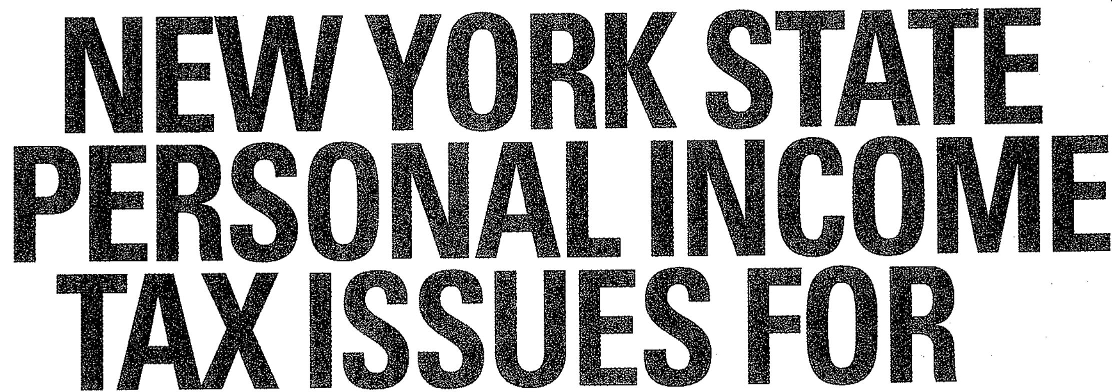

Taking advantage of unique rules may save taxes in New York.

NONRESIDENT CONSTRUCTION CONTRACTORS

JACK TRACHTENBERG, ESQ.

With the ascendancy of Eliot Spitzer to the governorship of New York, a new, more aggressive environment of tax enforcement—against both businesses and individuals—seems to be taking hold in the state. On July 3, 2007, the New York State Department of Taxation and Finance (the "Department") and the New York State Attorney General's office announced that seven individuals had plead guilty to criminal tax evasion for failing to file New York State personal income tax returns.[1] A little more than a week later, the Department announced that it had commenced more criminal actions in "cases against tax cheats," including some prominent individuals who are accused of failing to file tax returns or engaging in other alleged tax fraud.[2] According to William Comiskey, the new Deputy Commissioner of Tax Enforcement: "These cases illustrate the Department's determination to aggressively investigate criminal violations of our tax laws and to work with local prosecutors to bring tax cheats to justice."[3]

Clearly, not every incorrect tax filing constitutes a criminal violation of New York's tax laws. Nonetheless, the state's renewed focus on tax enforcement should give everyone an incentive to review his tax filing and reporting activities. This includes businesses and individuals involved in the construction industry. The construction industry is one of the fastest-growing private sector job producers in New York State, creating over 350,000 new jobs in May 2007 alone.[4] This means that there is an ever increasing need for construction industry businesses, executives and employees to understand their New York State per-

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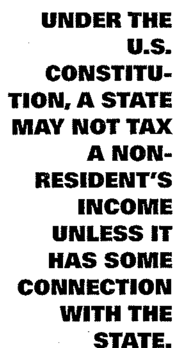
sonal income tax and withholding tax filing obligations.

Personal income and withholding taxes

When it comes to residents, New York State's personal income tax and withholding rules are fairly straightforward. Put simply, residents must pay tax on their worldwide income, regardless of the source of the income.[5] Thus, a New York resident employee will be taxed on *all* of his or her wages even if those services were performed in another state. Likewise, New York's withholding tax rules require employers doing business in the state to withhold tax on *all* wages paid to resident employees.[6]



UNDER THE U.S. CONSTITUTION, A STATE MAY NOT TAX A NONRESIDENT'S INCOME UNLESS IT HAS SOME CONNECTION WITH THE STATE.

The rules for nonresidents are a bit trickier. Under the United States Constitution, a state may not tax a nonresident's income unless it has some connection with the state.[7] Thus, New York's Tax Law provides that a nonresident's income cannot be taxed unless it is derived from or connected to New York sources.[8] Similarly, New York's withholding tax rules require employers to withhold taxes only from those wages that are sourced to the state (i.e., paid for services performed in New York).[9] The issue then is to determine what constitutes New York source income.

