

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :
of :
GABRIEL S. AND FRANCES B. BAUM :
for Redetermination of a Deficiency or for Refund :
of New York State Personal Income Tax under :
Article 22 of the Tax Law for the Year 2001. :

In the Matter of the Petition : DETERMINATION
of : DTA NOS. 820837 AND
820838
CHRISTIAN M. BOEGNER :
AND :
JOANNA TOWNSHEND :
for Redetermination of a Deficiency or for Refund :
of New York State Personal income Tax under :
Article 22 of the Tax Law for the Year 2001. :

Petitioners, Gabriel S. Baum and Frances B. Baum, and Christian M. Boegner and Joanna Townshend, filed petitions for redetermination of deficiencies or for refunds of New York State personal income tax under Article 22 of the Tax Law for the year 2001.

On September 4, 2006 and September 28, 2006, respectively, petitioners appearing by Hodgson Russ, LLP (Jack Trachtenberg, Esq. and Christopher L. Doyle, Esq., of counsel), and the Division of Taxation appearing by Daniel Smirlock, Esq. (Kevin R. Law, Esq., of counsel), waived a hearing and submitted the matters for determination based on documents and briefs to be submitted by June 29, 2007, which date commenced the six-month period for issuance of this

determination. After due consideration of the documents and arguments submitted, Dennis M. Galliher, Administrative Law Judge, renders the following determination.

ISSUES

I. Whether the Division of Taxation (Division) may properly include, in a nonresident taxpayer's income, the gain from the sale of that taxpayer's shares of a New York S corporation to an acquiring corporation, which sale is deemed, pursuant to an Internal Revenue Code (IRC) § 338(h)(10) election, to be a sale of the S corporation's assets.

II. Whether the Division may disallow a nonresident taxpayer's claimed loss on a deemed liquidation of that taxpayer's New York S corporation's stock which is treated as a stock sale as the result of such IRC § 338(h)(10) election, on the basis that such loss was not derived from or connected with New York sources because the proceeds of the deemed liquidation resulting in the loss arose from amounts paid for an intangible (stock) not employed in a trade or business in New York State.

III. Whether the Division's disallowance of a nonresident New York S corporation shareholder's claimed loss arising from the deemed liquidation as a result of an IRC § 338(h)(10) election violates the Privileges and Immunities Clause of the United States Constitution.

FINDINGS OF FACT¹

1. Petitioners, Christian M. Boegner, Joanna Townshend, Gabriel S. Baum and Frances B. Baum, were nonresidents of New York during the year 2001.²

2. During 2001, petitioners were shareholders of SBS International of New York, Inc. (SBS). SBS was incorporated under the laws of the State of New York on September 1, 1977, and reported taxes on a fiscal year spanning September 1 through August 31.

3. During the fiscal year ended August 31, 2001, SBS was taxable as an S corporation for federal and New York State tax purposes. During the fiscal year ended August 31, 2001, Christian M. Boegner owned 27.66% of the stock of SBS, and Gabriel S. Baum owned 16.69% of the stock of SBS.

4. On July 26, 2001, the shareholders of SBS sold all of their shares of stock of the corporation to an unrelated party, the Boeing Company (Boeing). In connection with this stock sale, the shareholders of SBS and Boeing made an election under section 338(h)(10) of the Internal Revenue Code to treat the transaction for federal income tax purposes as if SBS had sold all of its assets to Boeing (the deemed asset sale), followed by a liquidation and distribution of

¹ The parties executed a Stipulation of Facts setting forth 28 separately numbered and agreed to facts. In addition, petitioners included in their brief Proposed Findings of Fact numbered “1” through “22”. The Division has raised no objection to any of the proposed findings of fact, and careful review reveals that the same are supported by the evidence in the record. Accordingly, the Stipulated Facts and the Proposed Facts are incorporated in the Findings of Fact set forth herein noting, however, that the Stipulated Facts numbered “20” through “28” set forth the bases for the parties’ arguments and are presented under the caption “Summary of the Parties’ Positions.”

