June 8, 2012

Careful Planning Required When Moving to New York

By: Joseph Lipari

New York tax practitioners often counsel individual clients on the steps to take and the tax consequences of a planned move from New York to another state. Often, for example, attorneys draft letters or memoranda explaining the tax issues and provide a checklist of steps to take to demonstrate that the change of residence is done properly. In contrast, individuals planning a move to New York from another state often do not have New York counsel to advise them. A recent Determination by an Administrative Law Judge ("ALJ") of the Division of Tax Appeals, *Matter of Michaels*,[1] demonstrates that failure to plan properly for a move to New York can be extremely costly.

The situation in *Michaels* was straightforward. Glenna Michaels was a Connecticut resident who decided to move to New York. She had acquired her home in 1973. In 1996 she transferred ownership of the home to a trust she settled and for which she was the sole trustee.[2] In 2003 she listed the house for sale. In 2004 she received an offer to purchase the house and retained a Connecticut attorney to negotiate a purchase and sale contract. On September 14, 2004, a contract to sell the house for $14,000,000 was executed, and the purchaser put up a deposit of 10 percent ($1,400,000). The parties executed a rider to the contract in October.

The events of the following month proved critical to the ALJ determination. On November 5, Michaels met with her attorney to sign what, she believed, were all the necessary papers for the closing. She executed a warranty deed for the property and a power of attorney form authorizing her attorney to appear on her behalf at the closing. She also signed an affidavit of clear title required by the title company and letters of direction concerning the payments to be received. The contract provided for a closing on November 8, but contained a provision allowing the purchaser to postpone the closing date for up to three weeks. The contract provided that, in the event the closing was postponed by more than five business days, the purchaser would reimburse the seller for the carrying costs of the property.

On November 9, one day after the scheduled closing date, Michaels "closed on the purchase of a condominium in New York City and immediately began residing there, terminating her use of the Connecticut home as a residence." The sale of the Connecticut home then closed on November 29, at which time Michaels received $12,621,109.38, the balance of the purchase price after accounting for the $1,400,000 deposit and closing adjustments, which included a credit to Michaels for the costs of carrying the property between the scheduled closing date of November 8 and November 29.

Michaels filed her 2004 tax returns as a part-year Connecticut resident for the period January 1 through November 9 and as a part-year New York resident for the period November 10 through December 31. Her federal income tax return schedule of capital gains reflected gain of $11,611,424 on the sale of the home and provided for "an acquisition date of 01/01/84 and a sale date of 11/29/04". As a result, the sale of the house, according to the dates on the state tax returns, occurred during the New York residency period. However, Michaels' state tax returns treated the gain on the sale as accruing during her Connecticut resident period. The Audit Division disputed this position and found that the sale did not accrue until the closing. Consequently, the Division asserted additional New York Personal Income Tax, interest and penalty of $1,162,.083.64.[3]

Michaels' position is that the gain should not be included in her New York residence period income by reason of the "Special Accrual" rules contained in Tax Law section 639(b). That section provides that when an individual changes his or her status from nonresident to resident the individual must

> accrue to the period of nonresidence any items of income, gain, loss or deduction, … accruing prior to the change of status, with the applicable modifications and adjustments to federal adjusted gross income, itemized deductions and items of tax preference … other

Joseph Lipari *is a partner in the law firm of Roberts & Holland LLP.*

than items derived from or connected with New York sources … .

(The same language is used in New York City Administrative Code section 11-1754(c)(2).) The regulations under this section provide that the Special Accrual provisions apply "regardless of the method of accounting normally employed" by the individual.

ALJ Analysis

In analyzing the potential impact of section 639(b), the ALJ focused on language in the regulations which state that "the computation of the capital gain . . . to be reported is to be made in the same manner as the corresponding Federal computation."[4] The ALJ concluded that Tax law section 639 and the regulations "require conformity with the relevant provisions of the Internal Revenue Code (IRC) to determine the proper accrual of items of income . . . [5] Looking to federal law, the ALJ proceeded to discuss I.R.C. section 451, which governs the accrual basis of accounting. Under section 451, an item must be included in income "when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy . . . ."[6]

The ALJ noted that, under the Internal Revenue Code, gain does not arise until property is considered sold or otherwise disposed. Courts have consistently held that, for tax purposes, a transfer occurs upon the first of the passage of title or the passage of the benefits and burdens of ownership, and that this is a question of fact that must be resolved by an examination of all of the facts and circumstances.

The ALJ devoted a substantial part of the Determination setting forth many of the provisions of the contract. Although the contract did not include several contingencies commonly included in a sales contract such as a mortgage contingency, others were included. Significantly, if the purchaser failed to close, the seller's sole remedy was to retain the deposit as liquidated damages. If the seller could not deliver good title, the purchaser could cancel the transaction. In the event of a casualty prior to the closing, the purchaser could elect to close and receive the insurance proceeds or cancel the transaction. The ALJ reviewed several cases which consider when a sale is completed for tax purposes, [7] concluding that the authorities did not support a finding of a sale prior to closing under these circumstances. Accordingly, the ALJ concluded that the sale occurred after the change of residence to New York and was taxable in this state. The ALJ did, however, conclude that reasonable cause existed for the waiver of penalties on the theory that this was "a case of first impression."

