

New York State Department of Taxation and Finance
Office of Tax Policy Analysis
Technical Services Division

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Income Tax
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Acceptable Security Under Section 639(d) of the Tax Law

The issue is whether (1) a certificate of deposit (CD) held in street name by a brokerage firm and (2) a money market account meet the requirements of acceptable security under section 639(d) of the Tax Law and section 154.11 of the New York State Personal Income Tax Regulations (Regulations).

In 2003, while a resident of New York, an individual (X) sold his interest in an S Corporation. The sale resulted in an installment agreement. On September 3, 2003, X moved out of New York State. The installment agreement is scheduled to end in December 2007.

As a result of the installment sale, X incurred a personal income tax liability to New York State. In 2004, X purchased a certificate of deposit (CD) from a bank and retained a money market account with a foreign financial institution (Financial) to offer as collateral for the deferred tax pursuant to section 639(d) of the Tax Law. Financial holds securities for its customers in street name. X's CD is held by Financial as an electronic journal entry.

X submitted a letter prepared by Financial to the New York State Tax Department (Department) which states, in relevant part, as follows:

Per the signed IT-260.1 form, [Financial] recognizes the lien on the above account and the assets currently held within it by the state for tax escrow. As indicated on the form no withdrawal of principal will be permitted from the account without written consent from the [New York State Department of Taxation and Finance (Department)] in the event that the taxpayer defaults on their obligation to the state or until such time as their obligation has been met in its entirety.

In the event of taxpayer default, please notify [Financial] in writing on state letterhead indicating that the client has defaulted on their obligation and requesting the immediate disbursement of funds to the state from this account for the amount due. Upon receipt, [Financial] will liquidate the certificate of deposit and forward a check as directed to [the Department]. The funds will be disbursed on settlement date as instructed.

In consideration of [Financial] executing these instructions, the [Department] agrees to indemnify and hold harmless [Financial], its officers, directors, employees, agents, affiliates, representatives, and each of their heirs, successors and assigns from and against any liability that may arise by [Financial] acting on these instructions.

In addition, X submitted a Trade Confirmation Notice issued by Financial indicating a brokerage account held by Financial in the name of X. The notice describes the security as a bank CD in an amount slightly lower than X's tax liability. The account also included an amount to cover the remainder of X's tax liability held in a money market account.

Applicable law and regulations

Section 639 of the Tax Law provides, in part:

(a) If an individual changes status from resident to nonresident he shall, regardless of his method of accounting, accrue to the period of residence any items of income, gain, loss, deduction, items of tax preference or ordinary income portion of a lump sum distribution 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 under sections six hundred twelve, six hundred fifteen and six hundred twenty-two, if not otherwise properly includible or allowable for New York income tax purposes for such period or a prior taxable year under his method of accounting.

* * *

(c) No item of income, gain, loss, deduction, item of tax preference, ordinary income portion of a lump sum distribution or modification or adjustment which is accrued under this section shall be taken into account in determining the tax under this article for any subsequent taxable year.

(d) The accruals under this section shall not be required if the individual files with the commissioner a bond or other security acceptable to the commissioner, on condition that the amounts accruable under this section are taken into account in determining the tax under this article for one or more subsequent taxable years as if the individual had not changed his resident status.

(e) The foregoing provisions of this section shall apply if an individual changes his or her status from a resident to nonresident or from a nonresident to resident during a taxable year, or at the beginning of a taxable year, as a result of a change of domicile or as a result of becoming a resident or nonresident based on the definition contained in subsection (b) of section six hundred five of this article.

Section 8-102(7) of the Uniform Commercial Code (UCC) provides:

“Entitlement holder” means a person identified in the records of a securities intermediary as the person having a security entitlement against the securities intermediary. If a person acquires a security entitlement by virtue of Section 8-501(b) (2) or (3), that person is the entitlement holder.