Generally, the New York source income of a nonresident individual includes all items of income, gain, loss and deduction entering into the taxpayer's federal adjusted gross income that are attributed to: (1) the ownership of any interest in real or tangible property located in New York; or (2) a business, trade, profession or occupation carried on in New York.[10] Consequently, when compensation is earned for services performed wholly within New York, the nonresident's entire compensation is taxable by the State.[11] If compensation is paid for personal services rendered wholly outside of New York, the State may not tax any of the nonresident's income.[12] And when a nonresident performs services both within and without New York State, the nonresident's income must generally be allocated to New York based upon a ratio that the number of days worked in New York bears to the total number of days worked both within and without the State.[13]

Convenience-of-the-employer doctrine

In calculating a nonresident's income allocation ratio, New York applies a somewhat unique convenience-versus-necessity test.[14] This "convenience-of-the-employer" doctrine generally requires nonresidents who work for a New York employer to treat days worked outside of the state as New York work days if the taxpayer worked outside of New York for his or her convenience. The classic example is the employee who works from home outside of New York for a New York employer. In such a case, the Department would treat days worked at the out-of-state home as if they were New York work days for allocation purposes.

An exception to the convenience doctrine applies when the employer requires the employee to perform the services out of state, and the nature of those services is such that they cannot be performed in New York.[15] The emphasis, however, is on the second requirement of the exception: the services cannot be *of a type* that could be performed in-state. For example, in *Matter of Unterweiser,*[16] a taxpayer's New York desk job was eliminated and she was only allowed to continue to work if she stayed at her home and telecommuted. In spite of the fact that she had *no* office available to her in New York, the Tribunal held that the convenience rule applied. Similarly, in *Matter of Kakar,*[17] inadequate work space and the need for privacy were not sufficient to demonstrate that the taxpayer's work-at-home office in New Jersey qualified as non-New York days.

The convenience-of-the-employer doctrine is strictly applied and can (as seen in *Unterweiser* and *Kakar*) lead to harsh results. Executives and other employees who perform out-of-state services for New York construction contractors must be careful to determine whether the convenience doctrine applies when determining the proper allocation of their income. The rule may also impact the individual's employer for withholding

tax purposes. If the convenience doctrine applies to a specific nonresident employee, the employer must withhold in a manner that is consistent with the sourcing of the employee's income under the convenience rule.

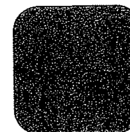
Unique forms of compensation

Putting aside the convenience of the employer doctrine, New York's sourcing and allocation rules are fairly straightforward when one is dealing with a nonresident whose compensation is limited to current wage income. Such wage income should be allocated based on the number of days the nonresident worked in New York, as compared to the total number of work days in the year. In these cases, the nonresident employee should have little difficulty determining his or her nonresident filing obligation in New York, and the nonresident's employer will likely have few problems determining the amount of New York source income subject to withholding.

When, however, a nonresident receives other forms of compensation it is often less clear how the income should be taxed by New York (or whether it can be taxed at all). Examples include non-compete payments and deferred compensation, such as termination pay, annuities, pension/retirement income and stock options. The remainder of this article will explore the application of New York's sourcing and allocation rules to each of these unique income types.

Non-compete payments. The Department's regulations assert that non-compete payments are subject to personal income tax if the non-compete agreement was entered into in conjunction with the sale of a New York business or with regard to New York services.[18] The regulations are outdated and do not reflect the Department's current position, which changed following the Tax Appeals Tribunal's decisions in *Matter of Haas*[19] and *Matter of Penchuk*.[20] In those cases, the Tribunal ruled that payments made under covenants not to compete, while ordinary income, were not taxable to nonresidents because they were not attributable to a business, trade, profession or occupation carried on in New York.

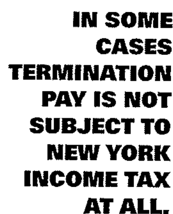
There continues, however, to exist some confusion as to what qualifies as an exempt non-compete payment. In *Matter of Colitti*,[21] the Tribunal was asked to address whether deferred stock option income that had been subject to forfeiture if the taxpayer competed with his former employer was New York source income when paid to a nonresident individual. The Department claimed that the option income was attributable to the taxpayer's former employment in New York. The Department noted that the taxpayer had originally been granted stock options as an incentive to remain employed, and that the non-compete and forfeiture provisions had simply been added on as an "upgrade" to the taxpayer's employment agreement when it was renegotiated to take the form of a retirement agreement. In the Department's view, the taxpayer could not alter the New York source nature of the option income simply by agreeing to a non-compete covenant prior to his exercise of the options.



