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No Repose on 338(h)(10) Elections: New York's Retroactive 'Correction'

by Timothy P. Noonan and Joshua K. Lawrence

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In 2010 the New York State Legislature enacted a statutory amendment that altered the way nonresidents of New York are taxed on the sale of stock in an S corporation when they make a federal 338(h)(10) election.[1] We didn't give it too much thought at the time, other than to remark that the stated purpose of the amendment (in the Legislature's words) was to "correct" the ruling in a case our firm had litigated and won in 2009.[2] But recently the effect of that law — and in particular, its retroactive application — is beginning to be felt. Auditors in the New York State Department of Taxation and Finance are now applying the 2010 legislation retroactively to prior tax years against nonresident taxpayers who sold S corporation stock years ago under a 338(h)(10) election. We suspect that there are many nonresidents out there with potentially significant tax exposure on this issue. And since it raises important questions about the constitutionality of retroactively applied tax legislation, we thought we'd give it a closer look.

The tax department's attempt to apply the 2010 legislation to transactions taking place as far back as 2007 raises two basic questions. The first is whether a state legislature dissatisfied with a judicial construction of an existing tax statute may later address the discrepancy by amending the statute. That's an easy one. Of course, it can. But the second question is more difficult. That is whether a legislature can apply a curative or "clarifying" amendment *retroactively* to cover tax years before its enactment — especially when a court has already judicially construed the scope and application of the statute as it previously existed. The 2010 amendment, which was passed to annul the New York Tax Appeals Tribunal's decision in *Matter of Baum*,[3] and the tax department's application of the law retroactively to old and closed transactions, provide the perfect context in which to examine that question more closely.

The *Baum* Saga

We discussed the *Baum* decision at length in this column after the case was decided in 2009, looking at the various issues it raised and resolved regarding how New York treats S corporation shareholders who sell stock under a federal 338(h)(10) election.[4] In a nutshell, the tax appeals tribunal held that a nonresident who sells stock under a 338(h)(10) election is treated as having merely sold stock (an intangible asset) and not the corporation's assets — even though the federal election creates a fictitious sale of the company's assets followed by a fictitious liquidation in exchange for stock to achieve the desired federal tax benefits. To a nonresident of New York, the distinction between a sale of stock and a sale of assets is significant. That's because under the

[1]*See* L. 2010 Ch. 57, Pt. C.

[2]*Matter of Gabriel S. and Frances B. Baum*, N.Y. Tax Appeals Tribunal, Feb. 12, 2009. (For the decision, *see Doc 2009-6709* or *2009 STT 57-21*.)

[3]*Id.*

[4]Timothy P. Noonan, Christopher L. Doyle, and Maureen R. Monaghan, "Noonan's Notes on Tax Practice — New York Section 338(h)(10) Elections on the Sale of S Corporation Stock," *State Tax Notes*, Apr. 27, 2009, p. 324, *Doc 2009-8889*, or *2009 STT 79-31*.

laws governing the allocation of nonresidents' income — both before and after *Baum* — a nonresident generally cannot be taxed on gains from the sale of intangible property such as stock; however, a nonresident *is* subject to tax on the sale of tangible assets located in New York.

The tribunal in *Baum* construed the statutes then governing the computation and allocation of an S corporation's income and the income of its shareholders as precluding the recognition of the fictitious asset sale and liquidation created by a federal 338(h)(10) election. Thus, the tribunal held that a nonresident shareholder of an S corporation selling shares under that election could not be treated as having realized taxable gain or loss from the sale of New York assets rather than nontaxable stock. The tribunal's decision affirmed a December 2007 determination by an administrative law judge.

> ***Can a legislature apply a curative or clarifying amendment*** **retroactively** ***to cover tax years before its enactment?***

Shortly after the 2009 decision in *Baum*, the Legislature introduced a bill to amend N.Y. Tax Law section 632(a)(2) to declare that New York conforms to the federal treatment when it comes to 338(h)(10) elections, and nonresidents who sell shares under that election are bound by the federal treatment. The legislation was enacted in 2010 as part of the state's 2010-2011 budget bill.[5] The Legislature made no bones about the purpose of the legislation: It was to reverse the tribunal's decision in *Baum*. In fact, the Legislative Findings accompanying the amendments acknowledged that:

> The legislature finds that it is necessary to correct a decision of the tax appeals tribunal . . . that erroneously overturned longstanding policies of the department of taxation and finance that nonresident subchapter S shareholders who sell their interest in an S corporation pursuant to [IRC section 338(h)(10)] are taxed in accordance with that election and the transaction is treated as an asset sale producing New York source income.[6]

