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Tax Topics

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The hungry caterpillar

States need revenue – and often take an expansive view of their tax laws so as to garner as many receipts as possible. What follows are two such examples, both involving New York: its "statutory residency" income tax rule, and a proposed "sale" that would trigger New York sales tax.

New York's "statutory residency" rule

New York's income tax law generally treats individuals as New York residents if they are "domiciled" in the state (as in, New York is where their hearts and permanent homes are). New York also treats individuals as residents if they are not domiciled in the state, but maintain a "permanent place of abode" in New York AND spend more than 183 days a year in the state – this is what's known as "statutory residency" (many states have similar rules).

The consequence of being a New York income tax resident is that New York taxes ALL of the taxpayer's income, regardless of its source. In other words, New York taxes not only earned income, such as wages, but "unearned" income as well, such as dividends and capital gains from a securities portfolio. This can mean, for example, that if a Connecticut resident runs afoul of New York's statutory residency rule and has dividend income, neither state will credit the tax paid to the other state on this income. It is therefore possible to be taxed twice on the same income.

Historically, New York has taken a broad view of what is meant by maintaining a "permanent place of abode": what typically matters is whether the abode *could* be used as a permanent residence, not whether the taxpayer, in fact, uses it that way. That is why *Matter of John Gaied v. New York State Tax Appeals Tribunal*, a recent case from New York's highest court, is of interest (N.Y. Court of Appeals, No. 26, 2/18/14). Here are the facts:

The facts. In November 1999, John purchased a multi-family dwelling in Staten Island in the same neighborhood as his car repair business, and about a 30 minute commute from his home in New Jersey.

John moved his elderly parents, whom he supported, into the first-floor apartment, and rented out the other two apartments (yes, he reported this rental income on his tax return). John paid the utilities for his parents' apartment, kept no clothes there and slept on the couch if he stayed overnight, which he sometimes did when his father needed help because of a medical condition. For tax years 2001 through 2003, John filed New York non-resident returns, although he voted in general elections in New York in 2000. In December 2003, John sold his New Jersey residence to satisfy a large 2002 federal tax obligation. He put his belongings in storage, and moved in with an uncle in New Jersey while he renovated the boiler room in the Staten Island property to make an apartment for himself, where he started living in 2004.

New York audited John's 2001, 2002 and 2003 returns, and said that John owed over $250,000 in New York State and City taxes because he was a statutory resident of New York: he had spent over 183 days in New York City each year *and* had maintained a "permanent place of abode" at the Staten Island property. John agreed about the 183+ days per year, but disagreed that he had maintained a permanent place of abode. An Administrative Law Judge (ALJ) heard the case, and sustained John's tax deficiency; John appealed. Initially, the Tax Appeals Tribunal reversed the ALJ's decision on the ground that he did not have living quarters at his parents' apartment, and therefore did not maintain a permanent place of abode.

The New York Department of Taxation moved for reargument, however; it contended that the Tribunal had failed to take account of controlling precedent holding that the statutory residency rules only require that the taxpayer *maintain* the abode, and not actually dwell in it. On reargument, the Tribunal agreed with the Department of Taxation, although one member of the Tribunal dissented. John appealed and went to New York's Appellate Division (No. 513285, 12/27/12).

The Appellate Division again held for the Tribunal, saying that the issue was whether John had maintained a permanent place of abode within the meaning of the tax statute. The Appellate Division concluded that he had, even though it stated that "a contrary conclusion would have been reasonable." Two judges dissented, saying that there was clear and convincing evidence that John did not live in the dwelling or have any "personal residential interest" in the property; to hold that John maintained a "permanent place of abode" within the meaning of the tax law was "irrational and unreasonable," and the income tax deficiency was therefore "improper."

John appealed to New York's highest court, the Court of Appeals. The Court of Appeals noted that the Tax Tribunal has interpreted "maintains a permanent place of abode" to mean that a taxpayer need not *reside* in the dwelling, but merely maintain it, to qualify as a statutory resident. The Court of Appeals examined whether that interpretation "comports with the meaning and intent of the statutes involved," and held there is "no rational basis" for it. Indeed, the statute was designed to prevent tax evasion by New York *residents*; accordingly, "the taxpayer, must, himself, have a residential interest in the property."

The Court of Appeals reversed the Appellate Division decision; it instructed that court to remand the case to the New York State Tax Appeals Tribunal, so that the Tribunal could re-examine the case to ascertain whether the taxpayer had a "residential interest" in the Staten Island property. Thus, although the Court of Appeals reframed the residency issue in a way that is favorable to John, it is still up to the Tribunal to determine whether this beneficial approach applies to John. In other words, the case isn't over yet.

