the recognition that Lepage, Inc., and Bakeast, Inc., are both "eligible S corporations" under the New York Tax Law. As defined in Tax Law § 660 (a), an eligible S corporation is "(i) *an S corporation* which is subject to tax under article nine-A or thirty-two of this chapter" (***see*** former Tax Law § 660 [i] [emphasis added]). The statute acknowledges the reality that a New York "eligible S corporation" and the existing federal "S corporation" are the same inseparable entity.

Due to the second path to becoming a New York S corporation by means of Tax Law § 660 (i), before Lepage, Inc., Bakeast, Inc., or any other eligible S corporation, can file as a New York C corporation in New York, they are required to apply the Investment Income Ratio Test to determine if they are required to file as a New York S corporation.

Which Tax Information to Use for the Investment Income Ratio Test

K. Tax Law § 660 (i) does not provide a definition of what "federal gross income" is or exactly which return such numbers are to come from for purposes of the Investment Income Ratio Test. The definition of an "eligible S corporation" in Tax Law § 660 (a), as a "[federal] S corporation," leads to the conclusion that when calculating an eligible S corporation's "federal gross income," the eligible S corporation's federal S corporation's actual federal return is the return that is used for the Investment Income Ratio Test. However, petitioners argue that since the eligible S corporation is still a New York C corporation until an election is mandated, the eligible S corporation's income used for the Investment Income Ratio Test should be the pro forma New York C corporation's tax numbers calculated pursuant to Tax Law § 208 (9). Tax Law § 209 provides New York S corporations the option to calculate their "entire net income" as though they had not made the federal S corporation election (***see*** Tax Law § 208 [9]). If petitioners' approach is followed, the deemed asset sale of Lapage, Inc., and Bakeast, Inc., would not be classified as gross income from the sale of assets but rather income to the shareholders directly from the sale of their stock in those companies.

The Division asserts that the parties should not look to the legislative history of Tax Law § 660 (i). The Division maintains the statute is clear on its face. Petitioners contend that the statutory language is not clear, and an examination of its legislative history is warranted.

L. It is well settled that in matters of statutory interpretation, the cardinal function is to effectuate the intent of the Legislature (***see Matter of Yellow Book of N.Y., Inc. v Commissioner of Taxation & Fin.***, 75 AD3d 931, 932 [3d Dept 2010], ***lv denied*** 16 NY3d 704 [2011]). First and foremost, the statutory language is the clearest indicator of legislative intent (***Matter of Lewis Family Farm, Inc. v New York State Adirondack Park Agency***, 64 AD3d 1009, 1013 [3d

Dept 2009]). Statutory rules of construction provide that "[t]he legislative intent is to be ascertained from the words and language used, and the statutory language is generally construed according to its natural and most obvious sense, without resorting to an artificial or forced construction" (***McKinney's Cons Laws of NY***, Book 1, Statutes § 94).

Given the fact that Tax Law § 660 (i) instructs parties to utilize "federal gross income" for completion of the Investment Income Ratio Test, the most logical answer is that an eligible S corporation's federal S corporation tax return information should be used for completion of the test. Words used within a provision are not to be rejected as superfluous when they may instead be given a distinct and separate meaning (***see Leader v Maroney, Ponzini & Spencer***, 97 NY2d 95, 104 [2001]; ***McKinney's Cons Laws of NY***, Book 1, Statutes § 231). Federal gross income logically comes from actual federal calculations and federal forms. Tax Law § 660 (i) in no way indicates that State tax forms or computations should be used to calculate "federal gross income."

However, regardless of how clear the wording of a statute is, a court may still refer to extrinsic aids, including legislative history, to assist in statutory interpretation (***see Wilson v State of New York***, 95 NY2d 455 [2000]).

M. In their brief, petitioners cite to a letter from the New York State Governor's Office describing an earlier version of the Tax Law § 660 (i) proposal,[3] noting that the law was created to "close a loophole that allows resident individuals to place assets into New York C corporations and avoid the personal income tax" (***see*** Office of the Governor of New York,

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[3] The earlier proposal set the threshold for triggering the Investment Income Ratio Test at 25%; however, the final legislation increased the threshold to 50%.