Section 8-102(8) of the UCC provides:

“Entitlement order” means a notification communicated to a securities intermediary directing transfer or redemption of a financial asset to which the entitlement holder has a security entitlement.

Section 8-102(14) of the UCC provides:

“Securities intermediary” means:

(i) a clearing corporation; or

(ii) a person, including a bank or broker, that in the ordinary course of its business maintains securities accounts for others and is acting in that capacity.

Section 8-102(17) of the UCC provides:

“Security entitlement” means the rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5.

Section 8-104(a) of the UCC provides:

A person acquires a security or an interest therein, under this Article, if:

(1) the person is a purchaser to whom a security is delivered pursuant to Section 8-301; or

(2) the person acquires a security entitlement to the security pursuant to Section 8-501.

Section 8-106(d) of the UCC provides:

A purchaser has “control” of a security entitlement if:

(1) the purchaser becomes the entitlement holder;

(2) the securities intermediary has agreed that it will comply with entitlement orders originated by the purchaser without further consent by the entitlement holder; or

(3) another person has control of the security entitlement on behalf of the purchaser or, having previously acquired control of the security entitlement, acknowledges that it has control on behalf of the purchaser.

Section 8-501(a) of the UCC provides:

“Securities account” means an account to which a financial asset is or may be credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the financial asset.

Section 8-501(b) of the UCC provides:

Except as otherwise provided in subsections (d) and (e), a person acquires a security entitlement if a securities intermediary:

(1) indicates by book entry that a financial asset has been credited to the person’s securities account;

(2) receives a financial asset from the person or acquires a financial asset for the person and, in either case, accepts it for credit to the person’s securities account; or

(3) becomes obligated under other law, regulation, or rule to credit a financial asset to the person’s securities account.

Section 9-102(49) of the UCC provides:

“Investment property” means a security, whether certificated or uncertificated, security entitlement, securities account, commodity contract, or commodity account.

Section 9-106(a) of the UCC, for purposes of control of investment property, provides:

Control under Section 8-106. A person has control of a certificated security, uncertificated security, or security entitlement as provided in Section 8-106.

Section 9-106(c) of the UCC provides:

Effect of control of securities account or commodity account. A secured party having control of all security entitlements or commodity contracts carried in a securities account or commodity account has control over the securities account or commodity account.

Section 9-314(a) of the UCC provides:

Perfection by control. A security interest in investment property, deposit accounts, letter-of-credit rights, or electronic chattel paper may be perfected by control of the collateral under Section 9-104, 9-105, 9-106, or 9-107.

Section 154.11 of the Regulations provides, in part:

(a) (1) The New York State income tax return and any schedules required to be filed with such return of an individual or of a trust for the period prior to a change of status from resident to nonresident may be filed without the special accruals referred to in this Part if such individual or trust files with the Division of Taxation a surety bond or other security acceptable to the division. Except with regard to withholding from New York State lottery winnings (see paragraph (d) (4) of this section), such surety bond or other security must be in an amount not less than the amount of additional New York State income tax (including the amount of additional New York State minimum income tax) which would be payable if no such surety bond or other security were filed. The filing of such surety bond or other security is conditioned upon the inclusion in future New York State nonresident personal or fiduciary income tax returns of amounts accruable (under section 154.10 of this Part) in New York taxable income, New York personal service taxable income and New York State minimum taxable income for one or more subsequent taxable years as if such individual or trust had not changed resident status. The additional New York State income tax (including the amount of additional New York State minimum income tax) which is considered in determining the amount of the surety bond or other security (except in the case of withholding from New York State lottery winnings) which the individual or the trust will be required to furnish, is computed at the rates which the individual or trust would have been obliged to pay if no bond or other security had been filed, taking into account all accrued items of income, gain, loss, deduction and any of the modifications permitted or required under Parts 112, 115 and 118 of this Title (as well as any accrued New York items of tax preference), and resolving against such individual or trust all matters in dispute affecting the amount of New York State income tax (including the amount of New York State minimum income tax).

