117 A.D.3d 168
Supreme Court, Appellate Division, First Department, New York.

Philip CAPRIO, et al., Plaintiffs–Appellants,
v.
NEW YORK STATE DEPARTMENT OF TAXATION AND FINANCE, et al., Defendants–Respondents,
Andrew M. Cuomo, etc., Defendant.

April 8, 2014.

Opinion

RICHTER, J.

***170** In this appeal, we are asked to decide whether an amendment to the Tax Law enacted on August 11, 2010 can be applied retroactively to a transaction entered into by plaintiffs on February 1, 2007, more than 3 1/2 years earlier. Applying the balancing test set forth by the Court of Appeals, we conclude that the retroactive application of the amendment as to plaintiffs is impermissible. Plaintiffs reasonably relied on the old law in structuring the transaction, and had no forewarning of the change in the legislation. In light of plaintiffs' reliance, the excessive length of the retroactive period, and the absence of a compelling public purpose, a due process violation occurred.

Plaintiffs, a married couple who reside in Florida, are the former owners and sole shareholders of Tri–Maintenance & Contractors, Inc. (TMC), a company that provides janitorial and other services. TMC, which conducts some of its business in New York, was incorporated in New Jersey, and had elected to be treated as an S–corporation for federal and New York State purposes. Under both the Internal Revenue Code and the New York Tax Law, S–corporations are permitted to avoid corporate income taxes by passing through income and losses to shareholders for inclusion in their individual federal and state income tax returns (*see* Internal Revenue Code [IRC] [26 USC] §§ 1361–1379; Tax Law § 660).

Pursuant to a stock purchase agreement dated February 1, 2007, plaintiffs sold all of their shares of TMC stock to Sanitors ***171** Services, Inc. for a base price of approximately $20 million, plus certain additional contingent payments. The agreement was structured so that Sanitors would pay the base price in two installments with interest: (1) an initial payment of approximately $19.5 million on March 1, 2007; and (2) the remaining sum of $500,000 on February 1, 2008. On the February 1, 2007 closing date of the transaction, Sanitors gave plaintiffs promissory notes for the installment obligations.

The parties' agreement also provided that they would jointly make an election pursuant to IRC 338(h)(10). That provision allowed the transaction to be treated, for federal tax purposes, as a sale of TMC's assets, immediately followed by a complete liquidation of TMC. Thus, TMC was deemed to have sold all of its assets to Sanitors in exchange for the promissory notes that plaintiffs received, and deemed to have made a distribution of the notes to plaintiffs. Under IRC 331(a), the amounts received by plaintiffs in the distribution in complete liquidation of TMC "shall be ****6** treated as in full payment in exchange for the stock."

Because TMC and plaintiffs received installment obligations (i.e., the promissory notes) in exchange for the TMC stock, they elected to use the installment method of accounting (*see* IRC 453, 453B; *see also* Tax Law § 605[a][3] [requiring New York taxpayers to use same accounting method used for federal income tax purposes]). Generally speaking, under the installment method, gains are recognized only when cash payments are actually received. Under IRC 453B(h), an S–corporation that distributes an installment obligation in a complete liquidation does not recognize any gain or loss with respect to the distribution. On its 2007 federal and New York State S–corporation tax returns for the short taxable year ending February 1, 2007 (the date of the transaction), TMC did not report any realized gain on the transaction. According to plaintiffs, no gain was reported because TMC had not received any cash payments from Sanitors (but only had received the installment obligations), and because no gain was realized with respect to the deemed distribution pursuant to IRC 453B(h).

The gain was, however, reported on plaintiffs' individual federal tax returns. IRC 453(h)(1)(A) provides that a shareholder who receives an installment obligation in exchange for stock in a section 331(a) liquidation does not recognize income upon receipt of the obligation, but only upon receipt of the payments thereunder. Such payments, when received by the ***172** shareholder, "shall be treated as the receipt of payment for the stock" (IRC 453[h][1] [A]). Plaintiffs received the first installment payment under the promissory notes on March 1, 2007, which resulted in a capital gain of over $18 million. Plaintiffs reported this amount on their 2007 individual federal income tax return as a gain from the installment sale of their TMC stock. Plaintiffs also reported a gain of over $1 million on their 2008 federal return in connection with the second installment payment for the stock.