Executive Budget Overview for Fiscal Year 2007-2008 [January 31, 2007]). However, petitioners fail to note that this same document also states that the Investment Income Ratio Test:

> "would apply to *Federal S corporations* with investment income that is more than 25 percent of *their* federal gross income. It would require these corporations to be S corporations for New York purposes" (***id.*** [emphasis added]).

This statement strongly supports the conclusion that the Investment Income Ratio Test is calculated using the eligible S corporation's federal S corporation tax return numbers, not New York C corporation pro forma tax numbers as advanced by petitioners. There is no evidence nearly as compelling that supports petitioners' competing approach in this case.

Furthermore, it appears it has been the longstanding and public position of the Division that the Investment Income Ratio Test is performed using the eligible S corporation's federal S corporation's tax return numbers. On January 31, 2008, the Division published guidance for practitioners summarizing corporate tax legislative changes enacted in 2007. In that guidance, the Division stated:

> "Section 660(i) has been added to the Tax Law to provide that if more than 50% of an eligible S corporation's federal gross income (as defined in Internal Revenue Code section 61(a)) for the current tax year is derived from investment income, then the shareholders of that eligible S corporation are deemed to have made the election to be a New York S corporation for the entire current tax year" (***see*** TSB-M-07[8]I).

Thus, guidance issued by the Division on or about the time Tax Law § 660 (i) was enacted instructed taxpayers to refer to the federal definition of gross income when applying the Investment Income Ratio Test.

Calculation of Federal Gross Income for the Investment Income Ratio Test

N. As noted, petitioners vigorously challenge where the numbers for the Investment

Income Ratio Test should come from; however, petitioners do not seriously challenge the components the Division used in calculating the federal S corporations' gross income or investment income amounts reflected below. For example, petitioners do not provide alternative calculations for federal gross income based upon numbers reported on the federal S corporations' tax returns.

In performing the necessary calculations, the use of the word "federal" for the calculation of the "federal gross income" component of the Investment Income Ratio Test takes parties to the federal classification of "gross income." Terms used in article 22 are given 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 (***see*** Tax Law § 607 [a]; ***Matter of Kallianpur,*** Tax Appeals Tribunal, May 29, 2019). IRC (26 USC) § 61 defines "gross income" as "all income from whatever source derived." As noted earlier, the Division's published guidance on the subject matter instructs taxpayers to refer to the definition of federal gross income in IRC (26 USC) § 61 (a) to apply the Investment Income Ratio Test (***see*** TSB-M-08[1]C).

O. IRC (26 USC) § 61 (a) lays out a nonexclusive list of items that are included in gross income, including gross income derived from business activities, gains derived from dealings in property, interest, rents, dividends, and taxpayers' distributive share of partnership gross income (***see*** IRC [26 USC] § 61 [a]). To determine the federal gross income of a federal S corporation, it is necessary to look to various places on the corporation's federal tax return to total the amounts of gross income reported.

P. For the tax year 2012, Lepage, Inc., had federal gross income in the amount of

$217,059,677.00 and Bakeast, Inc., had federal gross income in the amount of $65,676,614.00 calculated as follows:

Lapage, Inc.'s Gross Income Calculation:

Numbers are taken from Lapage, Inc.'s, 2012 federal S corporation tax return and schedules.

Lapage, Inc., Long Term Capital Gains:

Shares of Delhaize Group	$340,846.00
Sale of Partnership Interest	$6,377,151.00
Sale of Intangibles and Goodwill	$130,371,061.00
Gain on Distribution in Excess of Basis	$92,688.00
Passthrough from CK Sales	$16,225.00
Total	$137,197,971.00

Lapage, Inc., Pro-Rata Share of Partnership Income not already in income:

Partnership	Amount of Gain
CK Sales	$872,806.00
CK Trucking	$866,024.00
Green Mountain	$1,920,647.00
Total	$3,659,477.00

Lapage, Inc., 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	$137,197,971.00
Pro Rata Share of Partnership Income	$3,659,476.00
Federal Gross Income	$217,059,677.00

Bakeast, Inc.'s Gross Income Calculation:

Numbers are taken from Bakeast, Inc.'s, 2012 federal S corporation tax return and schedules.