Although we do not know what advice Michaels initially received, it seems likely that the argument under the Special Accrual rules was adopted after the delays in the closing of the Connecticut sale caused it to occur after she moved into the New York apartment.

Evaluating the Approach

With the benefit of 20/20 hindsight, there may possibly have been a better approach to take to avoid New York tax on the gain. Specifically, it is unclear why Michaels conceded that she had become a New York resident on November 9. The case was submitted to the ALJ on the basis of documents without a hearing. As noted above, the only references to November 9 are on Michaels' state tax returns and the ALJ's statement that, on that date, Michaels "closed on the purchase of a condominium in New York City and immediately began residing there, terminating her use of the Connecticut home as a residence." This finding is more than a little curious. The Determination does not explain whether the condominium was purchased furnished or whether Michaels managed to close and move in on the same date, which, in New York City, would generally be considered a feat of Herculean proportions.[8] Similarly, the Determination does not explain what happened to the furnishings of the Connecticut home, whether and when they were removed from the house, and why it was concluded that she had "terminated" her use of the Connecticut home on November 9.

It is therefore unclear what the parties would have done if Michaels had not conceded that she became a New York resident on November 9. Since Michaels was previously a domiciliary of Connecticut, she would not become a New York resident until she became a New York domiciliary whether or not she moved into the New York apartment on November 9. A change of domicile does not occur until the individual moves to a new location with the clear intention of abandoning the old domicile and acquiring a new one.[9] Simply moving into a new residence does not demonstrate a change of domicile. For example, in March 2011 this column discussed the case of a woman who moved from New York to London and years later was still held to be a New York domiciliary, on the ground that she had not permanently abandoned her New York domicile due to a relatively small chance she might return.[10] There are also cases involving individuals who move to Florida shortly before they recognize substantial gains where the Division has argued, often successfully, that the change of domicile to a location outside New York did not occur until after the sale was completed and the gain was recognized because, until then, the individual maintained substantial ties to New York.[11]

In this case a similar argument could be made that, even if she closed on a purchase of a condominium in New York City on November 9 and moved in, Michaels did not definitively become a New York domiciliary until after the closing of the Connecticut house. Certainly it seems possible to infer that if, for some reason, the sale did not close on November 29, she might have decided to move back to the Connecticut house. (Although it is likely that she gave no consideration at the time of her move to what she would have done in such case since the possibility was so remote, that does not preclude the parties from speculating after the fact.) In addition, if she had claimed that she did not change her domicile to New York before November 29, the

date of the sale of the Connecticut house, and the Division decided to challenge that position, the Division would have had the burden of proving a change of domicile on November 9 by clear and convincing evidence.[12] Thus, if she were to claim that her change of residency to New York was contingent upon the closing of the sale of the house, it is difficult to see how the Division could prove otherwise.

Of course, having moved into the New York condominium on November 9, Michaels may have been unwilling to testify that the change of domicile had not occurred on that date. Thus, in retrospect, the best solution would have been for her to use the tax savings to finance a long vacation elsewhere and wait to move.

---

1 DTA No. 823370, N.Y.S. Div. of Tax App., ALJ Unit, April 12, 2012.

2 Consequently, the trust is a grantor trust under I.R.C. § 671, and all of the income of the trust passed through to her.

3 Detailed calculations of the deficiency were not included in the Determination. It seems clear that Ms. Michaels would have been entitled to a state tax credit for the income taxes paid to Connecticut on the sale since those taxes were attributable to gain on sale of real property in that state. Nevertheless since the combined New York State and City personal income tax rates are substantially higher than those in Connecticut, the remaining deficiency was substantial.

4 20 N.Y.C.R.R. § 154.7(a).

5 The ALJ also cited *Matter of Brenhouse*, DTA No. 820708, N.Y.S. Tax App. Trib., Sept. 4, 2008.

6 Treas. Reg. § 1.451-1(a). The ALJ also cited *Matter of Blanc*, N.Y.S. Tax App. Trib. April 16, 2000, *confirmed*, 282 A.D.2d 896 (2001).

7 *Bradford v. U.S.*, 444 F.2d 1133 (Ct. Cl. 1971); *Keith v. Comm'r*, 115 T.C. 605 (2000); *Baird v. Comm'r*, 68 T.C. 115 (1977); *Merrill v. Comm'r*, 40 T.C. 66 (1963), *aff'd* 336 F.2d 771 (9th Cir. 1964).

8 Another possibility (reflecting pure speculation) is that Ms. Michaels moved into the condominium prior to closing her purchase.

9 20 N.Y.C.R.R. § 105.20(a)(1).

10 *Matter of Taylor*, DTA No. 822824, N.Y.S. Div. of Tax App., ALJ Unit, July 8, 2010; The Determination was affirmed by the Tax Appeals Tribunal on December 14, 2011.

11 *See, e.g.*, *Matter of Gray*, 235 A.D.2d 641 (1997), *aff'g* DTA No. 808982, Tax App.Trib., June 30, 1994.

12 *Bodfish v. Gallman*, 50 A.D.2d 457 (1976).