The Emperor Strikes Back in *Caprio*

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In this edition, the authors discuss a recent New York Court of Appeals decision upholding the retroactive application of a tax law amendment, and note several ways in which the decision should be troubling for taxpayers.

As recently as two years ago, the New York Court of Appeals wrote that "for centuries our law has harbored a singular distrust of retroactive statutes."[1] We suppose it's true what they say — that all good things must come to an end. A newly issued decision by that same court, the highest in the state, seems to have turned that principle on its head. We are troubled by the court of appeals' recent decision in *Matter of Caprio v. New York State Department of Taxation & Finance*.[2] Some might say this opinion gives New York state carte blanche to enact retroactive tax legislation anytime it (or more accurately, the Department of Taxation and Finance) disagrees with an administrative decision by the State's Division of Tax Appeals (DTA). The decision also appears to be an affront to the DTA process, potentially offering the tax department the ability to appeal adverse decisions of its own internal appeals agency through the legislative process.

New York calls itself "The Empire State," which begs the question: Who is the emperor? Based on *Caprio*, the answer appears to be the commissioner of taxation and finance. In this article, we'll take a closer look at *Caprio* and provide some thoughts on the effect this case could have on the tax department's retroactive application of tax law amendments in other cases.

I. Undoing the *Caprio* Transaction

In a nutshell, *Caprio* involved the question whether the amendments to New York's personal income tax law enacted in 2010 could, as a constitutional matter, be retroactively applied to tax nonresidents who sold shares in S corporations years earlier. The court of appeals said that retroactivity did not offend constitutional due process, at least with regard to the taxpayer in the case.

We wrote briefly about the first *Caprio* decision, reached in the New York County Supreme Court in June 2013.[3] The Caprios were New York nonresidents who in early 2007 sold stock in an S corporation. In conjunction with the stock sale, the Caprios made a joint IRC section 338(h)(10) election with the buyer. This resulted, for federal purposes, in the stock sale being treated as a deemed sale of the S corporation's assets, followed by an immediate deemed liquidation of the S corporation. The S corporation also received an installment note from the buyer as part of the sale, and in exchange for the Caprios' stock, the S corporation made a liquidating distribution of the installment note to them.

When the S corporation made the liquidating distribution of the installment obligations, the Caprios treated it as payment for the sale of their S corporation stock and reported no New York-source gain on the sale. As New York nonresidents, under a plain reading of the tax law at the time of the sale, the Caprios determined that the sale of their S corporation stock was properly treated as the sale of an intangible asset, and they sourced none of the sale proceeds to New York. The Caprios did this under the well-settled principle that New York nonresidents generally do not owe

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[1] *James Sq. Associates LP v. Mullen*, 21 N.Y.3d 233 (2013) (citing *Eastern Enterprises v. Apfel*, 524 U.S. 498 (1998) (Breyer, J., dissenting)); *see also Caprio v. New York Dep't of Tax'n and Fin.*, 2014 N.Y. Slip. Op. 02399 (1st Dep't 2014).

[2] No. 116 (N.Y. 2015).

[3] 37 Misc.3d 964 (Sup. Ct., N.Y. County 2012); Timothy P. Noonan, "New York Litigation, Part 2: Recent Headlines From the New York Courts," *State Tax Notes*, June 24, 2013, p. 987.

tax to the state on the sale of intangible assets such as stock.[4] Note that all this, including negotiations for the sale of the Caprios' company, happened in 2006 and 2007.

Under IRC section 453(h)(1)(A), a shareholder who exchanges S corporation stock for installment obligations (in a liquidation to which IRC section 331 applies) received by the S corporation in a sale or exchange is treated as receiving payment for the sale of stock on receipt of the installment payments. Before 2010, and as the Caprios argued to the appellate division, under a plain reading of the New York tax law, receipt of the installment payments should be treated as consideration for the sale of stock, not assets. In 2009 a New York administrative law judge confirmed this statutory reading in *Matter of Mintz*.[5] Earlier in 2009, New York's Tax Appeals Tribunal reached a similar conclusion in *Matter of Baum*,[6] holding that then-existing New York statutes did not allow the deemed asset sale under a federal section 338(h)(10) election to be treated as an actual sale of assets for purposes of determining whether the gain was taxable to a nonresident. Rather, the sale was treated as a nontaxable sale of stock.