THERE CONTINUES TO EXIST SOME CONFUSION AS TO WHAT QUALIFIES AS AN EXEMPT NON-COMPETE PAYMENT.

The Tribunal in *Colitti* disagreed. It ruled that the taxpayer's stock option income was not subject to New York State income tax because the taxpayer's right to the income "*depended on* . . . not accepting employment with a competitor."[22] Of significance to the Tribunal was the fact that if the taxpayer had competed with his former employer, "he would have been in breach of his [retirement] agreement and would not have earned the compensation which [was] sought to be taxed."[23] The Tribunal rejected the argument that the taxpayer had upgraded his employment agreement, ruling instead that the taxpayer had forfeited his previous stock option rights in favor of new rights that were contingent upon the non-compete agreement.

In contrast to *Colitti* is the decision in *Matter of Clapes*,[24] which also dealt with a taxpayer who received income from options that were awarded during a period of New York employment. Prior to exercising the options, though, the taxpayer entered into an early retirement agreement that contained a non-compete



IN SOME CASES TERMINATION PAY IS NOT SUBJECT TO NEW YORK INCOME TAX AT ALL.

covenant (but not a forfeiture clause pursuant to which the taxpayer would lose his rights to the options if he did compete with his former employer). The agreement also provided that the taxpayer's original stock option grants would remain in effect and would be fully exercisable after his termination. The taxpayer argued that *Colitti* applied, but this time the Tribunal ruled in favor of the Department. The Tribunal distinguished *Colitti* on the basis that the taxpayer there had given up his rights to stock options that had been acquired in connection with his New York employment, in favor of new rights to stock options under the terms of an employment termination agreement that contained a non-compete clause.[25] According to the Tribunal, the taxpayer in *Clapes* did not do this. Rather, his stock option awards, which were derived from his New York employment, were to remain in effect under the early retirement agreement.

The exact meaning of *Colitti* and *Clapes* is unclear. On the one hand, *Colitti* makes it plain that income, even if it takes the form of deferred compensation, will not be treated as having a New York source if it is received solely for an agreement not to compete. *Clapes,* however, cautions taxpayers not to take *Colitti* too far: if the non-compete provision is a mere afterthought or "window dressing" it may not render nontaxable that income that would otherwise be connected to prior New York services. In between these two extremes probably lies a lot of gray area. An example would be a case where the non-compete provision is clearly a negotiated and paid for element of the termination agreement, but where it is not obvious what or how much is being paid for the non-compete. Things may be particularly confusing where other payments called for in the agreement are clearly for prior New York services. The Department would likely treat all of the payments under the agreement as having a New York source (because the consideration being paid for the non-compete is not clear) but as a matter of fairness it seems that taxpayers should be allowed in such circumstances to place a reasonable value on the non-compete covenant. At the end of the day, many of these potential problems may be avoided through a careful drafting of the termination or retirement agreement.

Termination pay. It is not uncommon for nonresidents to receive payments from their employer upon their termination of employment. These payments frequently take the form of salary continuation payments, deferred compensation, severance or other types of payments, and generally constitute New York source income if paid for personal services previously rendered in New York State. In such cases, the termination pay is generally allocable to New York State based on a fraction, the numerator of which is New York compensation for the year of retirement plus the preceding three years, and the denominator of which is total compensation for the same period.[26]

In some cases, however, termination pay is not subject to New York income tax at all. In *Matter of McSpadden,*[27] the Tribunal held that termination pay granted to a nonresident employee does not constitute New York source income if it was paid to buy out the remainder of the employee's employment contract. For example, if a nonresident employee with a five-year employment contract is terminated after one year and receives a lump sum as consideration for the cancellation of the balance of the employment contract, the lump sum is not taxable. According to the Tribunal, the lump-sum payment is to be treated as a payment for an intangible, specifically the remaining term value of the employment contract.

