

## Watch Out for New York's Accrual Rule

by Timothy P. Noonan and Joseph N. Endres

New York's accrual rule kind of reminds us of that famous line from *The Godfather, Part III*: "Just when I thought I was out, they pull me back in!" Al Pacino delivers this line with seething frustration and anger. I think many former New York state residents have felt similar frustration on moving to another state. Just when they think they're out, they get hit with a sizable tax bill.

To be fair, moving into or out of New York can create many tax planning opportunities if you know the applicable rules. However, one little-known personal income tax rule continually catches taxpayers and tax practitioners by surprise. That rule, set forth in Tax Law section 639, is known as the accrual rule. That rule essentially transforms all cash-basis taxpayers into accrual-basis taxpayers for the year in which a residency change occurs. Thus, taxpayers attribute items of income, gain, loss, or deduction to their former state of residence if they had the right to receive those items before their move. Because many taxpayers change their residence in connection with the sale of a business (often at retirement), the accrual rule can dramatically increase an unwary taxpayer's liability. However, practitioners who are familiar with the rule can easily structure the residency change or a transaction so that their clients avoid an unintended accrual of income.



### Examples

To illustrate the accrual rule, let's examine the following scenarios:

#### Example 1

Patrick is the sole shareholder of a New York C corporation. The corporation owns and operates a bar and restaurant called Big Red's. Patrick enters into a contract to sell his stock in the corporation to Mary on June 1, 2008. The contract stipulates that Mary will pay Patrick \$200,000 for his stock. Patrick moves to Florida on July 1, 2008. Patrick receives payment on August 1, 2008. When Patrick files his 2008 part-year resident return, does he have to include the gain from the stock sale in his New York resident period?

#### Example 2

Janet wins \$2 million in the Florida lottery on June 1, 2008, and elects to defer lottery payments over a three-year period. The amount and timing of the payments are determined according to a schedule maintained by the Florida lottery's administration. On July 1, 2008, before any payments are made (and for weather-related reasons, of course), Janet changes her residence from Florida to Buffalo, N.Y. On August 1, 2008, Janet receives her first lottery payment. When Janet files her 2008 part-year resident return, should she include the lottery payment in her New York resident period?

### Analysis

In general, residents pay New York personal income tax on all items of income regardless of its source.<sup>1</sup> Nonresidents and part-year residents, however, pay tax only on those items of income that are sourced to New York.<sup>2</sup> Tax Law section 639(a) requires taxpayers who change their filing status from resident to nonresident to include in their resident period any income that has accrued before the date of their change of residence, regardless of the fact that, as a cash-basis taxpayer, the former resident does not receive payment until after the change in resident status.<sup>3</sup> Similarly, Tax Law section 639(b) requires taxpayers who change their filing status from nonresident to resident to include in their nonresident period any income that has accrued before the date of the change of residence.<sup>4</sup> In other words, the accrual rule applies regardless of whether you are entering or exiting New York. The rule also applies to changes in New York City residency.<sup>5</sup>

The New York State Department of Taxation and Finance has promulgated regulations explaining the accrual rule. The regulations make it clear that the taxpayer must include in his or her income "all items required to be included if a Federal

income tax return were being filed for the same period on an accrual basis."<sup>6</sup> Because the department's regulations concerning the accrual rule refer specifically to the federal rules, the courts and the department rely heavily on federal tax principles in determining whether an item of income has accrued to the taxpayer's period of nonresidency for New York state income tax purposes.<sup>7</sup> As a result, New York has consistently applied the federal all events test to determine whether income is accruable.<sup>8</sup>

On the federal level, the all events test is typically used to determine whether an item of expense should be accrued to a particular year. Thus, the test examines a taxpayer's "liabilities." However, New York applies the test to items of income and gain as well as items of loss or deduction. Under the test, income is accruable to a taxpayer's original state of residence when: All the events that bear on the fact of income have occurred and the amount of income can be determined with reasonable accuracy.<sup>9</sup> The accrual rule has been applied to numerous situations, including:

- gain realized from the short sale of stock consummated after the taxpayer moved out of New York was not taxable to New York;<sup>10</sup>
- a lump sum payment of accumulated sick leave hours attributable to the taxpayer's nonresident employment was not taxable to New York;<sup>11</sup>
- bonus compensation and nonstatutory stock options accrued to New York because neither item of income satisfied both prongs of the all events test during the taxpayer's nonresident period;<sup>12</sup> and
- gain from the installment sale of real property accrued in full to New York.<sup>13</sup>

With those basic rules in mind, let's revisit the examples detailed above.