Fast-forward to 2010. The New York State Legislature amended Tax Law section 632(a)(2), the provision creating sourcing rules for nonresident S corporation shareholders and partners in partnerships. This amendment added language requiring nonresident S corporation shareholders who sold stock subject to an IRC section 338(h)(10) election, or who received installment obligations under a liquidating distribution to which IRC section 453(h)(1)(A) applied, to source the sale proceeds received to New York in accordance with the entity's New York business allocation percentage.

In the legislative findings accompanying the act, the Legislature made no bones about its intent: The act was "necessary to correct a decision of the tax appeals tribunal [*Baum*] and a determination of the division of tax appeals [*Mintz*]" that "erroneously overturned the longstanding policy of [the] department of taxation and finance."[7] The act was made retroactive to the 2007 tax year.

II. New York's Retroactive Application of the 2010 Amendments

With the 2010 amendment, the current law in New York, at least from August 2010 onward, is clear and only moderately controversial: Nonresident S corporation shareholders — who either (1) sell their S corporation stock in conjunction with a section 338(h)(10) election, or (2) receive installment obligations from the S corporation in a liquidating distribution to which IRC section 453(h)(1)(A) applies — must source gain from sale proceeds to New York in accordance with the S corporation's business allocation percentage.[8]

However, rather than taking these steps to "correct" the *Baum* and *Mintz* decisions prospectively, the Legislature went a step further: It made the amendments retroactive to January 1, 2007. Although the legislative findings noted that this was in part to "prevent confusion in the preparation of returns, unintended refunds, and protracted litigation," the practical effect of the retroactivity was to give the tax department the ability to go back and assess additional tax on nonresidents who had structured deals years earlier, arguably in reliance on the tax law as it stood prior to the 2010 amendments.[9]

III. The Caprios' Constitutional Challenge

The 2010 amendments to Tax Law section 632(a)(2) created two new rules made applicable to transactions dating back to January 1, 2007. The *Caprio* decisions considered only the constitutionality of the retroactive application of the IRC section 453(h)(1)(A) amendment to Tax Law section 632(a)(2) (that is, the provision designed to overturn *Matter of Mintz*). The litigation did not consider the constitutionality of the retroactive application of the IRC section 338(h)(10) amendment to Tax Law section 632(a)(2). Because of the limited scope of the *Caprio* courts' review, the decisions arguably do not settle that question.[10]

After being assessed, the Caprios skipped the DTA administrative processes and took their challenge straight to

[4]*See, e.g.,* N.Y. Tax Law section 631(a)(2).

[5]*Matter of Mintz*, ALJ determination (June 4, 2009).

[6]*Matter of Baum*, ALJ determination (Dec. 20, 2007).

[7]L. 2010, Ch. 57, pt. C, section 1.

[8]*Burton v. New York Dep't of Tax'n and Fin.*, 2015 N.Y. Slip. Op. 05624 (July 1, 2015). The amendment to Tax Law section 632(a)(2) regarding the tax treatment of IRC section 338(h)(10) deemed asset sales for nonresident S corporation shareholders was challenged from a New York constitutional law perspective by the Burtons, but the challenge was rejected on the same day *Caprio* was issued.

[9]The Tax Appeals Tribunal in *Matter of Baum* (Feb. 12, 2009) confirmed that the plain language in the New York tax law did not require (or permit) the fictional asset sale or the deemed liquidation to be recognized in calculating an S corporation's income or the pro rata share of that income flowing through to a nonresident taxpayer. In doing so, the tribunal reasoned that "the federal [338(h)(10)] election was designed to provide very specific and limited federal tax consequences" and that "such election does not affect the substance of the transaction, which in this case, is a stock sale." Thus, the tribunal held that "a plain reading" of Tax Law section 208(9) made it clear that S corporations must compute their income flowing through pro rata to shareholders as if an S election had not been made and, consequently, as if the 338(h)(10) election had not been made.