Bakeast, Inc.'s, Long Term Capital Gains:

Sale of partnership interest	$4,611,440.00
Sale of Intangibles and Goodwill	$51,474,382.00
Gain on Distribution In Excess on Basis	$92,682.00
Passthrough from CK Sales	$16,225.00
Total	$56,194,729.00

Bakeast, Inc.'s, Pro-Rata Share of Partnership Income not already in income:

Partnership	Amount of Gain
CK Sales	$1,059,278.00
CK Trucking	$866,024.00
Green Mountain	$2,940,147.00
Total	$4,865,449.00

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

Type of Income	Amount
4797 Gain	$4,608,706.00
Interest	$7,731.00
Long Term Capital Gains	$56,194,729.00
Pro Rata Share of Partnership Income	$4,865,448.00
Federal Gross Income	$65,676,614.00

The Calculation of Investment Income for the Investment Income Ratio Test

Q. The second step in applying the test under Tax Law § 660 (i) is to calculate each eligible S corporation's investment income. "Investment income" is a specifically defined term in Tax Law § 660 (i) (3). The definition in the statute is controlling (***see Bond v U.S.***, 572 U.S. 844, 871 [2014]). "Investment income" is defined to include "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 included in federal gross income for the taxable year" (Tax Law § 660 [i] [3]). Although Tax Law § 660 (i) (3) does not explicitly reference IRC (26 USC) § 61 (a), since IRC (26 USC) § 61 (a) was utilized in the computation of the denominator, federal gross income, and the definition of investment income directs parties to include items to the extent they would have been included in federal gross income (a calculation that utilized IRC [26 USC] § 61 [a]), it is appropriate to utilize IRC (26 USC) § 61 (a) to determine what the individual components of investment income are for the Investment Income Ratio Test.

Items included in "investment income" under Tax Law § 660 (i) (3) are interest, dividends, and rents. These items must be included in investment income to the extent they were included in federal gross income as reported on each entity's federal S corporation return. In addition to these items, the definition of "investment income" includes "gains derived from dealings in property" (Tax Law § 660 [i]). IRC (26 USC) § 61 (a) (3) explicitly includes "gains derived from dealings in property" as one of the items included in federal gross income. The relevant Treasury Regulations specifically define "gains derived from dealings in property" (Treas Reg [26 CFR] § 1.61-6) to include the "*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] [emphasis added]). Any amounts that fall within this definition are included in investment income pursuant to Tax Law § 660 (i) (3) to the extent they were included in the federal gross income computation.

R. Unfortunately, the parties provided limited information regarding how the dollar gains were classified amongst the various categories on the federal S corporation tax returns. However, it appears both Lepage, Inc., and Bakeast, Inc., reported the majority of their respective gains from the deemed sale of assets on federal form 8949 (Sales and Other Dispositions of

Capital Assets). Both Lepage, Inc., and Bakeast, Inc., reported this income as gains from the "sale of intangibles and goodwill." This self-reported classification of the income falls squarely within the parameters of the gains derived from dealings in property as provided in Treas Reg (26 CFR) § 1.61-6 (a). Thus, it is concluded that these gains were properly classified as "investment income" under Tax Law § 660 (i). Likewise, the gains classified by Lepage, Inc., and Bakeast, Inc., as "4797" gains presumably related to gains reported on federal form 4797 (sales of business property) and as such fall under the umbrella of "gains derived from dealings in property." Since the sale of intangibles and goodwill and the 4797 gains account for the majority of the total investment income calculated, the remaining components would be immaterial to the determination of the mandatory S corporation election.

S. For the tax year 2012, Lepage, Inc., had investment income of $167,792,400.00 and Bakeast, Inc., had investment income in the amount of $61,677,190.00 calculated as follows:

Lapage, Inc.'s, Investment Income Calculation:

Numbers are taken from Lapage, Inc.'s, 2012 federal S corporation tax return and schedules.