Plaintiffs, however, did not pay New York State taxes on these gains. New York State levies personal income tax on nonresident individuals only to the extent their income is derived from or connected to New York sources (Tax Law § 601[e]). Under Tax Law § 631(b)(2), gains received by nonresidents from the disposition of intangible personal property, such as stock, are not considered to be derived from a New York source unless the stock itself (as opposed to the underlying assets of the corporation) is "employed in a business, trade, profession, or occupation carried on in [New York]" (*see also* 20 NYCRR 132.5[a], 132.8[c]). Here, there is no allegation that the TMC stock itself was used in a New York trade or business. Thus, because IRC 453(h)(1)(A) treats the installment payments as the receipt of payments for stock, plaintiffs did not report the gains as derived from a New York source on their 2007 and 2008 New York nonresident individual tax returns.

In June 2009, the New York State Division of Tax Appeals issued a ruling involving an installment transaction similar to the one here. In *Matter of Mintz* (2009 WL 1657395 [N.Y. State Div. of Tax Appeals June 4, 2009]), an administrative law judge (ALJ) held that the nonresident shareholders of an S–corporation did not have New York source income for payments they received under an installment obligation distributed by the S–corporation in an IRC 331 liquidation governed by IRC 453(h)(1)(A). The ALJ concluded that since the installment payments the shareholders received were gains from the sale of stock held by a nonresident, they were not includable as New York source income ****7** and thus not subject to taxation by New York State. The result in *Mintz* is consistent with plaintiffs' treatment of their gain as coming from the sale of stock not taxable by New York.

Defendant New York State Department of Taxation and Finance (the Tax Department) subsequently proposed legislation to override the *Mintz* decision and to provide that the type ***173** of transaction at issue here would result in taxable New York Sate income. As relevant here, in August 2010, the following sentence, drafted by the Tax Department, was added to Tax Law § 632(a)(2):

> "If a nonresident is a shareholder in an S corporation ... and the S corporation has distributed an installment obligation under section 453(h)(1)(A) of the Internal Revenue Code, then any gain recognized on the receipt of payments from the installment obligation for federal income tax purposes will be treated as New York source income ..."

(the 2010 amendment)(L. 2010, ch. 57, part C, as amended by L. 2010, ch. 312, part B).[1] This new provision of the Tax Law applied to taxable years beginning on or after January 1, 2007, a more than 3 1/2 year period of retroactivity.[2]

In February 2011, six months after the new legislation was enacted, DTF issued a notice of deficiency with respect to plaintiffs' 2007 and 2008 state income tax returns, assessing approximately $775,000 in additional taxes and interest due as a result of the TMC transaction. Plaintiffs then commenced this action seeking a declaration that the retroactive application of the 2010 amendment, as to them, violates the Due Process Clauses of the federal and state constitutions. Plaintiffs named as defendants the Tax Department, its commissioner and mediation bureau, the State of New York and Governor Andrew M. Cuomo. Plaintiffs also sought an injunction preventing defendants from enforcing the notice of deficiency against them.

Defendants moved for summary judgment dismissing the complaint, and plaintiffs cross-moved for summary judgment in their favor. The parties agreed that their respective motions raised an issue of law that could be decided without the need for developing a more detailed factual record. In an order entered September 25, 2012, the motion court denied plaintiffs' cross motion, granted defendants' motion, and dismissed the complaint. A judgment was subsequently ***174** entered on November 5, 2012 dismissing the complaint.[3] Plaintiffs appeal and we now reverse.[4]

Retroactive legislation is generally looked upon with disfavor and distrust (*James Sq. Assoc. LP v. Mullen,* 21 N.Y.3d 233, 246, 970 N.Y.S.2d 888, 993 N.E.2d 374 [2013]). Nevertheless, retroactive provisions of tax legislation are not necessarily unconstitutional, and can be considered valid if they allow for a "short period" of retroactivity (*id.*). "The courts must examine in light of the nature of the tax and the circumstances in which it is laid, [whether] the retroactivity of the law is so harsh and oppressive as to transgress the constitutional limitation" (*id.* [internal quotation marks omitted]).