Subsequent case law makes it clear that the *McSpadden* rule does not apply unless the taxpayer can prove that a formal employment agreement existed with his or her employer.[28] In other words, the employee must have had a *right* to future employment and cannot claim *McSpadden* treatment if he or she was an employee at will.[29] A formal agreement can be found based on an understanding of the parties, even if there is no written employment contract. Indeed, in *Matter of Davis,*[30] the ALJ ruled that a separate

written termination agreement is not required in order for the *McSpadden* rule to apply. The Department appears to disagree and has asserted on audit that termination pay will not be treated as a nontaxable buy-out payment unless the employee can prove the existence of a written employment contract.[31] There is currently no binding case law to support the Department's position, but taxpayers should be cautious about claiming the *McSpadden* exception in the absence of a written employment contract. The Department will likely challenge on audit a taxpayer who claims that his or her termination pay was a nontaxable contract buyout if there is no written contract. And in the absence of compelling circumstantial evidence that the taxpayer had a right to future employment, it may be difficult to prove that the *McSpadden* rule was properly applied.

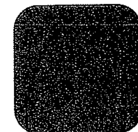
Annuities. Under New York's Tax Law, pensions in excess of $20,000 per year are taxable when paid to nonresidents if they do not qualify as an annuity and are attributable to services performed by the nonresident in the state.[32] To qualify as an exempt pension, several requirements must be met. First, the pension must be paid in money only.[33] Second, it must be payable at regular intervals for the life of the recipient, or over a period that is not less than one-half of the recipient's life expectancy.[34] Third, the pension must be payable at a uniform rate, or at a rate that varies in conjunction with certain specified criteria.[35] Finally, a written instrument must exist to prove that the recipient has a right to receive the pension.[36]

Not covered by the regulations is Public Law § 104-95, a federal statute that prohibits the states from taxing a nonresident's "retirement income," regardless of its source.[37] P.L. § 104-95 defines "retirement income" to include most qualified and tax-favored plans under the Internal Revenue Code (the "Code").[38]

Also exempt is "any plan, program, or arrangement described in Section 3121(v)(2)(C)" of the Code if the income from such plan, program or arrangement is part of a series of substantially equal periodic payments (not less frequently than annually) made for either (i) the life or life expectancy of the recipient or (ii) a period of not less than 10 years.[39] Under P.L. § 104-95, these federal "annuity" payments are exempt from state taxation without regard to the criteria set forth in the regulations.[40] Moreover, recent federal legislation makes it clear that such payments are also exempt when paid to retired or retiring partners.[41]

Stock options. The rules for taxing stock option income have been the subject of much litigation. The dispute began with *Michaelsen v. New York State Tax Comm'n*.[42] In *Michaelsen*, the Court of Appeals held that a nonresident employee who receives incentive stock options (and who sells the stock at a gain post-exercise) is not taxable on gains due to appreciation after the exercise date. According to the court, the "compensable period" ends on the date the option is exercised. Gains after that date constitute nontaxable investment income.

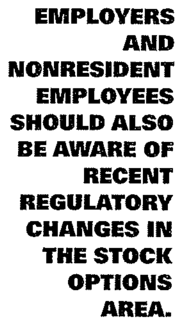
The Department interpreted *Michaelsen* as a grant of permission to tax the "compensable portion," which is the difference between the market value of the stock at the time the option was exercised and the market value of the stock at the time the option was granted. And under rules issued in 1995 through an interpretive memorandum—TSB-M-95(3)I—the Department required that the income be allocated to New York based on the nonresident's New York work days during the entire "grant-to-exercise" period. For example, if an employee lived and worked in New Jersey, the employee would have to pay New York tax on a portion of his stock option income if he or she occasionally traveled into New York for meetings, to entertain clients, to participate in seminars, etc. during the grant-to-exercise period (which could be a period that spans several years).



THE RULES FOR TAXING STOCK OPTION INCOME HAVE BEEN THE SUBJECT OF MUCH LITIGATION.

In most cases, the Department was able to successfully defend its position and apply the grant-to-exercise allocation methodology. Recently, however, the Department suffered a significant defeat in *Matter of E. Randall Stuckless*.[43] In *Stuckless*, the Tribunal expressly rejected the Department's "grant-to-

exercise" methodology for the taxation of a nonresident's stock option income. The Tribunal determined that the Department had no regulatory authority to impose a multi-year, "look-back" allocation rule on stock option income. Rather, it held that any allocation of stock option income by a nonresident of New York must be based on the taxpayer's New York work days during the year in which the option income was realized (i.e., the year of exercise).