Type of Income	Amount
4797 Gain	$29,699,596.00
Interest	$9,927.00
Dividends	$18,882.00
Long Term Capital Gains[4]	$137,197,971.00
Rental Income from CK Trucking	$866,024.00
Lapage, Inc.'s Investment Income	$167,792,400.00

Bakeast, Inc.'s Investment Income Calculation:

Numbers are taken from Bakeast, Inc.'s, 2012 federal S corporation tax return.

[4] Which includes $130,371,061.00 in gains from the sale of intangibles and goodwill.

Type of Income	Amount
4797 Gain	$4,608,706.00
Interest	$7,731.00
Long Term Capital Gain[5]	$56,194,729.00
Rental Income From CK Trucking	$866,024.00
Bakeast Inc.'s Investment Income	$61,677,190.00

Investment Income Ratio Test Calculation

T. The final step in applying the Investment Income Ratio Test is to divide each corporation's investment income by its federal gross income to determine if the corporation's ratio exceeded 50%. Applying this simple calculation, Lepage, Inc.'s, investment income was 77.3% of its federal gross income ($167,792,400.00/$217,059,677.00 = 77.3%), and Bakeast, Inc.'s, investment income was 93.9% of its federal gross income ($61,677,190.00/$65,676,614.00 = 93.9%). Since both entities' Investment Income Ratio Test results exceed 50%, both Lepage, Inc., and Bakeast, Inc., are subject to the mandated New York S corporation election, and the shareholders are deemed to have made the election to be treated as a New York S corporation under Tax Law § 660 (a) for 2012.

Limiting the Application of Tax Law § 660 (i)

U. Petitioners argue that the Legislature enacted Tax Law § 660 (i) as a narrow exception to the general rule that shareholders must affirmatively make a New York S corporation election. Petitioners assert that the Legislature enacted § 660 (i) to eliminate a specific abusive tax planning strategy in which New York residents placed investment portfolios in an eligible S corporation to take advantage of the New York corporate tax investment capital provisions.

[5] Which includes $51,474,382.00 in gains from the sale of intangibles and goodwill.

Petitioners point to a letter from the then New York State Department of Taxation and Finance Acting Commissioner Barbara G. Billet to Governor Spitzer (dated April 9, 2007) in which Acting Commissioner Billet noted that:

> "In other cases, shareholders who anticipate moving out of the state avoid tax on the gain from the sale of an asset by transferring it to the corporation while they are a New York resident; the corporation then sells the asset and the gain is taxed under the corporation's presumably low investment allocation percentage. The distribution of the gain to the shareholder is then delayed until the resident shareholders have moved out of state. At that time, the distribution will not be subject to tax by New York" (April 9, 2007 letter from New York State Department of Taxation and Finance Acting Commissioner Barbara G. Billet to Governor Eliot Spitzer).

Petitioners argue that this statement supports the conclusion that the section 660 (i) legislation was passed for one purpose and one purpose only, and that was to prevent the very limited transactions to which Acting Commissioner Billet referred. In further support of this position, petitioners also point to the previously mentioned January 31, 2007 letter from the Office of the Governor noting that the law was created to "close a loophole that allows resident individuals to place assets into New York C corporations and avoid the personal income tax" (***see*** conclusion of law M).

V. Petitioners argue that the legislation cannot capture transactions other than the one mentioned in Acting Commissioner Billet's letter and the Office of the Governor's letter. Instead of utilizing Tax Law § 660 (i), petitioners suggest that the Division must address the current transaction at issue via the sham transaction, step transaction, or substance over form tax doctrines. Petitioners' interpretation of the statute effectively adds words and very limiting requirements that are not present in the plain reading of the statute, thus making an inappropriate attempt to significantly limit the statute as enacted.

W. It is noted that the method of calculating the Investment Income Ratio Test as determined herein would in fact catch the transaction referred to in Acting Commissioner Billet's and the Office of Governor's letters. However, the actual statutory language used does not limit the statute to just that one type of transaction. Furthermore, the Division's January 31, 2008 guidance summarizing the legislative changes enacted in 2007, specifically addressed Tax Law § 660 (i), and in no way indicated that it was limited to just one specific type of transaction as petitioners claim (***see*** TSB-M-07[8]I).