Example 1 illustrates the traditional accrual rule (that is, Tax Law section 639(a)). Tax practitioners typically encounter that situation in conjunction with a taxpayer's retirement. After years of owning a business and working in New York, many taxpayers decide to sell their businesses and retire to warmer climates. In example 1, Patrick, a New York state resident, is closing up shop and moving to Florida. Before the move, however, Patrick enters into a contract to sell his shares in a New York C corporation. Patrick receives payment for the stock sale during his New York nonresident period.

Normally, the gain would not be taxed to Patrick, a nonresident, because a capital gain from the sale of stock is generally not considered to be New York-source income. But we can't forget about the accrual rule. To determine whether Patrick's gain is taxable to New York, we must determine whether the two requirements of the all events test are satisfied. First, have all the events that bear on the fact of liability occurred? If there are no contingencies contained in the stock sale contract, then it is likely that that requirement is satisfied. However, what if the contract is expressly contingent on the restaurant's liquor license transferring to the new owner? Or the contract could require that the restaurant pass a health inspection by the applicable governmental authority. If such contingencies exist in the contract, and they are not satisfied before Patrick's move to Florida, Patrick could argue that the gain from sale should not be included in his New York state taxable income because not all events that fix his right to receive the income have occurred. Of course, the smart tax practitioner will avoid that situation altogether by advising Patrick not to enter into the contract before his move to Florida. If the contract is executed after Patrick's move, he will have a much stronger argument for excluding the gain from his New York taxable income.<sup>14</sup>

The second prong of the all events test requires that the amount of the liability be determined with reasonable accuracy. In example 1, that prong is most likely satisfied. The contract stipulates that Patrick will receive \$200,000 in exchange for his stock in the corporation. Thus, the liability can be determined with reasonable accuracy. However, what if the restaurant was in the middle of a sales tax audit and the contract stipulated that the purchase price would be reduced by any sales tax liability? If the audit was not completed before his move to Florida, Patrick would have a strong argument that the income should not accrue to New York because the purchase price could not be determined with reasonable accuracy during his resident period.<sup>15</sup>

Example 2 illustrates the opposite situation -- a New York nonresident moving into the state. That is frequently referred to as the reverse accrual rule (that is, Tax Law section 639(b)). In example 2, Janet, a Florida resident, wins the Florida state lottery before moving to New York. However, she does not receive payments from the lottery until after she is a New York resident. Does she have to include the lottery payments in her New York taxable income?

Based on those facts, it is clear that both requirements under the all events test are satisfied. Janet has won the lottery. She is entitled to and will receive the payments. Thus, all events that bear on the fact of liability have occurred. Moreover, the lottery administration has determined the exact amount that Janet will receive as well as the timing of the payments. So it appears that the second prong of the all events test is satisfied. Janet can accrue the lottery payments to her nonresident period.

In that situation, the accrual rule serves to protect taxpayers from additional New York state tax. When representing taxpayers on audit, tax practitioners should be sure to review the possibility of making a reverse accrual rule argument if the income in question arises during a taxpayer's nonresident period.

### **The Accrual Rule and Statutory Residency**

An individual can qualify as a resident of New York either because he or she is domiciled in New York or because he or she is a statutory resident of the state (that is, the individual maintains a permanent place of abode in New York and spends more than 183 days in New York). Because determining statutory residency is an annual inquiry based on maintenance of a permanent place of abode and days spent in New York, a taxpayer can qualify as a statutory resident in one year and not in the next. Until recently, however, changes of residence occurring as a result of New York's statutory residency provisions sometimes were not treated as changes of residence for purposes of the application of Tax Law section 639. That changed, however, in 2004, when the Legislature added subsection (e) to Tax Law section 639. Tax Law section 639(e) provides that the provisions of the accrual rule apply both to changes of domicile and to changes resulting from a change in statutory residency status.<sup>16</sup> Those amendments have also been incorporated into the New York City Administrative Code.<sup>17</sup>

