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State & Local Tax Advisory ■

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Taxpayer Win on Retroactivity: An Important Step for New York Tax Law

For a number of years, taxpayers have been on the business end of retroactive tax laws with both state legislatures enacting tax laws with retroactive effects and state courts enforcing the retroactive tax laws. But on December 26, 2019, taxpayers got a much-needed win, as the New York Supreme Court, Appellate Division held that a retroactive decertification of tax credits violated the taxpayers' due process rights.

The case at issue, *Matter of Mackenzie Hughes LLP v. New York State Tax Appeals Tribunal*, involved law firm Mackenzie Hughes, whose partners received New York's qualified empire zone enterprise (QEZE) tax credits because the firm leased an office in a QEZE zone. The partners had taken advantage of the QEZE tax credits since 2002. In June 2009, however, New York's governor signed legislation that changed the criteria for businesses to remain QEZE certified. Subsequently, Mackenzie Hughes was notified by the state that its QEZE certification was being revoked and that the revocation was effective January 1, 2008, 18 months before the governor signed the legislation. Meanwhile, Mackenzie Hughes's partners, having relied on the version of the QEZE law before its amendment, filed their 2009 income tax returns and received their refunds. The partners were later informed by the New York Department of Taxation and Finance (DTF) that their refunds were being disallowed because Mackenzie Hughes was no longer QEZE certified, and as a result, the partners received notices of deficiency.

Deciding to challenge the DTF's determination, Mackenzie Hughes's partners filed petitions with the Division of Tax Appeals, but the administrative law judge (ALJ) sustained the notices of deficiency. The ALJ determined that the QEZE decertification should be deemed effective as of January 1, 2009. The ALJ also determined that the state's QEZE amendment did not constitute a retroactive application of a statute, and even if it did, such a retroactive application did not violate the partners' due process rights. The ALJ's decision was upheld by New York's Tax Appeals Tribunal on different grounds. The Tax Appeals Tribunal found that there was a retroactive application of the QEZE amendment, but that the amendment's application did not rise to a violation of the partners' due process rights.

The partners continued to fight the retroactive law, filing an appeal at the Appellate Division, which reversed the Tax Appeals Tribunal's decision. The Appellate Division determined that the retroactive application of the QEZE amendment infringed on the partners' due process rights. In reaching its conclusion, the Appellate

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Division applied the three-factor test first articulated by the New York Court of Appeals in *Matter of Replan Development Inc. v. Department of Housing Preservation & Development of the City of New York* to determine whether a retroactive law is constitutional. The three factors outlined in *Replan Development* are:

1. The public purpose of the retroactive application.
2. The length of the retroactive period.
3. A taxpayer's forewarning of the change in law and the reasonableness of the taxpayer's reliance on the old law.

Notably, the three-factor standard relied on by the Appellate Division from *Replan Development* varies from the *Carlton* standard that is often relied on by state courts to determine the constitutionality of retroactive state tax legislation. In *United States v. Carlton*, the U.S. Supreme Court considered whether the retroactive effect of a new amendment for an estate tax deduction violated the Due Process Clause of the U.S. Constitution. In reversing the judgment of the court of appeals, the Supreme Court determined that the amendment's retroactivity did not violate the due process clause and did so under what has become the "legitimate purpose furthered by rational means" test. Under this test, a statute's retroactivity does not violate the Due Process Clause if (1) the legislature—in *Carlton*, Congress—acts to correct "what it reasonably viewed as a mistake" in the original law and such a mistake would lead to a loss in revenue; and (2) whether the period of retroactivity is "modest."

The New York due process standard is similar to the *Carlton* standard because under both standards the taxpayer must prove that the legislature lacks a legitimate public purpose for enacting the retroactive statute and that the length of the retroactive period unfairly burdens the taxpayer. Arguably, however, the New York due process standard is more stringent than the *Carlton* due process standard because in addition to disproving a public purpose and a modest length of retroactivity, a taxpayer must also establish that it reasonably relied on the prior version of the tax law. Requiring a taxpayer to demonstrate to the satisfaction of a New York court the additional factor of reasonable reliance, which has become a determining factor under New York law, creates a higher degree of difficulty for taxpayers challenging retroactive tax laws.

Turning back to the Appellate Division's analysis, first the court relied on a prior New York Court of Appeals decision, *James Square Associates v. Mullen*, to determine that no public purpose was served by the QEZE amendment. Second, the partners conceded to the court that the second factor favored the state because the 2009 period of retroactivity was only 97 days. The court determined that this period of time was too short to functionally harm the partners.

Finally, the court determined that the partners did not have adequate forewarning of the change in law. In analyzing the third factor, the court stated that a taxpayer's "forewarning of the change in law" should focus on "whether [the taxpayers'] reliance on the old law was reasonable." The court rejected the commissioner of taxation and finance's argument that the partners were on notice of the law change in January 2009 because January was the start of the 2009 legislative session. The court stated that the introduction of proposed legislation only gives taxpayers notice that "at most, a new law was being contemplated" but "it did not give them any warning of a change in the law."