The August 2010 amendment specified that it would take effect immediately, but more importantly, in its final form it declared the amendment would apply to tax years beginning on or after January 2007 — a three-year period of retroactivity.[7] Nothing in the Legislative Findings directly addresses the retroactivity, but the findings do say that:

> [The amendment] 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.[8]

How It Plays Out

Let's consider a hypothetical transaction. In January 2008 Sam Sellers, a nonresident of New York, entered into a preliminary agreement to sell an S corporation in which he owned 100 percent of the outstanding shares and that did business partly within New York. The deal was originally contemplated as a straight sale of stock. But during the later negotiations, the buyer indicated a desire to make an election to treat the stock sale as a sale of assets under IRC section 338(h)(10). The critical benefit of that election for a buyer, as most practitioners are aware, is that the fictional *deemed* asset sale allows the buyer to acquire a stepped-up basis in the assets of the underlying company — something unavailable via a straight sale of stock. Sam agreed to make the election on one condition: Any negative tax consequences of the election on him as the seller (state or federal), would be borne by the buyer, either through an increase in the purchase price or by indemnification. That is a normal concession in almost all section 338(h)(10) transactions, so the buyer agreed. In an attempt to quantify the amount of additional tax that might result, Sam and his tax adviser then researched the law on section 338(h)(10) elections at the time. In 2008 they would've found that the section 338(h)(10) election had no New York effect because the law would still treat the sale as a sale of stock for New York purposes. And if they were really good, they would have found the ALJ's decision in *Baum*, issued in the latter part of 2007, which said the same thing. So based on that research, Sam agreed to the section 338(h)(10) election without requiring additional purchase money or indemnification from the buyer.

Fast-forward to 2011. Based on the new 2010 law, Sam receives a notice of a proposed assessment from a New York auditor, claiming that he failed to properly allocate the gain from the 2008 sale of his business on his 2008 nonresident tax return. Now Sam is faced with an out-of-pocket cost on a transaction that took place more than three years ago —

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[5]L. 2010 c.57, pt. C.

[6]*Id.* at section 1 (Legislative Findings).

[7]Originally, the statute was to have applied to *all* tax years for which the statute of limitations for refund or assessment were still open, but that period was later modified to the three-year period back to 2007. *See* L. 2010 c. 12, pt. B, section 1.

[8]L. 2010 c. 57, pt. C, section 1 (Legislative Findings).

and no chance to get the recovery he could have been entitled to back when the deal was negotiated.

This is a hypothetical, but we wouldn't be shocked if similar stories are playing out in real life around the state. (Probably because we've actually seen it happen!)

When Is Retroactivity OK?

The validity and propriety of retroactive tax laws is not a new topic; in fact, a large body of case law has developed around it.[9] The question comes down to one of constitutional due process. Whether retroactive tax legislation can withstand due process scrutiny generally depends on whether, "consider[ing] the nature of the tax and the circumstances in which it is laid . . . the retroactive application is so harsh and oppressive as to transgress the constitutional limitation."[10] New York's Court of Appeals has adopted essentially the same formulation as expressed by the U.S. Supreme Court, saying that a determination of whether a retroactive tax statute is sufficiently "harsh and oppressive" in its application is a "question of degree," requiring a "balancing of equities."[11]

The Court of Appeals applied those concepts in 1942 to an action similar to the *Baum* saga. In *Lacidem Realty Corp. v. Graves*,[12] the Legislature had taken issue with a 1940 Court of Appeals ruling[13] that construed New York City's utility tax to exclude landlords who charge their tenants for submetered electricity. The Legislature had responded to that decision by adopting a law in 1941 stating that submetering receipts by landlords *were* subject to the utility tax and were intended to have been taxable with the original adoption of the utility tax in 1937. The court found that rather than a clarification, the 1941 amendment was instead "an attempt to atone for past omissions by making the new provisions retroactive" and found the five-year period of retroactivity to be overly harsh and oppressive and to violate due process.[14]

In a decision issued just last November, New York's Appellate Division clearly enunciated three equitable factors to be weighed in determining whether retroactive application of a taxing statute offends due process. In *James Sq. Associates et al. v. Mullen*,[15] the court found that a 2009 amendment changing the minimum criteria for participation in New York's Empire Zone tax incentive program could not be applied retroactively to 2008 to disqualify the plaintiffs, whose businesses had satisfied all the previous criteria for that year. In reaching that conclusion, the court applied three equitable factors to be weighed in making such a decision: (1) whether the taxpayer was forewarned of the change so that it was unreasonable to rely on the old law; (2) whether the length of the retroactivity was excessive; and (3) whether retroactive application of the new law serves some legitimate public purpose.[16]