X. Petitioners also argue that in a letter from one of the Division's auditors, the Division makes the admission that petitioners' approach of classifying the sale as a stock sale is correct. On March 2, 2015, Ms. Vicki Auerbach, a Tax Auditor I with the Division, wrote to Francoise LePage and indicated "[a]s supplied correspondence reiterates the income reported from the sale of this entity [Lapage, Inc.] represents a sale of stock which would fall under intangible property as does goodwill." Petitioners assert that this statement is a concession that the classification of the income as a sale of stock means it should not be treated as income from a sale of assets under IRC (26 USC) § 338 (h) (10).

However, the letter also notes:

> "After review of the supplied correspondence, it is the department's position that the sale of [Lepage, Inc.] does constitute investment income for purposes of *660(i) Mandatory New York S Corporation Election* (See attached TSB-M-07(8)I) and that this entity would be mandated to file as NYS S Corporation and that income from this entity reported by shareholders should be allocated to NY based on Business Allocation Percentages and should be billed accordingly." (March 2, 2015 letter from Ms. Vicki Auerbach, Tax Auditor I, New York State Department of Taxation and Finance, to Francoise LePage [emphasis in original])

A review of the subject letter indicates that enclosed with the letter was a copy of the

Summary of Budget Bill, Personal Income Tax Changes Enacted in 2007, and Treas Reg (26 CFR) § 1.61-6. It is clear that the auditor is attempting to convey the opinion that the sale of the stock is part of investment income under Tax Law § 660 (i). The auditor may not have properly articulated the legal analysis underlying the Division's classification of the sale of stock as a sale of assets, but it is clear the auditor was trying to explain the opinion that the transaction resulted in investment income under Tax Law § 660 (i). The petitioners' attempts to use a letter from an Auditor I, a staff level position, as dispositive proof that the transaction must be treated as a sale of stock for tax purposes, is misplaced.

Y. Petitioners cite to the Division's Publication No. 35 (New York Tax Treatment of S Corporations and Their Shareholders, dated January 3, 2000) to support their position that companies must be classified as C corporations for the Investment Income Ratio Test. In part, petitioners use Publication 35 and other documents, to advance the claim that a corporation is a New York C corporation by default before it can be converted to a New York S corporation. Although Publication 35 appears to have still been in circulation during the year at issue (2012), its statements must be put in context. It was published well before Tax Law § 660 (i) or the modifications to Tax Law § 632 (as discussed below) were passed. Publication 35 specifically states that "[i]t is not meant as a technical instruction guide but as a general overview which will help taxpayers determine whether to make the New York S election. Taxpayers who have New York S corporation issues not addressed in this publication should contact the Tax Department." Other statements in Publication 35 clearly establish that the publication was produced before major relevant changes were made to the Tax Law. Moreover, petitioners' argument that a New York corporation is first a C corporation by default does not change the conclusions found herein. That is, even if a corporation is a New York C corporation by default, and only switches

to a New York S corporation if it elects to do so, or alternatively if it triggers the mandatory Tax Law § 660 (i) election for purposes of the Investment Income Ratio Test, the federal gross income amount is taken from the eligible S corporation's federal S corporation tax return.

Petitioners' Additional Arguments Against the Analysis

Z. Petitioners argue that when calculating Lepage, Inc.'s, and Bakeast, Inc.'s, federal gross income amounts for the Investment Income Ratio Test, the calculations cannot treat the proceeds from the sale of stock as proceeds from the sale of assets based upon the holdings of ***Matter of Baum*** (Tax Appeals Tribunal, February 12, 2009) and ***Matter of Zweig Total Return Advisors, Inc. et al.*** (Division of Tax Appeals, December 16, 2004[6]). In ***Baum***, petitioners' position, in part, was based upon the Tax Law § 208 (9) (ii) requirement that a New York S corporation's "entire net income" is determined as if the S corporation was a C corporation for federal purposes ***(see Baum***). The ***Baum*** argument, in essence, appears to be that clause (ii) of Tax Law § 208 (9) permits a New York S corporation to compute its entire net income as if it had not made a subchapter S election; therefore the gain from the deemed asset sale is not included because an IRC (26 USC) § 338 (h) (10) election is not available to a C corporation. As a result, any gain resulting from an IRC (26 USC) § 338 (h) (10) transaction is not included in the entire net income of the New York S corporation for purposes of determining its New York State franchise tax under article 9-A of the Tax Law. Petitioners refer to ***Zweig*** for a similar holding.