² Joanna Townshend and Frances B. Baum appear as petitioners in these matters solely by virtue of having filed joint New York State nonresident and part-year resident income tax returns with their respective spouses, Christian M. Boegner and Gabriel S. Baum. All items of income and loss at issue were recognized by Christian M. Boegner and Gabriel S. Baum (in their individual respective share or percentage amounts). Accordingly, unless otherwise indicated or required by context, all plural references to petitioners shall be to the two petitioners Christian M. Boegner and Gabriel S. Baum, and all singular references to petitioner shall be to either petitioner Christian M. Boegner or to petitioner Gabriel S. Baum, as is contextually appropriate.

the sales proceeds to the selling shareholders in exchange for the shareholders' stock under section 331 of the Internal Revenue Code (the deemed liquidation).

5. The deemed asset sale resulted in federal taxable gain to the SBS shareholders of \$21,282,038.00. SBS reported this gain on line 4e(2) of Schedule K of its Federal S Corporation Income Tax Return (Form 1120S) for the fiscal year ended July 26, 2001.

6. The New York State business allocation percentage (BAP) of SBS at the time of the section 338(h)(10) transaction was 76.1667%.

7. For the fiscal year ended July 26, 2001, SBS issued a Form K-1 (Shareholder's Share of Income, Credits, Deductions, etc.) to each of its shareholders. Each Form K-1 reported, on line 4e(2), the respective shareholder's pro rata share of gain resulting, for federal income tax purposes, from the deemed asset sale. This amount was calculated by multiplying the total deemed asset sale gain of \$21,282,038.00 by the particular shareholder's ownership interest in SBS. Thus, as reported at line 4e(2) on their respective forms K-1, Christian M. Boegner's gain from the deemed asset sale was \$5,886,612.00 (i.e., \$21,282,038.00 x .2766), and Gabriel S. Baum's gain from the deemed asset sale was \$3,551,972.00 (i.e., \$21,282,038.00 x .1669).

8. Christian M. Boegner was deemed to have received cash proceeds in the amount of \$4,054,880.00 upon the deemed liquidation of SBS, and Gabriel S. Baum was deemed to have received cash proceeds in the amount of \$1,322,025.00 upon the deemed liquidation of SBS.

9. At the time of the deemed liquidation, Christian M. Boegner's adjusted basis in the stock that he was treated as selling pursuant to the deemed liquidation was \$5,767,033.00, and all of that basis was attributable to the \$5,886,612.00 of gain that flowed through to Christian M. Boegner from SBS as a result of the deemed asset sale. Likewise, at the time of the deemed liquidation, Gabriel S. Baum's adjusted basis in the stock that he was treated as selling pursuant

to the deemed liquidation was \$3,687,818.00, and \$3,551,972.00 of that basis was attributable to the gain that flowed through to Gabriel S. Baum from SBS as a result of the deemed asset sale. For purposes of this proceeding, it is assumed that the remainder of the basis was not attributable in any way to New York sources.

10. For the year 2001, Christian M. Boegner filed a Form IT-203 (New York State Nonresident and Part-Year Resident Income Tax Return). On the federal Schedule D (Capital Gains and Losses) attached to this return, Mr. Boegner reported on line 12 the \$5,886,612.00 gain from the deemed asset sale, and reported the \$1,712,153.00 loss that he recognized for federal income tax purposes upon the deemed liquidation of his SBS stock. The claimed loss was calculated by subtracting Mr. Boegner's \$5,767,033.00 adjusted basis in his SBS stock from the \$4,054,880.00 of cash proceeds that he was deemed to have received on the deemed liquidation. The net effect of this reporting position for federal income tax purposes was a gain to Mr. Boegner from the stock sale and section 338(h)(10) election in the amount of \$4,174,159.00.³ Christian M. Boegner allocated this amount to New York based upon the 76.1667% BAP of SBS, and therefore treated \$3,179,319.00 of his gain as New York source income. This resulted in a reported income percentage (Line 43 to Form IT-203) of 72.77% and a reported total tax due to New York of \$163,284.00.