****8** Determining whether the retroactive application of a tax statute violates a taxpayer's due process rights "is a question of degree" and "requir[es] a balancing of [the] equities" (*Matter of Replan Dev. v. Department of Hous. Preserv. & Dev. of City of N.Y.,* 70 N.Y.2d 451, 456, 522 N.Y.S.2d 485, 517 N.E.2d 200 [1987], *appeal dismissed* 485 U.S. 950, 108 S.Ct. 1207, 99 L.Ed.2d 409 [1988] [internal quotation marks omitted]). In *James Sq.,* the Court of Appeals recently reaffirmed a three-prong test to determine whether the retroactive application of a tax statute passes constitutional muster. "The important factors in determining whether a retroactive tax transgresses the constitutional limitation are (1) 'the taxpayer's forewarning of a change in the legislation and the reasonableness of ... reliance on the old law,' (2) 'the length of the retroactive period,' and 3) 'the public purpose for retroactive application' " (21 N.Y.3d at 246, 970 N.Y.S.2d 888, 993 N.E.2d 374, quoting *Matter of Replan,* 70 N.Y.2d at 456, 522 N.Y.S.2d 485, 517 N.E.2d 200).

With respect to the first factor, which has been described as the "predominant" factor (*Replan,* 70 N.Y.2d at 456, 522 N.Y.S.2d 485, 517 N.E.2d 200), plaintiffs here had no actual forewarning of the change made by the 2010 amendment. Indeed, the amendment was not even proposed to the legislature until after the *Mintz* decision was issued in June 2010, long after plaintiffs had entered into the February 2007 TMC transaction. Thus, plaintiffs had "no warning and no opportunity [in 2007] to alter their behavior in anticipation of the impact of the [2010 amendment]" (*James Sq.,* 21 N.Y.3d at 248, 970 N.Y.S.2d 888, 993 N.E.2d 374).

*****[Removed Dissent Argument]*****

Defendants' primary argument to the contrary is not based on a different reading of the then-applicable laws, but instead is rooted in their claim that New York had a longstanding practice of taxing S–corporation shareholders for transactions like the TMC sale.[5] The dissent echoes this argument, repeatedly referring to the Tax Department's purported long-established policy. The only proof that such a policy ****9** existed, however, is an isolated 2002 PowerPoint presentation made to Tax Department auditors purportedly reflecting such a practice. Even if such a policy were in existence, the record contains no evidence that the Tax Department took any steps to inform taxpayers of its policy. Nor is there any evidence that the internal PowerPoint presentation was made publicly available, or that plaintiffs, when they structured the 2007 transaction, had any other knowledge of the Tax Department's alleged practice. We disagree with the dissent that plaintiffs were required to have sought an advisory opinion from the Tax Department before entering into the TMC transaction. A reasonable reading of the Tax Law, as it existed ***176** in February 2007, is that the transaction was not subject to New York tax, and plaintiffs had no knowledge of the Tax Department's contrary view. Thus, they had no reason to seek clarification from the Tax Department.

Defendants argue that plaintiffs cannot establish reasonable reliance because they did not submit evidence on how they would have structured the TMC transaction differently had they known it could subject them to New York taxation. However, the law does not require plaintiffs to show a specific proposed alternative course of action to satisfy the element of reasonable reliance. Rather, the proper inquiry is whether plaintiffs "conducted their business affairs in a manner consistent with [the previous law], justifiably relying on the receipt of the tax benefits that were then in effect" (*James Sq.,* 21 N.Y.3d at 248, 970 N.Y.S.2d 888, 993 N.E.2d 374; *see Matter of Replan,* 70 N.Y.2d at 456, 522 N.Y.S.2d 485, 517 N.E.2d 200 [reliance factor focuses on whether the taxpayer's expectations as to taxation have been unreasonably disappointed]).[6] Because plaintiffs structured the TMC transaction in reasonable reliance on the previous law, and in the absence of any evidence that they had any forewarning of the change in the law, the first *James Sq.* factor weighs in their favor.