(2) If an individual or trust elects to defer New York State income tax (including New York State minimum income tax) in accordance with the provisions of this section, such taxpayer must forward, with the New York State income tax return(s) and any schedules required to be filed with such return(s) for the taxable year in which the change of residence occurred, separate statements for New York State income tax and New York State minimum income tax purposes showing the following information:

(i) the nature and amount of each item of accrued income, gain, loss or deduction as of the date of the change of residence, together with a computation of the additional New York State income tax which would be due if the election provided by this section had not been made, and if the accrued items were properly included in the New York taxable income and New York personal service taxable income on the final New York State income tax return filed as a resident; and

(ii) the nature and amount of each accrued New York item of tax preference as of the date of the change of residence, together with a computation of the additional New York State minimum income tax which would be due if the election provided by

this section had not been made, and if the accrued New York items of tax preference were properly included in the New York State minimum taxable income on the final *New York State Minimum Income Tax Computation Schedule* filed as a resident.

(b) Surety bond. If an individual or a trust makes the election provided by subdivision (a) of this section and files a surety bond with the Department of Taxation and Finance, the surety bond to be submitted must be:

(1) executed by a surety company which is registered with, and under the supervision of, the Insurance Department of New York State;

(2) approved by the Department of Taxation and Finance;

(3) in an amount not less than the amount of deferred New York State income tax (including the amount of deferred New York State minimum income tax) determined under subdivision (a) of this section;

(4) filed with the New York State income tax return for the period prior to the change of residence;

(5) accompanied by properly executed form IT-260 in triplicate; and

(6) accompanied by the statement(s) referred to in paragraph (a)(2) of this section.

(c) Security. (1) If an individual or a trust makes the election provided by subdivision (a) of this section and offers security to the Department of Taxation and Finance as collateral in lieu of a surety bond, the following kinds of security will be accepted:

(i) certificated United States treasury bonds;

(ii) certificated bonds of New York State;

(iii) certificated bonds of any political subdivision of New York State having general governmental powers in connection with which the credit of the political subdivision is pledged for the payment of the interest and principal due on such bonds;

(iv) bank passbooks and certificates of deposit;

(v) irrevocable standby letters of credit made payable to the New York State Department of Taxation and Finance;

(vi) withholding of New York State personal income tax from payments of lottery winnings by the New York State Division of the Lottery (see section 171.11 of this Title); and

(vii) other forms of security acceptable to the Department of Taxation and Finance.

(2) The security offered as collateral by the taxpayer must be forwarded, by registered mail, addressed to the Income Tax Audit Administrator, Central Office Audit Bureau, W.A. Harriman Campus, Albany, NY 12227, together with the following items attributable to the year the change of residence occurred:

(i) the New York State income tax return(s);

(ii) any schedules required to be filed with the New York State income tax return(s);

(iii) the statement(s) referred to in paragraph (a)(2) of this section; and

(iv) properly executed form IT-260.1 in triplicate.

Opinion

When an individual changes status from resident to nonresident, section 639 of the Tax Law requires the individual to accrue to the resident period items of income accruing prior to the change of status. However, the accruals are not required, and the tax may be deferred to subsequent years, if the individual files a bond or other acceptable security with the Department in an amount not less than the amount of additional New York personal income tax that would be payable if no security were filed.

Section 154.11(a) of the Regulations provides that the New York State personal income tax return and schedules required to be filed may be filed without the special accruals. Section 154.11(c)(1)(vii) of the Regulations provides that if an individual makes the election to defer New York personal income tax, in lieu of a surety bond, other forms of security may be accepted as collateral.

In the present case, X purchased a CD and retained a money market account as security for the deferred tax. As indicated in the Trade Confirmation Notice issued by Financial, a brokerage account has been established by X. The brokerage account consists of a CD and money market account that will be retained by Financial in the brokerage account in the name of X.