Because the accrual rule applies to statutory residents of New York, taxpayers must be especially careful with items of deferred compensation such as bonuses. Take, for example, the following illustration:

Monica owns an apartment in New York City. She and her family live in Connecticut, but Monica's job requires her to frequently work in New York. In 2006 Monica spent 190 days in New York City and qualified as a statutory resident of both the state and the city. In 2007 Monica spent only 150 days in New York and did not qualify as a resident. Monica earns an annual bonus for each year of employment. The bonus is paid in April of the following year.

In the above example, Monica may have to pay full New York state and city income tax on the bonus she receives in 2007, while she is a nonresident. Monica was paid the bonus for her work in 2006. Thus, assuming no other contingencies or conditions, Monica earned the right to the bonus while she was a New York state and city resident. If the amount of the bonus can be determined with reasonable accuracy in 2006 (for example, if it is a set rate bonus), she could have to pay New York state and city tax on the income even though she received it during a nonresident period. Taxpayers who occasionally qualify as statutory residents should pay close attention to items of deferred compensation.

### **Conclusion**

As often stated by our colleague Mark Klein, New York's accrual rule is just that: It's "a cruel rule." And it can have a substantial effect on a taxpayer's personal income tax liability. With proper planning, however, taxpayers can make sure that once they're out of New York, the department will not be able to drag a portion of their income back into the state. Similarly, when arriving in New York as a new resident, a taxpayer can avoid the unwanted welcome of a large tax liability. The key to successfully entering and exiting the state is simply a matter of understanding the accrual rule.

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### **FOOTNOTES**

<sup>1</sup> N.Y. Tax Law section 601(a).

<sup>2</sup> *Id.*

<sup>3</sup> N.Y. Tax Law section 639(a).

<sup>4</sup> N.Y. Tax Law section 639(b).

<sup>5</sup> NYC Admin. Code section 11-1754(c).

<sup>6</sup> 20 NYCRR section 154.10(a).

<sup>7</sup> See *Matter of Blanco*, 723 N.Y.S.2d 558, 560 (3d Dep't 2001); *Matter of Schibuk*, 733 N.Y.S.2d 801 (3d Dep't 2001); *Susan Byrne Montgomery*, TSB-A-97(7)I (Aug. 12, 1995).

<sup>8</sup> Treas. reg. section 1.451-1(a).

<sup>9</sup> *Burnham Corp. v. Comm'r*, 90 TC 953 (1988) (citing *U.S. v. Hughes Properties, Inc.*, 476 U.S. 593 (1986)); see also *U.S. v. Anderson*, 269 U.S. 422 (1926); *Schibuk*, 733 N.Y.S.2d at 804. The department has issued a publication detailing the state's special accrual rules. See Publication 210, *Change of Resident Status -- Special Accruals*. This publication, however, is under revision and unavailable on the department's Web site.

<sup>10</sup> *Paul A. Curtis*, TSB-A-96(8)I (Dec. 24, 1996).

<sup>11</sup> *David C. Mallen*, TSB-A-98(2)I (Feb. 2, 1998).

<sup>12</sup> *In the Matter of Alain J. and Haydee L. Belda*, ALJ (May 4, 2006).

<sup>13</sup> *In the Matter of William and Patricia Longson*, TAT (Mar. 20, 1997).

<sup>14</sup> It is important to note that the accrual rule also applies to contracts whereby the purchase price is paid in installments. 20 NYCRR section 154.10(b).

<sup>15</sup> *U.S. v. Harmon*, 205 F.2d 919 (10th Cir. 1953).

<sup>16</sup> There is (or was) some uncertainty regarding the effect of the 2004 law change and whether it was a substantive law change or just clarification. On audit, the tax department has occasionally taken the position that the accrual rule does not apply to residency changes based on statutory residency before 2004, but that position might be inconsistent with legislative history. See Memorandum in Support of Senate Bill S 7561; *Matter of Schibuk*, 733 N.Y.S.2d 801 (3d Dep't 2001).

<sup>17</sup> NYC Admin. Code section 11-1754(c)(5).