The Ins and Outs of New York Nonresident Allocation Issues

by Timothy P. Noonan

As I've chronicled over the years in this column, New York is an incredibly aggressive state in the residency area. Auditors across the state are focused on audits and investigations of taxpayers who claim to have established residency somewhere else.[1] But there is another side to these audits, one that many taxpayers and practitioners sometimes overlook: Taxpayers who are able to establish residency in another state still aren't out of the woods. Why? Under New York's rules, nonresidents also have to pay New York state taxes in some situations, depending on the nature and source of their income. This article reviews some of the more common forms of income that lead to questions in New York personal income tax audits.

Overview of Nonresident Taxation

The tax computation for New York residents is simple. Residents are taxable on one thing: everything. Nonresidents, however, can be taxed only on income that is derived from or connected to New York sources.[2] That isn't just because New York likes to treat nonresidents more favorably. Under the U.S. Constitution, a state may not tax a nonresident's income unless it has some connection with the state.[3]

So the focus in nonresident allocation cases is usually on one question — whether the taxpayer's income was derived from or connected to New York sources. Generally, under Tax Law section 631, 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 the ownership of any interest in real or tangible property located in New York or a business, trade, profession, or occupation carried on in New York. There are, of course, many cases and rulings addressing the type of items generally considered to be New York-source income. Further, the Department of Taxation and Finance has detailed audit guidelines in the area, discussing the sourcing of various forms of income the nonresident taxpayers may receive.[4] For the most part, the rules are straightforward and similar to the kinds of things you'd see in other states in the allocation context. Of course, as with other areas of personal income tax, there are unique aspects to New York's rules. And because of the creativity of many state auditors, you'll see issues in New York that you may not see in other states. So let's examine the rules in the context of some common forms of income we generally see in our cases.

Employee Wages

Employees' wages likely constitute the most common form of income in allocation audits. And for the most part, the rules are straightforward. If all the employee's services are performed in New York, all compensation is allocated to New York. When a nonresident performs services both within and outside New York state, the nonresident's income must be allocated to New York according to a fraction, the numerator of which is the number of days worked in New York and denominator of which is the total number of days worked everywhere.[5]

What is a "workday"? New York's allocation guidelines say that the taxpayer need not work an

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[1]Timothy P. Noonan and Mark S. Klein, "The Nuts and Bolts of a Residency Audit," *State Tax Notes*, Dec. 22, 2008, p. 793, *Doc 2008-25828*, or *2008 STT 247-3*.

[2]Tax Law section 631.

[3]*Shafer v. Carter*, 252 U.S. 37 (1920).

[4]Nonresident Income Allocation Guidelines, para. 4.

[5]*Id.* at section 132.18(a). There are exceptions for railroad workers, the military, commission salespeople, and others. *See* 20 NYCRR section 132.11.

entire day for the day to count as a workday.[6] A short phone call or meeting may not be enough to constitute a workday, but a series of short meetings or calls probably would. In many cases my firm, when creating its allocation formula, takes the position that taxpayers can work half-days in New York or in other locations. Travel days also are considered workdays, even if no work is really done on the day in question. If my employer tells me I have to travel to California and leave on a Saturday, I'm going to count that Saturday as a workday even though I may not do any official work that day. That is supported by the guidelines and by advisory opinions.[7]

New York's allocation guidelines say that the taxpayer need not work an entire day for the day to count as a workday.

New York's convenience of the employer rule also comes into play when dealing with wage allocation issues. Obviously, there has been sufficient commentary in this and other publications addressing that issue, so we don't have to get into a detailed analysis here.[8] But the basic rule is as follows: For purposes of determining whether something is a "New York workday," you look to where the taxpayer was physically present. The convenience of the employer doctrine generally requires nonresidents who work for a New York employer to treat days worked outside the state as New York workdays if the taxpayer worked outside New York for his or her convenience. The classic example is the employee who works from home outside New York for a New York employer. In that case, the department would treat days worked at the out-of-state home as if they were New York workdays for allocation purposes. So that is something to watch out for as well.