In *James Square*, the court found that none of those factors weighed in New York's favor. Perhaps most importantly, the court found that businesses like the plaintiffs' had no forewarning that the minimum standards for obtaining lucrative Empire Zone tax credits would change, either prospectively or retroactively, and thus the plaintiffs had not merely been enjoying a continuing benefit provided by a tax statute. Rather:

> they were induced to conduct their business activity in a particular way in disadvantaged areas in reliance upon the availability of [Empire Zone] tax credits. Under the circumstances, those tax credits 'have induced action in reliance thereon [and thus] . . . may not be invalidated by subsequent legislation.'[17]

The Appellate Division also found that the 16-month period of retroactive applicability of the Empire Zone statute was excessive when considered in light of the plaintiffs' notice and their reliance on prior law. Finally, the court also disputed whether there was a legitimate public purpose supporting the retroactivity, finding that the Legislature's stated purpose of raising additional revenue, "balanced against the inequity to plaintiffs, is insufficient."[18]

What About the *Baum* Legislation?

Does a similar balancing of the equities validate New York's three-year retroactive legislation regarding 338(h)(10) elections? We think not. Much like the plaintiffs in *James Square*, the taxpayer in our hypothetical could make a legitimate claim he was induced to structure a multi-million-dollar sale of his business in a particular way (namely agreeing to forgo indemnification or additional purchase money) because of his reliance on the law as it stood at the time of the transaction. With no forewarning that

[9]*See, generally, United States v. Carlton*, 512 U.S. 23 (1994); *Welch v. Henry*, 305 U.S. 134 (1938); *Replan Dev., Inc. v. Dep't of Hous. & Preserv. & Dev. of City of N.Y.*, 70 N.Y.2d 451 (1987).

[10]*Welch*, *id.*, at 147.

[11]*See Replan Dev.*, *supra* note 9, at 455.

[12]288 N.Y. 354 (1942).

[13]*Matter of 436 W. 34th Street Corp. v. McGoldrick*, 288 N.Y. 346 (1942).

[14]*Lacidem Realty*, 288 N.Y. at 357.

[15]91 A.D.3d 164 (N.Y. App. Div. 2011).

[16]*Id.* at 173 (citing *Replan Dev.*, *supra* note 9).

[17]*Id.* (citing *People v. Brooklyn Garden Apts.*, 283 N.Y. 373).

[18]*See Replan Dev., supra* note 9, at 173-74.

the law would be amended more than two years later (in response to a yet-to-be issued Tribunal decision), the taxpayer would certainly have thought it reasonable to rely on the law as it stood. Even though the Legislature in 2010 made it known that it considered the tribunal and ALJ's construction of the prior law to be "erroneous" and against "long-standing policy," it is well settled that even in the context of a "clarifying" amendment, "the Legislature has no power to declare, retroactively, that an existing statute will receive a given construction when such construction is contrary to that which the statute would ordinarily have received."[19] Calling the reversal of a binding judicial determination a "correction" doesn't change things, because a decision by the tax appeals tribunal on an issue (here the statutory construction of the Tax Law before 2010) "finally and irrevocably" settles the issue as a matter of law.[20] Indeed, like the U.S. Supreme Court, the tribunal isn't last because it is right. It is right because it is last!

The length of the retroactivity for the *Baum* legislation — more than three full tax years — also raises concerns. According to the Court of Appeals, what makes the length of retroactivity "a crucial factor" in these cases is that excessive periods "deprive taxpayers of a reasonable expectation that they will secure repose from the taxation of transactions, which have, in all probability, been long forgotten."[21] Thus, courts have generally upheld tax legislation enacted during a tax year and made retroactive to the beginning of the tax year — or even the prior year — to be valid.[22] Here, any repose nonresident taxpayers may have enjoyed — and planned around — as far back as 2007 stands to be interrupted by tax assessments based on a statement of the law in 2010.[23]

Which brings us to public purpose. Given that the Legislature passed the 2010 amendment ostensibly to "prevent confusion in the preparation or returns, unintended refunds, and protracted litigation," we're unsure how assessing tax in 2012 on four- or five-year-old transactions serves that purpose. If anything, a policy of auditing long-closed S corporation transactions under the 2010 amendment *invites* protracted litigation on the resulting assessments.