11. For the year 2001, Gabriel S. Baum filed a Form IT-203 (New York State Nonresident and Part-Year Resident Income Tax Return). On the federal Schedule D (Capital Gains and Losses) attached to this return, Mr. Baum reported on line 12 the \$3,551,972.00 gain

³ The net gain amount of \$4,174,159.00 set forth in the parties' stipulation is \$300.00 less than the amount which results from subtracting the claimed loss from the gain on the deemed asset sale (i.e., \$5,886,612.00 less \$1,712,153.00 equals \$4,174,459.00). This small difference is not explained and presumably results from transcription error.

from the deemed asset sale, and reported the \$2,365,793.00 loss that he recognized for federal income tax purposes upon the deemed liquidation of his SBS stock. The claimed loss was calculated by subtracting Mr. Baum's \$3,687,818.00 adjusted basis in his SBS stock from the \$1,322,025.00.00 of cash proceeds that he was deemed to have received on the deemed liquidation. The net effect of this reporting position for federal income tax purposes was a gain to Mr. Baum from the stock sale and section 338(h)(10) election in the amount of \$1,186,179.00. Gabriel S. Baum allocated this amount to New York based upon the 76.1667% BAP of SBS, and therefore treated \$903,473.00 of his gain as New York source income. This resulted in a reported income percentage (Line 43 to Form IT-203) of 48.65% and a reported total tax due to New York of \$30,399.00.

12. The Division of Taxation (Division) audited petitioners' nonresident returns for the year 2001 and concluded that petitioners had improperly offset their respective gains from the deemed asset sale by their respective losses recognized upon the deemed liquidation of SBS. As a result, the Division disallowed Christian M. Boegner's claimed loss on the deemed liquidation and issued an audit adjustment that allocated 76.1667% of Mr. Boegner's \$5,886,612.00 deemed asset sale gain to New York based upon the BAP of SBS. Thus, \$4,483,638.10 of such gain was treated as New York source income, resulting in total tax due to New York in the amount of \$252,274.48. In the same fashion, the Division disallowed Gabriel M Baum's claimed loss on the deemed liquidation and issued an audit adjustment that allocated 76.1667% of Mr. Baum's \$3,551,972.00 deemed asset sale gain to New York based upon the BAP of SBS. Thus, \$2,705,419.86 of such gain was treated as New York source income, resulting in total tax due to New York in the amount of \$152,140.55.

13. On July 19, 2004, the Division issued a separate Notice of Deficiency to each petitioner. The notice issued to Christian M. Boegner asserts additional personal income tax due for the year 2001 in the amount of \$88,990.48, plus interest in the amount of \$12,907.31. The notice issued to Gabriel S. Baum asserts additional personal income tax due for the year 2001 in the amount of \$121,741.55, plus interest in the amount of \$17,657.58. The additional tax asserted as due per the respective notices results solely from the Division's disallowance of the loss that each petitioner recognized upon the deemed liquidation of SBS.

14. If Christian B. Boegner had been a resident of New York State during the year of the stock sale and section 338(h)(10) election, his New York State personal income tax liability would have been \$224,384.00. If Gabriel S. Baum had been a resident of New York State during the year of the stock sale and section 338(h)(10) election, his New York State personal income tax liability would have been \$62,485.00.

15. As noted in Findings of Fact "10" and "11", Christian M. Boegner and Gabriel S. Baum paid New York State personal income tax for the year 2001 in the respective amounts of \$163,284.00 and \$30,399.00, based upon the respective reported income percentages (at line 43 of their returns) of 72.77% and 48.65%. In contrast, the Division's notices of deficiency assert additional personal income tax against Christian M. Boegner and Gabriel S. Baum based on income percentages of 112.43% and 245.39%, respectively.

SUMMARY OF THE PARTIES' POSITIONS

16. The issues in this case involve whether the Division may assert tax against petitioners on the gain recognized for federal income tax purposes upon the deemed asset sale, and if so, whether petitioners are entitled to offset the taxable gain by any portion of the loss recognized for federal income tax purposes upon the deemed liquidation of the SBS stock. The Division

maintains that, since a section 338(h)(10) election was made, petitioners must be taxed as if SBS had sold all of its assets at their fair market value to the acquirer in a single transaction prior to the deemed liquidation. The result, according to the Division is that petitioners are subject to New York State personal income tax on their pro rata share of the gain recognized by SBS for federal income tax purposes, as allocated to New York in accordance with the BAP of SBS.