EMPLOYERS AND NONRESIDENT EMPLOYEES SHOULD ALSO BE AWARE OF RECENT REGULATORY CHANGES IN THE STOCK OPTIONS AREA.

The *Stuckless* decision has already had a significant impact on nonresidents with stock option income. Take the example above: If the New Jersey employee were able to avoid working in New York during the year in which he planned to exercise his options, he could eliminate all of the New York income tax on his option income. Likewise, a retired taxpayer should not be required to pay any tax to New York, so long as the options are exercised after the taxpayer moved out of New York. It should be noted, however, that the Department appears to be taking the position that the year-of-exercise rule under *Stuckless* does not apply when options are exercised post-retirement. Indeed, in a technical bulletin—TSB-M-06(7)I—that was issued after the *Stuckless* decision, the Department seemed to assert that the year-of-exercise rule should not be used when options are exercised post-termination because it does not result in a "fair and equitable" allocation of income. The new TSB-M suggests that it may be necessary in such cases to use an alternative allocation method, such as the very same multi-year grant-to-exercise rule that was deemed invalid by the Tribunal in *Stuckless*! Many practitioners believe that *Stuckless* prevents the Department from doing this,[44] but until future litigation resolves the issue, taxpayers should be aware that the Department might challenge retirees who fail to allocate income to New York upon the exercise of their options.

Retirees who do allocate a portion of their option income to New York (despite the fact that they did not work in New York during the year of exercise) should file protective refund claims pending a review of the issue by the administrative or state courts. Similarly, non-retired taxpayers who paid taxes voluntarily or upon audit under the grant-to-exercise methodology prior to *Stuckless* may be eligible for refunds. Generally, New York law allows refund claims to be filed within two years from the date of payment or three years from the date on which the tax return reporting the income was filed. Taxpayers and practitioners should take immediate steps to file refund claims if they believe that taxes were overpaid given the *Stuckless* decision.

Employers and nonresident employees should also be aware of recent regulatory changes in the stock options area. The new regulations require stock option income to be allocated based on the taxpayer's workday allocation factors between the date on which the options were granted and the date on which the options vested.[45] The new "grant-to-vesting" rules are retroactive to January 1, 2006 and apply to all option exercises undertaken after that date. For the 2006 tax year, however, taxpayers may elect to use the old grant-to-exercise method when allocating their option income.[46]

Conclusion

Failure to comply with New York's income allocation and withholding tax requirements can have significant consequences. New York employers in the construction industry who fail to withhold and remit the appropriate amount of personal income tax from their nonresident employees' wages may be held liable for the tax, along with penalties and interest.[47] These liabilities extend not only to the employer, but also to certain "responsible" employees, owners and officers, all of whom may be held personally liable if the employer fails to properly withhold.[48] Surely, many of the withholding errors committed by employers are inadvertent mistakes resulting, for example, from inconsistencies in payroll and personnel records. The inadvertent nature of these errors usually becomes clear during an audit, but this does not prevent the Department from holding the employer liable for its mis-

takes. Likewise, in the case of a nonresident employee, the Department may assess additional tax, interest and penalties if it determines that the individual allocated an insufficient amount of income to New York.[49]

Construction industry employers, as well as their executives and other employees should seek guidance from the state or their tax advisors when they are uncertain as to their New York State income or withholding tax obligations. Those who don't may wish they had once the Department commences an audit of their tax returns. And given the current enforcement environment in New York, taxpayers who are viewed as acting in a false or fraudulent manner may become subject not only to a civil liability, but criminal prosecution as well. ■

NOTES

1 Press Release, New York State Department of Taxation and Finance, "Seven Licensed Professionals Convicted of Tax Evasion, Well Paid Professionals Failed to File Income Tax Returns" (July 3, 2007) at http://www.tax.state.ny.us/press/2007/nonfilers0707.htm.

2 Press Release, New York State Department of Taxation and Finance, "Tax Department Announces Criminal Actions in Cases against Tax Cheats" (July 11, 2007) at http://www.tax.state.ny.us/press/2007/crimewrap0707.htm.

3 *Id.*

4 The Public Policy Institute of New York State, Inc., "Monthly Economic Update" (May 2007).

5 *See* N.Y. TAX LAW § 611, et. seq.