While *Mackenzie Hughes* is a win for taxpayers facing retroactive application of taxes and for those advocating that states have succeeded in passing tax laws with unconstitutional retroactive application, this result is far from commonplace. In 2015, the state's Court of Appeals upheld the retroactive application of a New York personal income tax law that taxed nonresidents selling shares in an S corporation.

In *Caprio v. New York State Department of Taxation*, the taxpayers, Florida residents, sold all of their stock in an S corporation in 2006 and 2007. In conjunction with this sale, the taxpayers and the stock's buyer made a joint IRC Section 338(h)(10) election. For federal tax purposes, this election treated the sale of the stock as a sale of assets. For New York tax purposes, the taxpayers interpreting New York Tax Law Section 632 before its amendment treated the election as a sale of S corporation stock and reported no New York–source gain on the sale.

In 2010, New York amended Tax Law Section 632 to require that both residents and nonresidents source gain from the sale proceeds of S corporation stock to New York in accordance with the S corporation's business allocation percentage. While few quarreled with this amended portion of Tax Law Section 632, the amendment also made the law retroactive to January 1, 2007, some two-and-a-half years before the law's amendment. And unsurprisingly, the amendment's retroactivity captured the taxpayers' transaction.

The DTF subsequently audited the taxpayers' state income tax returns and issued a notice of deficiency assessing additional taxes and interest due as a result of the sale of stock. The taxpayers challenged the law's retroactivity in the New York Supreme Court, arguing that the amended law violated their due process rights. The Supreme Court granted the DTF's motion for summary judgment, but the taxpayers appealed to the Appellate Division, where the court determined that the retroactivity of the statute violated their due process rights. However, the Appellate Division granted the DTF's motion for leave to appeal to the Court of Appeals.

Unfortunately for the taxpayers, their winning streak ended in the Appellate Division. In reversing the lower court, the Court of Appeals applied the three-factor test to determine whether Tax Law Section 632's retroactivity provision violated the taxpayers' right to due process. The court found that all three factors favored the retroactive application of Tax Law Section 632. First, the court agreed with the DTF that the state's legislature had a valid public purpose in enacting the retroactive amendment to Tax Law Section 632. The DTF argued that the purpose of the retroactivity was to correct an error in Tax Law Section 632 and to prevent "significant and unanticipated revenue loss." Second, the court found that the three-and-a-half-year retroactive period was not excessive. The court found persuasive the DTF's argument that the time period was designed by the legislature to cover open tax years and to prevent an unexpected loss of revenue.

Finally, the court determined that the taxpayers' reliance on Tax Law Section 632 before its amendment was not reasonable. After hearing the taxpayers' argument, the court determined that the taxpayers' interpretation of Tax Law Section 632 contradicted the state legislature's express intent of enacting the law and that by treating the sale of S corporation stock as a sale of assets, the taxpayers attempted to "circumvent the payment of state taxes altogether." Having decided the third factor in favor of applying retroactivity based on the taxpayers' interpretation of the prior version of Tax Law Section 632, the court did not discuss whether the taxpayers had adequate forewarning of the law's change.

By analyzing the opinions in both *Mackenzie Hughes* and *Caprio*, it is clear that the contrasting outcomes came down to how the taxpayers relied on prior law and whether such reliance was fair and equitable. The partners in *Mackenzie Hughes* had taken advantage of the QEZE tax credits for many years before the law's amendment. Further, the partners' reliance on the QEZE tax credits was the correct reading of the statute; the DTF did not argue that the partners were improperly taking advantage of tax credits. In contrast, the Court of Appeals in *Caprio* determined that the taxpayers interpreted Tax Law Section 632 too liberally and structured the sale of the S corporation stock to avoid paying New York income tax. In the future, taxpayers challenging the retroactive nature of New York tax laws would be wise to specifically consider their "reliance" on prior law. While taxpayers might argue that their reliance is always reasonable, *Mackenzie Hughes* and *Caprio* demonstrate reliance is in the eyes of the court.

Unfortunately, even outside New York, the taxpayer-adverse outcome of *Caprio* is the norm. Before the U.S. Supreme Court agreed to hear *South Dakota v. Wayfair Inc.*, many state tax practitioners (especially the authors of this article) were hopeful that if the Court agreed to hear a state tax case, it would address retroactivity. In fact, while the Supreme Court was deciding whether to take *Wayfair,* a number of retroactivity cases were also before the Court. Unfortunately, the Court declined to take these cases.

Without a *Wayfair*-like pronouncement from the U.S. Supreme Court on retroactivity, courts may see more taxpayers necessarily challenging future retroactive tax statutes. In time, the taxpayer-friendly result in *Mackenzie Hughes* should be a more ordinary outcome, not an outlier.

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