With respect to the deemed liquidation, the Division asserts that no part of the loss incurred by petitioners should be treated as a New York source loss because the sale proceeds treated as received by petitioners in the deemed liquidation constituted amounts paid in exchange for an intangible, i.e., petitioners' shares of SBS stock, which does not have a New York source unless the stock is employed in a trade or business within New York.

17. Petitioners assert, in contrast, that for New York State personal income tax purposes, the transaction in question should be directly and simply treated as a nontaxable sale of stock by a nonresident. Assuming such direct treatment is not allowed, then as a first alternative argument, petitioners maintain that the deemed liquidation loss constitutes a New York source loss to the extent that the basis in the shares deemed sold arises from income subject to New York tax. That is, petitioners assert that they should be permitted to offset the deemed asset sale gain by the portion of the deemed liquidation loss recognized for federal income tax purposes that results from basis increases in petitioners' shares attributable to the New York source income that flowed through from SBS.

18. As a second alternative, petitioners assert that the Division's application of a source fraction in excess of 100% and its failure to allow any portion of the deemed liquidation loss is improper and results in an unconstitutional application of the Tax Law.

19. If, as a result of this proceeding, petitioners establish that the Division cannot tax the deemed asset sale gain, then Christian M. Boegner is entitled to a refund in the amount of \$163,284.00 and Gabriel S. Baum is entitled to a refund in the amount of \$30,399.00.

20. If, as a result of this proceeding, it is determined that the deemed asset sale gain is taxable, but petitioners establish that they are entitled to offset the gain by the portion of the deemed liquidation loss attributable to New York source basis adjustments, then the petitions should be granted and the notices of deficiency cancelled.

21. If, as a result of this proceeding, it is determined that it was improper for the Division to use a source fraction in excess of 100%, then the Notice of Deficiency issued to Christian M. Boegner should be revised to reflect a deficiency in the amount of \$61,100.00 and the Notice of Deficiency issued to Gabriel S. Baum should be revised to reflect a deficiency in the amount of \$32,086.00.

CONCLUSIONS OF LAW

A. Petitioners were two of the three shareholders of SBS, a New York corporation taxable during its fiscal year ended August 31, 2001 as an S corporation for both federal and New York State purposes. On July 26, 2001, the three shareholders of SBS sold all of their SBS shares to Boeing, an unrelated party. There is no dispute between the parties that the three shareholders of SBS, and Boeing, entered into a valid federal income tax election pursuant to IRC § 338(h)(10), the result of which was that the shareholders' sale of their shares of SBS stock to Boeing was treated, for federal income tax purposes, as if SBS sold all of its assets to a new corporation and then liquidated.

B. By way of background, while Boeing acquired SBS via the purchase of the stock of SBS, for federal income tax purposes a legal fiction was created affording Boeing the

convenience of a stock purchase with the tax benefits of an asset purchase. Pursuant to IRC § 338(a), the purchaser in a qualified stock purchase may make an election whereby the target corporation is treated as having sold all of its assets on a certain date and is then treated as a new corporation which purchased the assets. Consequently, the target recognizes gain or loss on the difference between the fair market value of the assets and the adjusted bases of the assets deemed sold. The bases of the assets deemed sold are stepped up or down, and the selling shareholders (of SBS) recognize gain or loss on the disposition of their stock.

In addition, if the purchaser makes an election pursuant to IRC § 338(a), the purchaser and the seller (here the selling S corporation shareholders) may make an additional election pursuant to IRC § 338 (h)(10). Under this further election, the target is deemed to have sold all of its assets and distributed the proceeds in a complete liquidation, and the sale of the target stock in the qualified stock purchase is usually ignored. The gain or loss on the deemed asset sale is included in the tax return of the selling consolidated or affiliated group or of the S corporation shareholders, but no gain or loss is recognized on the sale of the target stock. The S corporation's gain (or loss) from the deemed asset sale is taken into account pro rata by the S corporation's shareholders (IRC § 1366), and the basis in their S corporation stock is increased (or decreased) accordingly (IRC § 1367; Treas. Reg. § 1.338[h][10]-1[d][5][i]). In turn, these basis adjustments stemming from the deemed asset sale will produce either capital gains or capital losses to the S corporation's shareholders on the deemed distribution in liquidation (Treas Reg § 1.338[h][10]-1[d][5][ii]).