[10]*Caprio*, slip op. at 4 ("We note that, in their submissions before [the]Supreme Court, plaintiffs limited their challenge to the retroactive application of the amendments pertaining to the tax treatment of installment obligations under 26 U.S.C. section 453(h)(1)(A), and expressly acknowledged that they 'd[id] not challenge those portions of the 2010 Amendments related to 26 U.S.C. section 338(h)(10), which have no bearing on [plaintiffs'] claims and [were] not even identified in the Verified Complaint'").

the New York Supreme Court. They argued that the retroactive enforcement of the 2010 amendment to section 632(a)(2) violated their federal and New York constitutional rights to due process. But the court upheld the assessment, determining that the retroactive application of the 2010 amendment did not violate the Caprios' due process rights.

The Caprios appealed the decision, and New York's appellate division (quite resoundingly) overturned it.[11] The appellate division determined that the retroactive application of the 2010 amendment was unconstitutional as applied to the Caprios, and it enjoined the tax department from enforcing its assessment. Over a one-judge dissent, the majority determined that the Caprios' reliance on prior law in structuring their deal was reasonable and that they had no forewarning the law would change more than three years later. And the court dismissed the department's argument that lengthy retroactivity was justified by a "curative" intent.

IV. The Due Process Test

Not all retroactive legislation, including tax legislation, is per se unconstitutional. But when the retroactive application of a tax law is so "harsh and oppressive" as to transgress a taxpayer's due process rights, it can be struck down as unconstitutional.[12] To determine if the retroactive application of a tax law amendment crosses this threshold, New York courts use a three-factor "balancing-of-the-equities" test, first articulated by the court of appeals in *Replan Development Inc. v. Department of Housing Preservation & Development of City of N.Y.*[13] The New York Court of Appeals in *James Square Associates LP v. Mullen*[14] later explained the importance of the three-part test — and really, the entire retroactive tax issue — in a single, simple sentence: "The focus of the three-pronged test is fairness."[15] The three factors to be weighed are (1) whether the taxpayer reasonably relied on the law as it existed when structuring the transaction and whether the taxpayer had forewarning of the change; (2) the length of the period of retroactivity; and (3) the strength of the public purpose behind the retroactive application of the law.

In applying this test, the appellate division held that retroactive application of the 2010 amendment violated the Caprios' due process rights. The court found that the Caprios had reasonably relied on the existing law in 2007 to structure their transaction, writing that a "reasonable reading of the Tax Law, as it existed in February 2007, is that the transaction was not subject to New York tax, and [the Caprios] had no knowledge of the tax department's contrary view." The court further concluded that the Caprios had no forewarning that the law would be amended more than three years later. The court also determined that the period of retroactivity (approximately 3 1/2 years) was excessive[16] and that the 2010 amendment was not curative in nature but was more closely akin to a wholly new tax. Finally, the court determined that the public purpose for the retroactive application as asserted by the tax department was not convincing, even if on balance, the issue presented a "close question." Looking to *James Square* for guidance, the court found that raising revenue and preventing revenue loss are not "'particularly compelling justification[s]' and '[are] insufficient to warrant retroactivity in a case where the other factors militate against it.'" In other words, the appellate division found that even if the Legislature may have a compelling reason for imposing tax retroactively, it still must be weighed against the other factors, particularly the taxpayer's reasonable reliance on prior law.

V. The Court's Decision: Missing the Mark?

Unfortunately, the court of appeals went in the opposite direction on each of the three *Replan* factors. Its justification for doing so in each instance raises questions.

A. Justifiable Reliance on Prior Law

The weight given by the court to the reliance factor confirms prior pronouncements that the taxpayer's reliance is perhaps the "predominant element in the equation" when considering retroactive tax statutes.[17] The court noted that justifiable reliance exists only if the taxpayer "obtained a sufficiently certain right to the money prior to the enactment of the new legislation" and noted that whether or not the retroactive statute was curative, as opposed to a new tax, could affect the reasonableness of a taxpayer's reliance. For this, the court cited the U.S. Supreme Court's decision in *United States v. Carlton*,[18] a case involving markedly different facts, including a slightly-greater-than-one-year period of retroactivity.