6 20 NYCRR § 171.5.

7 *Shafer v. Carter,* 252 U.S. 37 (1920).

8 N.Y. TAX LAW § 601(e).

9 *See* 20 NYCRR § 171.6; *see also* Publication NYS-50: Employer's Guide to Unemployment Insurance, Wage Reporting, and Withholding Tax (N.Y.S. Dept. of Tax'n & Finance).

10 N.Y. TAX LAW §§ 631(a) & (b). Income from items of intangible personal property (i.e., annuities, dividends, interest and gains from sales of intangibles) are not considered to be derived from New York sources unless the income is derived from property employed in a business, trade, profession or occupation carried on in New York. *Id.* at § 631(b)(2). A recent statutory change also treats certain sales of shares in a New York cooperative housing corporation as a taxable sale of real property, sourced to New York. *Id.* at § 631(b)(1)(E); TSB-M-04(5) (Oct. 19, 2004).

11 20 NYCRR § 132.4(b).

12 *Id.*

13 *Id.* at § 132.18(a). There are exceptions for railroad workers, the military, commission salesmen and others. *See* 20 NYCRR § 132.11.

14 *Id.* at § 132.18.

15 *See Matter of Friedman (ALJ June 27, 2002)*; *see also Lopez, Edwards, Frank & Co., LLP,* TSB-A-99(4).

16 *Matter of Unterweiser,* Tax App. Trib. (July 31, 2003).

17 *Matter of Kakar,* Admin. Law Judge, Small Claim (Feb. 16, 2006).

18 *See* 20 NYCRR § 132.4(d)(1).

19 *Matter of Haas,* Tax App. Trib. (Apr. 17, 1997).

20 *Matter of Penchuk,* Tax App. Trib. (Apr. 24, 1997).

21 *Matter of Colitti,* Tax App. Trib. (June 19, 2003).

22 *Id.* (emphasis added).

23 *Id.*

24 *Matter of Clapes,* Tax App. Trib. (Jan. 6, 2005), *aff'd* at 825 N.Y.S.2d 168 (3d. Dep't 2006).

25 *Id.*

26 20 NYCRR § 132.20.

27 *Matter of McSpadden,* Tax App. Trib. (Sept. 15, 1994).

28 *Matter of Brophy,* Tax App. Trib. (Dec. 7, 1995).

29 *Matter of Morgan,* Admin. Law Judge (May 22, 2003); *see also Donahue v. Chu,* 104 A.D.2d 523; *Gordon,* TSB-A-00(7).

30 *Matter of Davis,* Admin. Law Judge (Jan. 14, 1999).

31 *See Braun,* TSB-A-05(2).

32 N.Y. TAX LAW § 612(c).

33 20 NYCRR § 132.4(d)(2)(i).

34 *Id.* at § 132.4(d)(2)(ii).

35 *Id.* at § 132.4(d)(2)(iii).

36 *Id.* at § 132.4(d)(2)(iv). Other specified requirements must be met where the pension is paid to a nonresident beneficiary or deceased employee. *Id.* at § 132.4(d)(2)(v).

37 4 U.S.C. § 114.

38 *Id.*

39 *Id.* The payments must also be received after termination of employment and under a plan maintained solely for the purposes of providing retirement benefits for employees in excess of the limitations imposed by one or more of Sections 401(a)(17), 401(k), 401(m), 402(g), 403(b), 408(k) or 415 of the IRC, or any other limitation on contributions or benefits in the Code on plans to which any of these sections apply.

40 *Id.*

41 *See* P.L. § 109-264.

42 67 N.Y.2d 579 (1986).

43 *Matter of E. Randall Stuckless,* Tax App. Trib. (Aug. 17, 2006).

44 *See, e.g.,* Noonan and Trachtenberg, "Stock Options—The New York Tax Department's Effort to Undermine *Stuckless,*" *State Tax Notes,* April 2007.

45 20 NYCRR § 132.24.

46 *Id.* at § 132.24(c)(3)(i)(b).

47 N.Y. TAX LAW §§ 671(a)(1) & 675.

48 *Id.* at § 685(g); *Matter of Oehler,* Tax App. Trib. (July 10, 2003).

49 *Id.* at §§ 684 & 685.