In this case, petitioners assert that the ***Baum*** and ***Zweig*** analyses were never impacted by the legislative changes to Tax Law § 632 or the subsequent holding in ***Caprio v New York State***

[6] It is noted that determinations issued by administrative law judges, "shall not be cited" and "shall not be considered as precedent" (***see*** Tax Law 2010 [5]); petitioners appear to assert ***Baum*** and ***Zweig*** can be utilized for the same analysis sought with regard to the application of Tax Law § 208.

Dep't. of Taxation & Fin. (25 NY3d 744 [2015], ***rearg denied*** 26 NY3d 955 [2015]). The petitioners' argument in this regard might have merit if it was appropriate to use the New York C corporation pro forma tax numbers in performing the relevant Investment Income Ratio Test. However, neither the New York C corporation nor New York S corporation returns are the correct returns to utilize for the Investment Income Ratio Test; as noted, Tax Law § 660 (i) requires the use of the federal S corporation return data. Accordingly, petitioners' argument does not impact the outcome of this case.

Furthermore, the holding in ***Caprio*** does apply in this case as it impacted the holding in ***Baum***.

AA. In ***Baum***, the Tax Appeals Tribunal held that, notwithstanding an election under the provisions of IRC (26 USC) § 338 (h) (10), the substance of stock sale transaction, remained the sale of stock, and that since gains from the sale of stock are not New York source income to a nonresident, such gains were not required to be included in the New York entire net income of the subchapter S corporation, or to be passed through to the shareholders thereof.

At the time of the transaction in ***Baum,*** former Tax Law § 632 (a) (2) did not specifically address how a New York nonresident's gain from the sale of stock in a New York S corporation would be impacted where such a transaction was treated, pursuant to a valid IRC (26 USC) § 338 (h) (10) election, as a deemed sale of the assets, notwithstanding that the transaction was carried out (in fact) via the sale of the S corporation's stock.

In 2010, and specifically in response to the results in ***Baum*** and other cases, the Legislature amended Tax Law § 632 (a) (2), effective August 11, 2010, to address the issue of nonresident S corporation shareholders' treatment of income related to IRC (26 USC) §§ 338 (h)

(10) 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]).

In ***Caprio***, Philip Caprio, a nonresident of New York, sold all of the shares in an S corporation that earned income in New York. The parties to this sale jointly elected an IRC (26 USC) § 338 (h) (10) deemed asset sale treatment. Mr. Caprio reported no income or gain from the sale for New York purposes, upon the position that the same should be treated as proceeds of the sale of an intangible, i.e., stock, as opposed to the sale of assets, notwithstanding the deemed asset sale result afforded under the federal IRC (26 USC) § 338 (h) (10) election.

The ***Caprio*** court recognized, based on the Legislature's findings in support, that the 2010 amendments served to clarify and confirm the Division's longstanding correct interpretation, application and administration of existing law, whereby gains from a deemed asset sale under

IRC (26 USC) § 338 (h) (10) are not excluded from a nonresident's New York source income as gains from the disposition of stock, but rather are included to the extent of the S corporation's New York BAP.

In the case at hand, Lepage, Inc., and Bakeast, Inc., are required to file as New York S corporations because they triggered the mandatory Tax Law § 660 (i) election. The sale of stock is treated as the sale of assets because of the IRC (26 USC) § 338 (h) (10) election. Furthermore, the petitioners must include the income from the deemed sale of assets as income from a New York source.

Constitutional Claims

BB. Petitioners raise constitutional challenges to the tax imposed in this case. First, petitioners claim that it is not constitutionally appropriate to apply the State personal income tax to nonresident shareholders of a New York C corporation because, citing to ***S. Dakota v Wayfair, Inc.*** (138 S.Ct. 2080 [2018]), such an application allegedly violates the Commerce Clause of the U.S. Constitution which requires that the taxed activity have a "substantial nexus with the taxing state." Similarly, again citing to ***Wayfair***, petitioners argue that the Division's actions violate the Due Process Clause of the U.S. Constitution because that provision requires that there be "some definite link, some minimum connection, between a state and the person, property or transaction its seeks to tax." In support of these positions, petitioners again cite to New York State Department of Taxation and Finance Publication No. 35 (New York Tax Treatment of S Corporations and their Shareholders [January 3, 2000]) and note that if the New York S election is not made, "nonresident shareholders are not subject to [New York] tax."

