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New York Section 338(h)(10) Elections on the Sale of S Corporation Stock

by Timothy P. Noonan, Christopher L. Doyle, and Maureen R. Monaghan

In 2001 Gabriel Baum and Christian Boegner (the petitioners), nonresidents of New York, sold all their stock in SBS International of New York Inc. (SBS), an S corporation doing business primarily in New York. Since they were not New York residents, the gain they recognized from the sale would ordinarily have been excluded from tax under New York's tax law, which provides that gain or loss from the sale of stock, an intangible, is sourced to the taxpayer's domicile.

In this instance, however, the purchasers and sellers of the SBS stock made a valid election under Internal Revenue Code section 338(h)(10). Under this election, the target corporation is deemed to have sold all of its assets to itself as a new corporation and then distributed the proceeds to its shareholders in a deemed liquidation. The target corporation must include (and flow through to the selling shareholders) the gain on the deemed sale of its assets in its federal tax report, and the shareholders do not recognize gain on their sale of the stock. Also, the purchaser receives a stepped-up basis in the acquired assets equal to the stock purchase price.

Thus, a 338(h)(10) election essentially divides a one-step stock sale into two separate fictional transactions entered into by the selling corporation: a deemed asset sale and a deemed liquidation in which the proceeds of the deemed asset sale are distributed to the shareholders in exchange for their stock. For federal tax purposes, SBS recognized a gain on the deemed asset sale that flowed through to the petitioners. The gain the petitioners recognized increased their bases in their SBS stock. The petitioners therefore recognized a loss from the deemed liquidation of SBS. For federal tax purposes, that loss partially offset the gain recognized from the deemed asset sale.

But what is the proper New York tax treatment?

The New York state tax treatment of a nonresident individual may differ significantly depending on whether stock or assets are sold. In effect, New York taxes nonresidents by having them compute their tax as if they were residents and then allocate the tax to New York using a "source fraction," the numerator of which is New York adjusted gross income from only New York sources and the denominator of which is New York AGI from all sources. Under New York's tax law, the gain or loss recognized from the sale of S corporation assets is sourced to New York based on New York's corporate income tax rules for apportionment of income. However, gain or loss recognized by a nonresident individual from a stock sale is sourced to the taxpayer's domicile. In *Baum*, the New York Department of Taxation and Finance honored the 338(h)(10) election and treated the stock sale by the nonresident petitioners as two discrete and unrelated fictional transactions. Accordingly, the department sourced to New York the gain the petitioners recognized from the deemed asset sale in accordance with SBS's business allocation percentage. The loss recognized from the deemed liquidation of the SBS stock, however, was sourced outside New York as a loss recognized from the exchange of an intangible. As a result, the department denied the petitioners the ability to offset the gain they recognized on the deemed asset sale with the loss they recognized on the deemed liquidation of their stock, in stark contrast to the federal tax treatment, which permitted the offset.

Many aspects of the tax division's proposed disparate tax treatment of the transaction are troubling. For example, the loss recognized by the petitioners on the deemed liquidation of SBS was entirely attributable to the gain recognized on the deemed asset sale, and New York's tax law requires consistent sourcing of gains and losses. Also, if the petitioners had been New York residents, the loss recognized on the deemed stock liquidation would have been sourced to New York and thus be fully deductible. Consequently, the division's tax treatment of the transactions categorically placed the petitioners in a worse tax position than if they had been residents. Had the result of the audit withstood judicial review,

one of the petitioners, as a nonresident, would owe almost two and a half times the tax computed as if he were a resident. By sourcing the loss recognized on the deemed stock liquidation outside New York, the division asserted additional tax against one petitioner based on 245.39 percent of his income (by comparison, tax is imposed on 100 percent of the income of a resident) and against the other petitioner based on 112.43 percent of his income.

At the hearing level, the administrative law judge struck down the division's assessment on statutory grounds by determining that the federal 338(h)(10) election should not be honored for New York state tax purposes, at least for nonresident shareholders. The ALJ found that for sourcing purposes, the tax law requires that an S corporation compute and apportion its income as if it had not made a subchapter S election. Here, if SBS had not made a subchapter S election and were treated as a C corporation, it would be ineligible to make a 338(h)(10) election, because under the Internal Revenue Code, those elections are available only when the target corporation is an S corporation or a member of a selling consolidated group of corporations. Since SBS was treated as a stand-alone C corporation for purposes of the apportionment rules under New York's corporate income tax, the ALJ determined that the two federal tax fictional transactions should be disregarded and that the petitioners' stock sale should be treated as such. Because any gain recognized from the stock sale would be sourced outside New York, the petitioners were not required to include any income from the transaction as New York-source income for New York tax purposes.

The ALJ addressed none of the other issues the petitioners raised. Recently the Tax Appeals Tribunal affirmed the ALJ's decision, but also declined to discuss the additional issues. (For the tribunal's decision, see *Doc 2009-6709* [**PDF**] or *2009 STT 57-21*.)

Although the tribunal's affirmance in favor of the petitioners necessarily resolves the narrow issue of the proper treatment of nonresident shareholders, several significant questions remain. Is a loss recognized by a nonresident from the sale or exchange of a capital asset sourced to New York if most of the cost basis is from income previously subject to New York tax? Does the tribunal's decision have any ramifications for resident selling shareholders? What happens to the corporation after a 338(h)(10) election? Does it not receive the basis step-up that is one federal tax consequence of a 338(h)(10) election? Could the division impose the tax law in a way that categorically treats nonresident sellers of S corporation stock worse than resident sellers? The rest of this article briefly examines two of those issues.