Comments. This case is being viewed as a sea change in New York's ability to assert that a taxpayer is a statutory New York resident because of merely *maintaining* a permanent place of abode in New York. Yet before rejoicing, readers may want to review a few points. First, John asserted that in the years in question, he *never* used his parents' apartment as a residence – remember that he kept no clothes there, and slept on the couch the few times he stayed over. Second, the Tax Tribunal must now reexamine John's case in light of that "residential interest" – the evidence may or may not support his claim that he had none. Third, how

does the standard of "residential interest" help, for example, a Connecticut resident who trips the 183+ day test and buys a New York vacation home on Long Island that he only uses for several weeks a year? Answer: it won't, as even that brief usage presumably evinces a "residential interest." (See *Matter of Barker*, Tax Appeals Tribunal, 1/13/11, and the 04/06/11 *Tax Topics*.) Where this case may be helpful is for non-resident taxpayers who own New York rental property in which they occasionally "camp out" – assuming New York has asserted a statutory residency claim against them.

…and now for the New York sales tax issue

"Intentionally defective grantor trusts" have an unfortunate name, but are anything but "defective." Rather, they are carefully structured so that the creator of the trust (the "grantor" or "settlor") owns them for income tax purposes, but not for estate tax purposes. In other words, the grantor retains enough of a string to be responsible for paying the trust's income taxes (regardless of whether the income stays in the trust or is distributed to beneficiaries), but not enough of a string so that the trust will be includible in the grantor's estate when she dies. A typical means for creating defective grantor trust status is for the grantor to have the power to reacquire trust property by swapping property of equivalent value (also known as a power of substitution).

The New York State Department of Taxation and Finance recently addressed the potential exercise of such a power in an advisory opinion (TSB-A-14(6)S, January 29, 2014). The question was whether the grantor's prospective swap of tangible personal property for trust property that was not tangible personal property would be subject to New York sales tax. The opinion said that it would be.

The opinion's analysis. The opinion explained that New York's tax law imposes sales tax on every retail sale of tangible personal property unless an exemption applies (none did here). A "sale" includes any "transfer of title" for "consideration." Here, the grantor proposed transferring tangible personal property to another "person" (the trust) in exchange for other property the trust owned. Because the grantor would be receiving something of value, he would be receiving "consideration," notwithstanding the grantor's insistence that the trust precluded him from receiving consideration in a swap and that the trustees had no bargaining power.

Said the Tax Department: "a transfer to a trust does not require negotiation to be supported by consideration....As long as the individual receives something of value in the transfer, consideration is present." The Tax Department also took note of a prior advisory opinion (TSB-A-99(22)S), in which a grantor retitled his car in the name of his revocable trust: although the opinion did not state whether the grantor had in fact received anything of value in the transfer, it simply noted that if the grantor did, then, yes, the transfer would be subject to sales tax; if he did not, the transfer would be free from sales tax. As to this proposed swap, the opinion concluded that the grantor and the defective grantor trust are "separate taxpayers capable of entering into a sale" for purposes of the sales tax, even though such a sale would be ignored for income tax purposes.

Comments. The grantor's proposed property swap may not sound like a "retail sale" of tangible personal property, but it would be for purposes of New York's sales tax statute: title to this tangible personal property would change and the grantor would be receiving something of value. What is more curious, however, is why this transaction even came up in the first place: it seems unusual for a grantor to swap tangible property (such as a painting) for other property the trust holds (such as stock). Suppose, instead, the grantor wanted to swap stock for stock, which seems more typical. Although this wouldn't be a "sale" for purposes of the sales tax, since stock is "intangible" rather than "tangible" property, one wonders if some other New York levy could apply to such a transaction. What an unwelcome thought! Perhaps, in retrospect, the grantor wishes he hadn't asked the question.

To sum up

Whether it is a broad reading of the statutory residence rules or what constitutes a "sale" for purposes of the sales tax, states are rarely at a loss when it comes to casting a wide net for potential tax revenue.

January, February and March 7520 rates

The January, February and March 2014 applicable federal rates are as follows: the January 7520 rate was 2.2%, an increase of 0.20% (20 basis points) from December's 2.0% rate. January's mid-term rates were also up slightly: 1.75% (annual), 1.74% (semiannual and quarterly), and 1.73% (monthly). (December's mid-term rates were: 1.65% (annual), 1.64% (semiannual and quarterly), and 1.63% (monthly).) February's 7520 rate is 2.4%, and the February mid-term rates are 1.97% (annual), 1.96% (semiannual and quarterly) and 1.95% (monthly). March's 7520 rate is 2.2%, and its mid-term rates are 1.84% (annual), 1.83% (semiannual and quarterly) and 1.82% (monthly).

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