The publication states:

> "The mere ownership of C corporation stock by a nonresident does not create tax jurisdiction under the New York personal income tax. As previously discussed, an S corporation which is a New York C corporation is viewed as a C corporation for New York tax purposes. Accordingly, nonresident shareholders of such a New York C corporation are not subject to tax on S corporation income" (New York State Dept. of Taxation and Finance Publication No. 35 [January 3, 2000]).

Petitioners argue that "a New York S election is an explicit consent by a nonresident individual to be subject to tax (i.e., have nexus) in New York." Petitioners claim that without that "explicit consent," the State does not have the requisite nexus to subject nonresident individuals to taxation.

CC. This forum does have jurisdiction to consider whether the application of a statute to a particular set of facts is unconstitutional (***see Matter of Eisenstein***, Tax Appeals Tribunal, March 27, 2003; ***Matter of David Hazan, Inc.***, Tax Appeals Tribunal, April 21, 1988, ***confirmed sub nom Matter of David Hazan, Inc. v Tax Appeals Trib. of State of N.Y.***, 152 AD2d 765 [3d Dept 1989], ***affd*** 75 NY2d 989 [1990]). The above constitutional arguments made by the petitioners appear to set forth "as applied" challenges and as such will be addressed herein. Tax Law § 208 (1-A) provides in relevant part:

> "The term 'New York S corporation' means, with respect to any taxable year, a corporation subject to tax under this article for which an election is in effect pursuant to subsection (a) of section six hundred sixty of this chapter for such year, any such year shall be denominated a 'New York S year', and such election shall be denominated a 'New York S election'. The term 'New York C corporation' means, with respect to any taxable year, a corporation subject to tax under this article which is not a New York S corporation..." (Tax Law § 208 [1-A]).

As discussed above, after application of the Investment Income Ratio Test of Tax Law § 660 (i) for the year at issue, Lepage, Inc., and Bakeast, Inc., were required to become New York

S corporations. Therefore, petitioners' analysis, in as much as it pertains to New York C corporations is misplaced because the entities were no longer New York C corporations; they were New York S corporations. Petitioners also allege that imposing a tax on nonresident shareholders of a New York S corporation is unconstitutional under the Commerce and Due Process Clauses because New York allegedly does not have nexus over such parties.[7]

In this case it appears uncontested that both Lapage, Inc., and Bakeast, Inc., operated in New York State, derived receipts from New York State, voluntarily reported BAPs allocating a portion of their receipts to New York State, and filed New York State tax returns for the year at issue, 2012.

The parties did not provide specific details for the income allocations made to petitioners. However, resident and nonresident shareholders of New York S corporations pass-through items of income, gain, loss and deductions to the shareholders themselves, keeping the federal tax character that the S corporation had in such items (***see*** Tax Law § 660). Nonresident shareholders then allocate income to New York based upon a State allocation percentage.

DD. In ***Matter of Shell Gas*** (Tax Appeals Tribunal, September 23, 2010), the Tribunal addressed the constitutionality of the taxation of nonresidents that receive income as shareholders of a limited liability company (LLC), a pass-through entity, operating in New York. In ***Shell Gas***, the Tribunal rejected the argument that petitioners had no presence in New York State and thus were not responsible for taxes on New York income that was passed-through to them as shareholders of an LLC that conducted business within the State. The Tribunal determined that

[7] As the Division notes in its brief, this argument appears to only pertain to petitioners Francoise LePage and the Jalberts. Petitioners Andrew Barowsky and Albert LePage voluntarily filed New York nonresident and part-year resident New York State income tax returns (form IT-203), for the tax year at issue, 2012, and self-reported New York sourced income unrelated to the sale, thereby presumably conceding New York's nexus over them as taxpayers.

when accounting for pass-through income, the Commerce and Due Process Clause tests are applied against the pass-through corporation itself and the determination needs to be made whether the requisite tests are met by that corporation. In this case that would be Lepage, Inc., and Bakeast, Inc. Based upon the facts stipulated to, including the fact that the corporations already filed State tax returns in New York for the year at issue, those entities clearly meet the four-prong test established in ***Complete Auto Transit*** (430 US 274 [1977]), and the substantial nexus and minimum connections tests as interpreted by ***Wayfair***.