The election under IRC § 338(h)(10) may be made only if the target corporation is a member of a selling consolidated or affiliated group or an S corporation (IRC § 338[h][10][B];

Treas Reg § 1.338[h][10]-1[c]). Pursuant to IRC regulations, if a section 338(h)(10) election is invalid, the entire section 338 election is invalid (Treas Reg § 1.338[h][10]-1[d][4]).⁴

C. Turning to the New York State implications of the sale of SBS to Boeing and its specific impact on the nonresident petitioners, New York State imposes personal income tax on the income of nonresident individuals to the extent that their income is derived from or connected to New York sources (Tax Law § 601[e]). The income tax is imposed on the nonresident's "tax base," which is their tax liability calculated as if the nonresident individual was a New York resident, multiplied by the "New York source fraction" (Tax Law § 601[e][1],[2]). The numerator of the fraction is the portion of the individual's adjusted gross income derived from or connected with New York sources, as determined per Tax Law §§ 631 through 639 (Tax Law § 601[e][3]). The denominator of the fraction is the individual's entire New York adjusted gross income, consisting (generally) of the individual's Federal adjusted gross income with certain modifications (Tax Law § 601[e][3]; § 612). At issue is whether petitioners' pro rata shares of the gain from the deemed asset sale are properly includible in the numerator of their New York source fractions as New York source income or rather must be excluded as resulting from the nonresident petitioners' sale of an intangible, that is their shares in SBS.

⁴ IRC § 338(h)(10) does not explicitly permit the election to be made in connection with the sale of S corporation stock. However, regulations promulgated pursuant thereto permit the election (*see* Treas Reg § 1.338[h][10]-1). The regulations require that the election be made jointly by the purchasing corporation and the S corporation shareholders (Treas Reg § 1.338[h][10]-1[c][2]). When the election is made, the S corporation is treated as if it had sold all of its assets to a hypothetical new corporation, which is identical to the "selling" corporation, for consideration, which includes the discharge of the selling corporation's liabilities. Immediately thereafter, the selling corporation is deemed to make a distribution in complete liquidation to its shareholders, to which IRC § 331 applies, and terminate its existence (Treas Reg § 1.338[h][10]-1[d][3][i]; § 1.338-1; § 1.338[h][10]-1[d][4]). IRC § 331 provides that "[a]mounts received by a shareholder in a distribution in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock."

D. There is no dispute between the parties that it is only the fictional transactions resulting from the IRC § 338(h)(10) election, most specifically the fiction of treating the stock sale as an asset sale, which cause the gain on the sale of SBS to Boeing to be treated by the Division as New York source income. Further, there appears to be no dispute that if there had been no IRC § 338(h)(10) election, the sale of SBS to Boeing would have been treated for what it actually was, namely a sale of stock not employed in a business, trade, occupation or profession in New York by nonresident shareholders, with no New York source income to petitioners resulting therefrom (Tax Law § 631[b][2]; 20 NYCRR 132.5[a]; 132.8[c]). This is borne out clearly by the Division's stance in disallowing the loss claimed by petitioners upon the deemed liquidation of SBS on the basis that the same resulted from the disposition of shares of stock by nonresidents thus not constituting a New York source loss.

E. Resolving this matter is not directly dependent upon an examination of the actual mechanics of IRC § 338(h)(10), or upon the legitimacy or result of such election as made by Boeing and the shareholders of SBS (including petitioners) for federal income tax purposes. Rather, the focus is upon whether such election may impact the transaction and the source of the income resulting therefrom for New York State purposes. The Division's position is premised on the argument that the result here flows from the federal election made by petitioners, that the Division is simply respecting such election, and that petitioners are bound to do the same and may not be permitted to "undo" such an election. The linchpin of the Division's argument is that the source of the S corporation's items of income, gain, loss and deduction flowing through to its shareholders is determined at the corporate level, that there was in this case an asset sale at the corporate level, and that the result therefrom must be sourced to New York to the extent of the corporation's BAP and must be allocated to the S corporation's shareholders as New York source