Gains and Losses Arising From the Same Source Should Be Allocated to the Same Source

Under section 631(b)(4) of the tax law, nonresidents may take deductions for capital losses if the losses are "based solely on income, gain, loss and deduction derived from or connected with New York sources." At least a portion of the capital losses recognized by the petitioners on the deemed liquidation was based solely on the gain they recognized for federal tax purposes on the deemed asset sale, because that gain caused the petitioners' bases in their SBS stock to increase. That basis increase, in turn, was the proximate cause of the loss recognized for federal tax purposes on the deemed liquidation. In other words, without the basis increase that resulted from the deemed asset sale gain, there would have been no loss recognized. Thus, if the gain is sourced to New York, it seems contrary to the tax law, established principles of equity, and common sense to source the corresponding loss outside New York, because both the loss and the gain arise out of the same transaction. Neither the ALJ nor the tribunal addressed that issue, so one is left to wonder whether a New York-source loss might result from the sale of a capital asset whose basis is composed of income that was New York-source income.

Take, for instance, an S corporation whose sole owner is a nonresident. The corporation's only asset is New York real property that is worth $1 million but is fully depreciated so that the corporation's basis in the real property is nil. The real property is unencumbered, and the shareholder recently purchased her shares for $800,000, an amount somewhat less than the value of the real property. If the corporation sells the real property for $1 million and distributes the proceeds in full liquidation, for federal tax purposes, the shareholder has a gain of $200,000 calculated as follows: $1 million of flow-through gain from the S corporation (which also increases her basis in her S corporation shares from $800,000 to $1,800,000) less the $800,000 loss recognized on the liquidation (that is, the excess of her basis in her shares over the $1 million distributed to her by the corporation). But what are the New York tax consequences to the nonresident shareholder?

The tax department would likely say that the shareholder must treat the $1 million of flow-through gain as New York-source income, but that it would get no offsetting loss on the liquidation. And the overall result is that the nonresident gets taxed by New York on five times as much income as she would have been taxed on had she been a resident. Can that be right? Because a majority (ten-eighteenths) of her basis is from income taxed in New York, one would think that at least ten-eighteenths of the loss should be treated as arising from New York sources.

Nonresidents Should Never Pay More Tax Than if They Were Residents

In *Baum* the petitioners also argued that taxing them more than they would have been taxed as residents would violate the privileges and immunities clause of the U.S. Constitution, which provides that "the Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several states."[1] That clause has been used for over 135 years to strike down taxing schemes that discriminate against nonresidents. For example, in *Ward v. Maryland*,[2] the U.S. Supreme Court held that the privileges and immunities clause "plainly and unmistakably secures and protects the right of a citizen of one State . . . to be exempt from any higher taxes or excises than are imposed by the State upon its own citizens." The ALJ and the tribunal did not address that issue.

There are constitutional cases involving other jurisdictions that support the taxation of nonresidents at an effective rate higher than what would have pertained had the taxpayer been a resident. However, all of those cases involve laws that directly applied the tax rate to income from in-state sources. New York's current derivative method of nonresident taxation -- the computation of tax "as if a resident" followed by the apportionment of the tax to New York using a source fraction -- is materially different than the laws considered in those earlier cases. New York's current method was developed to ensure that nonresidents paid tax at the same rates as residents. Thus, those cases involving taxation of nonresidents based on the direct application of the tax rate to in-state income are easily distinguished. And a recent case suggests that the privileges and immunities clause might have some application to cases like *Baum.*

In *Lunding v. New York Tax Appeals Tribunal*,[3] the U.S. Supreme Court struck down a provision of the New York tax law that denied to all nonresidents an income tax deduction for alimony payments. New York had sought to justify its discriminatory treatment of nonresidents by asserting that alimony deductions are purely personal in nature and are, as such, wholly (and in all cases) unconnected with the production of income in New York. Consequently, New York maintained that since it could not legally tax non-New York-source income, it also could not recognize those non-New York-source deductions. The Court rejected those asserted justifications and ruled that New York had failed, in light of the law's practical effects, to justify its discriminatory treatment of nonresidents. The Court did so for the following three reasons:

- New York's blanket denial of alimony deductions for all nonresidents was impermissible because states may only "limit nonresidents' deductions of business expenses and nonbusiness deductions based on the relationship between those expenses and in-state property or income."
- The Court was unable to find a rationale for New York's blanket denial of alimony deductions for nonresidents either in the statute's language or its legislative history.
- The Court recognized situations in which the statutory disallowance of alimony deductions for nonresidents could "operate to require nonresidents to pay significantly more tax than identically situated residents." In particular, the Court noted that the law could cause some nonresidents to have a New York-source fraction in excess of 100 percent, "thereby requiring that individual to pay more tax than an identically situated resident, solely because of the disallowed alimony deduction."

Lunding provides support for the view that the use of a source fraction in excess of 100 percent violates the privileges and immunities clause. In particular, the Court's third rationale seems to suggest that source fractions in excess of 100 percent, without a compelling reason for the discrimination against nonresidents, are constitutionally problematic.

Baum was a great taxpayer victory. But it leaves many questions unaddressed and even raises some new ones.

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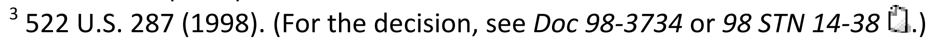
FOOTNOTES

[1] U.S. Constitution Article IV, section 2.

[2] 79 U.S. 418 (1870).

[3] 522 U.S. 287 (1998). (For the decision, see *Doc 98-3734* or *98 STN 14-38* .)



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