The collateral that is sought to be pledged is (1) a CD, and (2) a money market account. Both accounts are held in street name by Financial for the benefit of X. Under the UCC, Financial is the securities intermediary and X is the entitlement holder. In addition, the rights and property interest of the entitlement holders in the CD and money market account are security entitlements.

X is offering as collateral book-entry securities accounts instead of securities in certificate form. In either event, it is necessary for the Department to acquire a perfected security interest in the accounts in order for the requirements of section 639(d) of the Tax Law to be met.

For purposes of the UCC, a person acquires a security or interest therein if the person acquires a security entitlement to the security. Security entitlement means the rights and property interest of an entitlement holder with respect to a financial asset. Investment property includes a securities entitlement or securities account, like X's book-entry securities held in a brokerage account in the present case. Pursuant to section 9-314(a) of the UCC, a security interest in investment property may be perfected by control of the collateral under, among others, section 9-106 of the UCC. Under section 9-106 of the UCC, a person has control of a security entitlement as provided under section 8-106 of the UCC.

The control provisions in section 8-106 of the UCC and related provisions in Article 9 of the UCC are designed to facilitate transactions in which a person who holds book entry securities through a securities account uses them as collateral in an arrangement where the securities intermediary has agreed that if the secured party so directs, the intermediary will dispose of the securities. In such arrangements, the debtor (X) remains the entitlement holder but has agreed that the secured party (Department) can initiate entitlement orders.

Pursuant to section 8-106(d)(2) of the UCC, the Department has control of a security entitlement if a securities intermediary (Financial) agrees that it will comply with entitlement orders originated by the Department without further consent by X. The letter prepared by Financial and submitted by X states that upon notice from the Department on its letterhead indicating an event of default, Financial will liquidate the account and forward the proceeds to the Department. However, the letter in and of itself does not provide adequate control of the security entitlement under sections 8-106 and 9-106 of the UCC.

In order for the collateral offered by X to be considered acceptable security for purposes of section 639(d) of the Tax Law, X must submit a security agreement in the form of a document that he has signed agreeing that the Department, as the secured party, can initiate entitlement orders. The agreement must include a pledge of securities and a representation that no other party has been granted a security interest in the accounts, that no other party will be granted a security interest in the accounts, and that X is the only owner of the accounts. Further, the agreement must set forth X's and the Department's rights and remedies in the event of a default by X and, of special importance in a multi-state case such as this, must provide that New York

law will govern in the event of litigation over the provisions of the security agreement or entitlement order.

Financial's letter references a signed Form IT-260, *New York State and City of New York Surety Bond Form Change of Resident Status – Special Accruals*. However, the form is not applicable in this case because it only relates to securities that may be physically delivered to the Department. While Form IT-260 has been submitted and signed by X, it does not relate to a book-entry security and does not constitute an agreement to an entitlement order.

Lastly, the indemnification language contained in Financial's letter is not acceptable for purposes of section 639(d) of the Tax Law. The Department cannot agree to indemnify and hold harmless Financial, its officers, directors, employees, agents, affiliates, representatives, and each of their heirs, successors, and assigns from and against any liability that may arise by Financial acting on the instructions of the letter.

Accordingly, under the circumstances described in this case, X has not submitted acceptable security for purposes of section 639(d) of the Tax Law and section 154.11(c)(1)(vii) of the Regulations.

NOTE: NYT-Gs are informational statements of the Department's interpretation of the Tax Law and regulations and are based on a particular set of facts. NYT-Gs are accurate on the date they are published and are limited to the facts set forth therein. A NYT-G is based on the statutes, regulations, court cases, and Tax Appeals Tribunal decisions in effect on the date the NYT-G is issued (or in effect for the specific time period at issue in the NYT-G). Any changes in such legal authorities after the date the NYT-G is published may affect the conclusions stated therein.