The second *James Sq.* factor, the length of the retroactive period, also favors plaintiffs. Excessive periods of retroactivity "have been held to unconstitutionally deprive taxpayers of a reasonable expectation that they will secure repose from the taxation of transactions which have, in all probability, been long forgotten" (*Matter of Replan,* 70 N.Y.2d at 456, 522 N.Y.S.2d 485, 517 N.E.2d 200 [internal quotation marks omitted]). As noted earlier, retroactive application of tax laws can be considered valid if they provide for a "short period" of retroactivity (*James Sq.,* 21 N.Y.3d at 246, 970 N.Y.S.2d 888, 993 N.E.2d 374). In *James Sq.,* the Court concluded that a retroactive period of 16 months "should be considered excessive and weighs against the State" (21 N.Y.3d at 249, 970 N.Y.S.2d 888, 993 N.E.2d 374). Here, the period of retroactivity was 3 1/2 years—nearly three times longer than the period found excessive in *James Sq.* As in *James Sq.,* we conclude that this excessive period was "long enough ... so that plaintiffs gained a reasonable expectation that they would secure repose in the existing tax scheme" (*id.* [internal quotation marks omitted]; *see Matter of Lacidem Realty Corp. v. Graves,* 288 N.Y. 354, 43 N.E.2d 440 [1942] ***177** [four-year retroactive period invalidated as harsh and oppressive]).

Defendants contend that longer periods of retroactivity may be warranted where ****10** tax legislation does not impose a wholly new tax, but is a curative measure meant to correct errors (*see James Sq.,* 21 N.Y.3d at 249, 970 N.Y.S.2d 888, 993 N.E.2d 374). The parties sharply dispute whether the 2010 amendment is a new tax or was designed to correct a previous legislative error. The dissent points to the preamble of the legislation, which shows that the 2010 amendment was intended to make the law consistent with the Tax Department's (unpublished) policy, and to overturn an administrative decision that failed to account for this policy. Tellingly, defendants point to no legislative history that indicates that the legislature was correcting any specific error in the existing law, as opposed to amending the law to account for the Tax Department's purported policy. Thus, contrary to the dissent's view, the legislative history does not support a view that the 2010 amendment was a curative measure.

Plaintiffs, on the other hand, persuasively argue that the 2010 amendment created an exception to the general rule, set forth in Tax Law § 631(b)(2), that gains from a nonresident's sale of stock (not used in a New York business) are not subject to New York taxation. Under the 2010 amendment, the particular stock sale engaged in here is now unquestionably subject to New York taxation, and thus can fairly be considered a new tax. Because the 2010 amendment cannot be reasonably viewed as merely correcting a legislative error, the longer period of retroactivity urged by defendants is not warranted, and on balance, the second *James Sq.* factor weighs against defendants.

The final *James Sq.* factor is the public purpose for the retroactive application of the 2010 amendment. Although a close question, on balance, plaintiffs have the better argument. The legislative history indicates that enactment of the legislation was necessary to implement the 2010–2011 executive budget by raising tax revenues by $30 million in that fiscal year. Indeed, defendants expressly state in their brief that the legislature made the law retroactive to prevent revenue loss. But "raising money for the state budget is not a particularly compelling justification" and "is insufficient to warrant retroactivity in a case [as here] where the other factors militate against it" (*James Sq.,* 21 N.Y.3d at 250, 970 N.Y.S.2d 888, 993 N.E.2d 374). Defendants' argument that retroactivity is necessary so that other taxpayers are not unfairly burdened while plaintiffs receive a windfall is just another way of saying ***178** that the legislation is necessary to raise tax revenues. Indeed, we take issue with the dissent's use of the term "windfall" because if plaintiffs were merely following the law as it existed at the time they originally filed their state tax returns, there is nothing unfair about the result here. In any event, although apportionment of tax liability among various groups of taxpayers is a laudable goal, defendants offer no convincing rationale for applying the 2010 amendment retroactively instead of only prospectively.

Accordingly, the judgment of the Supreme Court, New York County (Paul G. Feinman, J.), entered November 5, 2012, dismissing the complaint, and bringing up for review an order, same court and Justice, entered September 25, 2012, which granted defendants' motion for summary judgment and denied plaintiffs' cross motion for summary judgment declaring unconstitutional the retroactive application of the 2010 amendment to Tax Law § 632(a)(2) as to them, should be reversed, on the law, without costs, the judgment vacated, it is declared that the retroactive application as to plaintiffs of the 2010 amendment to Tax Law § 632(a)(2) resulted in a due process violation, and defendants are hereby enjoined from enforcing ****11** the notice of deficiency. The Clerk is directed to enter judgment accordingly.

*****[Dissent Removed]*****