income in accordance with their pro rata ownership interests in the corporation. Petitioners, for their part, raise no challenge to the allocation of the corporation's business income by its BAP. Rather, petitioners' primary argument is that the IRC § 338(h)(10) election was not permitted for New York tax purposes under the circumstances of this case, that the fictional asset sale created thereunder did not occur, that the gain therefrom was not allocable to New York because such asset sale gain was not there to allocate, and that the transaction must be taxed for what it was, namely a stock sale by nonresidents of New York State.

F. There was, in fact, no sale of the S corporation's assets. Rather, there was a sale of the S corporation's stock. The "asset sale" was a "deemed" sale, a legal fiction resulting only from a federally available election. Hence, the essential question is whether such an election, available under the federal rules and allowing for a transaction to be treated in a fictitious manner so as to allow calculations providing for an advantageous federal tax result, can change the nature and source of the income, gain, loss or deduction resulting from what actually occurred, a stock sale by a nonresident. As explained below, Tax Law § 208(9), by its specific terms, precludes the result sought by the Division and effectively "undoes," by its own terms, the impact of the IRC § 338(h)(10) election.

G. A New York subchapter S corporation is subject to tax on either the higher of the tax that would be computed by a C corporation on its entire net income base or the fixed dollar minimum reduced by the "article twenty-two tax equivalent" but not less than the fixed dollar amount (Tax Law § 210[1][g]). Tax Law § 208(9) impacts the calculation of entire net income with regard to a subchapter S corporation by providing, in relevant part, as follows:

The term "entire net income" means total net income from all sources, which shall be presumably the same as entire taxable income (but not alternative minimum taxable income),

(i) which the taxpayer is required to report to the United States treasury department, or

(ii) which the taxpayer would have been required to report to the United States treasury department *if it had not made an election under subchapter s of chapter one of the internal revenue code*, or

(iii) which the taxpayer, in the case of a corporation which is exempt from federal income tax (other than the tax on unrelated business income imposed under section 511 of the internal revenue code) but which is subject to tax under this article, would have been required to report to the United States treasury department but for such exemptions. . . . (Emphasis added.)

H. As specified above, clause (ii) of Tax Law § 208(9) requires an S corporation, such as SBS, to compute its entire net income as if it had not made a subchapter S election, i.e., as if it were a C corporation. As noted earlier, an IRC § 338(h)(10) election is not available to a C corporation which is not a member of a selling consolidated or affiliated group of corporations (*see* Conclusion of Law “B”). SBS was not a member of a selling consolidated or affiliated group of corporations, and thus the IRC § 338(h)(10) election was simply not available to SBS at the State level under the terms of Tax Law § 208(9)(ii). Since an invalid IRC § 338(h)(10) election means that no portion of IRC § 338 is applicable, then the fictions resulting therefrom, the deemed asset sale and the deemed distribution in complete liquidation, do not apply to the sale of SBS to Boeing for New York State purposes. Thus, it follows that the gain from the deemed asset sale may not be included in the entire net income of the New York S corporation, SBS, for purposes of determining its New York State franchise tax under Article 9-A of the Tax Law, nor may the same be passed through, pro rata, as New York source income to the shareholders of SBS. Accordingly, for New York State purposes, petitioners’ gain from the sale

of SBS resulted from the sale of their stock in SBS and, as nonresidents, petitioners were not required to include such gain as New York source income subject to New York tax.

I. In view of the foregoing, it is unnecessary to address the alternative arguments raised by the petitioners.

J. The petitions of Gabriel S. and Frances B. Baum, and Christian M. Boegner and Joanna Townshend, are hereby granted, the notices of deficiency dated July 19, 2004 are cancelled, and the Division is directed to refund to petitioners the amounts specified and agreed to in Finding of Fact "19," together with such interest as may be due thereon.

DATED: Troy, New York
December 20, 2007

/s/ Dennis M. Galliher
ADMINISTRATIVE LAW JUDGE