The court also discounted the Caprios' reliance on the pre-2010 law, instead finding the evidence of the department's "long-standing policy" regarding installment obligations (predating the Caprios' transaction) more persuasive. On this point, the court gave significant weight to the

[11]The appellate division's determination has a four-member majority and a lone dissenter. The court of appeals issued a unanimous decision.

[12]21 N.Y.3d 233, at 246; *Welch v. Henry*, 305 U.S. 134, 147 (1938).

[13]70 N.Y.2d 451, 456 (1987).

[14]21 N.Y.3d 233.

[15]21 N.Y.3d at 248.

[16]In *James Square*, the court of appeals was faced with an argument from the tax department that the law in question was made retroactive for only 16 months and from the petitioners that the law was made retroactive for 32 months. The court of appeals didn't really care who was right. In its eyes, the period of retroactivity was excessive, regardless of whether it was 16 or 32 months. 21 N.Y.3d at 249.

[17]*Matter of Chrysler Props. v. Morris*, 23 N.Y.2d 515, 521 (1969); *see also Replan*, 70 N.Y.2d at 456.

[18]*United States v. Carlton*, 512 U.S. 26 (1994) (upholding a retroactive amendment to narrow what was perceived as an overbroad deduction subject to abuse).

legislative findings accompanying the 2010 act, in which the Legislature declared that such "long-standing policy" existed and that decisions by the DTA had "erroneously overturned" those polices. Of course, the DTA, in binding (*Baum*) and nonbinding (*Mintz*) decisions, had confirmed that the Caprios' interpretation of the tax law in 2007 with regard to 338(h) elections and/or 453(h)(1)(A) installment obligations was correct as a matter of law. What did the tax department present as evidence of its "long-standing" policy? Not much. It offered just an internal PowerPoint presentation from 2002, an affidavit of a tax department employee, and a blurb from a New York informational publication.

This hardly seemed sufficient evidence of a long-standing policy or that the Caprios could have known about it. And at oral argument, the court of appeals judges appeared troubled by the lack of evidence that such a policy existed with respect to installment obligations.[19] The tax department argued that the legislative history itself supported the existence of a preexisting policy, pointing to its memorandum in support of the amendments. But as Judge Eugene M. Fahey pointed out at oral argument, the tax department itself wrote that memo.[20] The court thus agreed that the 2010 amendments confirmed a long-standing department policy, simply because the department said it did.

Still, after all this, had the Caprios been able to plead stronger facts indicating reliance on the prior law, that is, advice sought and received from a tax adviser prior to the deal, we think this case could have come down differently.

B. Length of the Period of Retroactivity

Three and a half years is an awfully long period of retroactivity. The court seemed to brush this fact off, however, by noting that longer periods of retroactivity have been accepted. But the only case offered for this was *Matter of Varrington Corp. v. City of N.Y. Department of Finance*,[21] a case in which a taxpayer filed for and received refunds following the issuance of a nonbinding advisory opinion and two years later was assessed to recover those refunds after the New York City Department of Finance adopted contrary legislation. Although the retroactivity in *Varrington* stretched back six years to the first refund filed, the court found the retroactive period was justified because "no cognizable detrimental reliance" could be found with respect to the nonbinding advisory opinion issued to a different taxpayer.[22]

It seems the court of appeals was also persuaded by the New York Legislature's findings — which as noted, really were the department's findings — stating that the "curative" nature of the amendments, and their necessity to prevent "unintended refunds" and "confusion in the preparation of returns," rationalized the length of retroactivity.

But there's nothing curative about the 2010 amendments. They flatly change the plain and reasoned reading of the tax law as it existed in 2007.