Estoppel Argument

Speaking generally, there is also a whole other legal avenue that taxpayers faced with retroactive actions by a tax department can employ: the doctrine of estoppel. We had experience with an estoppel-type action years ago in *Matter of Reiner*.[24] In *Reiner*, the taxpayer successfully used an estoppel argument against the retroactive application of a change in the tax department's regulations that resulted in significant additional tax to the taxpayer. There, the taxpayer had planned his residency change to Florida around an existing tax department regulation providing for the nontaxability of gains flowing through to him from an S corporation as long as he was out of New York by a specific date. The taxpayer planned his move to Florida in consultation with his accountants and around those regulatory rules, only to find out that, years later, the tax department changed the regulation. Under the new regulation, it didn't matter whether the taxpayer was out of New York by a specific date during a tax year. Instead, his gain was required to be prorated throughout different portions of the tax year under the new formulation. That resulted in the taxpayer having a huge additional tax liability to New York. Had he known about that proration rule, he could have easily structured his move to Florida for a much earlier date. In a rare move, though, an ALJ in the Division of Tax Appeals used the estoppel doctrine against the tax department, refusing to allow the retroactive application of the regulation against the taxpayer.

Three requirements must be satisfied in order for estoppel to be invoked: (1) the taxpayer must have had a right to rely on a representation made by the tax department; (2) there must have been actual reliance on that representation; and (3) that reliance must have been to the detriment of the taxpayer relying on the representation.[25] In *Reiner*, the ALJ found that the taxpayer had relied on a regulation specifically adopted to address situations such as the taxpayer's, involving the effect of a midyear residency change. Further, the judge acknowledged that the taxpayer and his wife tailored and timed their change of domicile to Florida to achieve a tax result, "in clear reliance" on the regulation. Finally, that reliance was to the taxpayer's detriment, because he would have been able to act differently had he known the rule was going to be changed.

It would seem the same rationale from *Reiner* could apply to a taxpayer faced with a retroactive attack based on the *Baum* legislation. For instance, in most transactions in which a 338(h)(10) election is

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[19] *Matter of Roosevelt Raceway v. Monaghan*, 9 N.Y.2d 293, 304, *appeal dismissed* 368 U.S. 12.

[20] *See* N.Y. Tax Law section 2016.

[21] *Replan Dev.*, *supra* note 9, at 456.

[22] *See, e.g.* Welch 305 U.S. at 126.

[23] Of course, New York's three-year statute of limitations on assessments still applies, making 2007 (and for some taxpayers, 2008) now generally incapable of being opened, unless the statute was extended by consent.

[24] Admin. Law Judge Determination, July 13, 2006.

[25] *See Matter of Consolidated Rail Corp.*, Tax Appeals Tribunal, Aug. 24, 1996, *aff'd* 231 A.D.2d 140 (3rd Dept 1997).

made, the parties are able to negotiate so that the seller is made whole as a result of the additional state or federal tax that could apply as a result of the election. Before the law changed, of course, taxpayers investigating the New York taxability of a 338(h)(10) election to a nonresident would find that there would be no additional tax liability — the *Baum* decisions make that clear. Thus, taxpayers like the one in the hypothetical above would have taken no additional steps in the negotiation process to be made whole as a result of any additional state tax resulting from the 338(h)(10) election. If the Legislature decides to retroactively change that rule years later, those taxpayers are in a tough spot. They have lost the ability to renegotiate the deal (since it closed years earlier), and under the new formulation of the rules, they now owe additional state tax precisely because of the 338(h)(10) election. Frankly, this looks like a classic estoppel case: taxpayers reasonably relied on the old tax law in making sound business decisions; the reliance was justified; and that reliance is now to their detriment, since they are unable to be made whole for the tax the tax department now asserts is due.

All courts recognize that enforcing an estoppel doctrine against a taxing jurisdiction is a heavy lift. But it has been done before, as *Reiner* demonstrates, and the type of situation we've been examining here with the enforcement of the *Baum* legislation seems to create another custom-made estoppel case.

Conclusion

We know the tax department is now attempting to retroactively enforce the *Baum* fix in a few open cases. We assume that even more are out there. The case law suggests, however, that this type of action is subject to attack. Although retroactivity in taxing provisions may be valid in some cases, it doesn't appear that there is any basis to conclude so for the application of the *Baum* legislation to assess tax on long-closed transactions. So onward and upward. Taxpayers faced with the prospect of those retroactive assessments shouldn't give up. ✰

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