EE. Petitioners fail meet the substantial burden in seeking to limit the application of Tax Law § 632 only to shareholders who affirmatively elect to have their corporations become New York S corporations. Furthermore, in that regard, most states have laws that automatically require federal S corporations to be treated as a state S corporation. Petitioners cite to no authority challenging such laws. The mandatory S corporation election of Tax Law § 660 (i) is similar in regard to many other states requiring mandatory state S corporation classification.

FF. Petitioners also argue that the mandatory S corporation treatment of them violates the Equal Protection clauses of the United States and New York Constitutions because the S corporation mandate can be applied against shareholders that own shares of an article 9-A corporation but not against shareholders that own shares of an article 32 corporation. Petitioners' argument in this regard amounts to a facial challenge to the laws at issue, and the Division of Tax Appeals lacks jurisdiction to consider facial validity challenges of statutes (***see Matter of Fourth Day Enters.***, Tax Appeals Tribunal, October 27, 1988).

However, even if petitioners' challenge was against the statute "as applied," petitioners' own brief notes that there were "meaningful difference[s]" between the taxation of article 9-A

and article 32 corporations during the year at issue.[8] Statutes that do not discriminate against a protected class or impair a fundamental right are subject to only rational basis review (***see Executive Land Corp. v Chu***, 150 AD2d 7, 12 [2d Dept 1989]). "[I]n taxation, even more than in other fields, legislatures possess the greatest freedom in classification" (***Madden v Kentucky***, 309 US 83, 88 [1940]). "[T]he equal protection clause does not prevent State Legislatures from drawing lines that treat one class of individuals or entities differently from others unless the difference in treatment is palpably arbitrary or amounts to invidious discrimination" (***see Trump v Chu***, 65 NY2d 20, 25 [1985], ***appeal dismissed*** 474 US 915 [1985]; ***see also Brady v State of New York***, 80 NY2d 596, 604-605 [1992], ***cert denied*** 509 US 905 [1993]). As a general rule, "legislatures are presumed to have acted within their constitutional power despite the fact that, in practice, their laws result in some inequity" (***see Nordinger v Hahn***, 505 US 1 [1992], citing ***McGowan v Maryland***, 366 US 420, 425-426 [1961]). The Equal Protection clause is satisfied "so long as there is a plausible policy reason for the classification" ***(see Nordinger***, citing ***U.S. Railroad Retirement Bd. v Fritz***, 449 US 166, 174, 179 [1980]).

The many differences between the taxation of companies subject to article 9-A as opposed to companies subject to article 32 provide a clear basis to justify treating the shareholders of such entities differently for taxation purposes based upon those classifications alone.

GG. Lepage, Inc., and Bakeast, Inc., should be treated as S corporations for purposes of recalculating their corporate franchise tax under article 9-A for tax year 2012, subject to the terms agreed upon by the parties in findings of fact 64, 65 and 66.

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[8] Banking corporations were subject to article 32 during the year at issue. However, banking corporations are no longer treated separately under the Tax Law and are now subject to taxation under article 9-A.

HH. The petitions of Albert R. LePage, Francoise O. LePage, Andrew Barowsky, and Ronald A. and Mariette P. Jalbert are denied, and the notices of deficiency dated October 12, 2016 are sustained. The notice of deficiency for Albert R. LePage is subject to the agreed upon terms expressed in findings of fact 68, 69, 70 and 71.

II. Petitioners April 8, 2019 motion for summary determination is denied.

DATED: Albany, New York
December 19, 2019

/s/ Nicholas A. Behuniak
ADMINISTRATIVE LAW JUDGE