But there's nothing curative about the 2010 amendments. They flatly change the plain and reasoned reading of the tax law as it existed in 2007, notwithstanding a tax department internal PowerPoint and affidavit offered for litigation. That reading was confirmed in not only an ALJ determination (*Mintz*) but also in a binding Tax Appeals Tribunal decision (*Baum*). Indeed, by statute, tribunal decisions "finally and irrevocably" decide the tax issues they address, regardless of whether they contradict a department policy.[23] What's more, confusion in the prospective preparation of returns should have no bearing on the retroactive application of a new tax. The length of retroactivity should be considered in the context of the taxpayer's reliance on the old law and forewarning of a change. Perhaps a taxpayer in early 2010 could have expected the Legislature's amendments later that year. Could a taxpayer in January 2007 have anticipated that the New York Legislature would amend the law more than three years later in response to a DTA decision?

C. The Public Purpose for the Retroactive Application

This one hurts the most. The court of appeals gave the department a roadmap to keeping the retroactive application of tax laws free from constitutional reprisal: Make sure the legislative findings for the retroactive application of the law indicate that the measure was curative in nature. Brushing aside the reasoned decisions of each level of the DTA as "erroneous administrative determinations," the court of appeals decision ends up calling into question the legitimacy of the DTA process.

[19]A transcript of the *Caprio* oral argument is *available at* http://bit.ly/1gFoVFK.

[20]As noted *id.* at p. 8, Fahey wrote the following:

> Well, let me — let's slow down there. Let's talk about that a second. Let's follow up on that, because the legislative amendment, as I understood this, the DTF statement as to the longstanding practices, those were actually — that amendment preamble was actually drafted by DTF, isn't that correct?. . . Okay. So they — they drafted it. Because I looked at it, and there wasn't any citation to any statute, regulation or DTF document, though that did come later. There weren't any citations to the letter from the DTF Commission that Governor Paterson had commented on in the bill. And that's why, when we search the record, we're kind of struggling here to find out where in the record, as Judge Stein's original question was, points to something besides, you know, an argument or a rhetorical argument as to why this amendment should go forward.

[21]85 N.Y.2d 28 (1995).

[22]*Id.* at 35.

[23]N.Y. Tax Law section 2016.

Indeed, when the DTA was established in the late 1980s, a deliberate decision was made not to allow the department to appeal an adverse tribunal decision because the DTA, though a separate agency, is nonetheless part of the tax department.[24] So the decisions of the tribunal ultimately represent decisions of the department. And as the saying goes, the tribunal isn't last because it is right; it is right because it is last.[25] So for the department to suggest to the Legislature that the tribunal decision was wrong is, in a way, irrelevant. It is certainly the Legislature's prerogative to correct such a decision, prospectively; but when it comes to retroactivity, the department should be stuck with that decision, right or wrong, as if it were its own decision. Essentially, *Caprio* arguably allows the department to appeal an adverse tribunal decision, only in an easier, one-sided fashion: It can just go to the Legislature and retroactively change the law.

[24]According to Tax Law section 2000, "this article [Article 40] is enacted to establish an independent division of tax appeals within the department of taxation and finance."

[25]This derives from Supreme Court Justice Robert Jackson in *Brown v. Allen*, 344 U.S. 443 ("We are not final because we are infallible, but we are infallible only because we are final").

Ultimately, this is the most troubling aspect of *Caprio*. We've come to respect and praise the DTA for its independence and ability to resolve disputes in a fair and impartial manner, despite being under the umbrella of the department.[26] The department should not be able to make an end run around this appeals process by "appealing" tribunal decisions through the Legislature.

VI. Conclusion: Where to Go From Here?

Rest assured, retroactive tax laws are still the subject of great distrust. The Empire State, and even nonresidents outside it, still looks on retroactive tax laws with disfavor. The emperor, maybe not so much. Still, practitioners should remember that these cases depend on a balancing of the equities and thus live and die on their respective facts and circumstances. A different taxpayer with different facts may have received a different outcome. So this might not be the last we hear on retroactive taxation or on the 2010 amendments. Stay tuned. ☆

[26]Noonan and Arielle R. Doolittle, "Behind the Numbers: A Look Into New York's Division of Tax Appeals," *State Tax Notes*, Mar. 16, 2015, p. 653.