Bonuses

Bonuses are generally allocated in the same way as regular compensation. If a bonus is received during the tax year in which it was earned, the allocation fraction is simply based on the same wage allocation fraction used for regular salary. However, if a bonus is paid for work performed in a different year, the workday allocation fraction applicable for the year in which the bonus was earned is used. Thus, a bonus paid in February 2010 for work performed in 2009 would be allocated based on the workday allocation fraction applicable to the 2009 year.

Pensions and Retirement Income

First, the general rule: Compensation for services rendered in New York state is subject to tax even if it is received in a year when no services are performed in the state. So a former New Yorker who receives some form of a deferred compensation generally — and emphasis on the word "generally" — will be required to pay New York taxes on that compensation. The allocation formula for that type of income is 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.[9]

But there are several exclusions in New York and federal law that can apply to exclude some forms of compensation paid after termination of employment. 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. For a pension to qualify as exempt, several requirements must be met. First, the pension must be paid in money only. Second, it must be payable at regular intervals for the life of the recipient, or over a period that is not less than half the recipient's life expectancy. Third, the pension must be payable at a uniform rate, or at a rate that varies in conjunction with specified criteria. Finally, a written instrument must exist to prove that the recipient has a right to receive the pension.[10]

But there are also special federal rules applicable in this area that are not covered or addressed in New York's law or regulations. Public Law section 104-95 prohibits the states from taxing a nonresident's retirement income, regardless of its source.[11] P.L. section 104-95 defines retirement income to include most qualified and tax-favored plans under the Internal Revenue Code. Also exempt is "any plan, program, or arrangement described in section 3121(v)(2)(C)" of the IRC 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 the life or life expectancy of the recipient or a period of not less than 10 years.[12] Recent federal legislation makes it

[6]Nonresident Income Allocation Guidelines, para. .7.B.

[7]*See Curt*, TSB-A-95(13)I.

[8]*See, e.g.*, Noonan, Paul R. Comeau, and Joseph Endres, "New York's Revised Convenience Rule Provides Some Clarity and Continued Controversy," *Journal of Multistate Taxation* (Aug. 2006).

[9]20 NYCRR section 132.20.

[10]Tax Law section 612(c); 20 NYCRR section 132.4(d)(2).

[11]4 U.S.C. section 114.

[12]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

(Footnote continued on next page.)

clear that those payments are also exempt when paid to retired or retiring partners.[13]

Other Postemployment Compensation

Other forms of deferred compensation receive special treatment. For instance, some forms of termination pay avoid New York taxation under special circumstances. Generally, exclusion from tax can be obtained if the termination pay is attributable to the cancellation of an employee's future right to employment. However, termination pay attributable simply to past services — and not to the cancellation of an employee's future right to employment — is allocable in the same manner as compensation for past services, usually based on the "year of termination plus three years" formula discussed above.

The Tax Appeals Tribunal's decision in *Matter of McSpadden* is generally cited as the case that created that exclusion.[14] There, 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 on 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 — the remaining term value of the employment contract. The critical factor, however, in this and other cases is the existence of an employment agreement that guarantees a taxpayer the right to employment for some specified period of time. 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.[15]

Sometimes, in exchange for payments on termination, a former employee is paid *not* to work — that is, he is paid under a covenant not to compete. Special rules apply in that situation, also formed out of case law — the Tax Appeals Tribunal's decisions in *Matter of Haas* and *Matter of Penchuk*.[16] In those cases, the tribunal ruled that payments made under covenants not to compete, although they were ordinary income, were not taxable to nonresidents because they were not attributable to a business, trade, profession, or occupation carried on in New York. Note, however, that recent legislation proposed by Gov. David Paterson (D) aims to eliminate that exclusion and reverse those tribunal decisions. So stay tuned on this issue. If that legislation passes, it'll be covered here.

Stock options are another form of deferred compensation that has received a lot of coverage in practitioner circles and publications.[17] Stock options need not be addressed in detail here. And in any event, the rules for income from stock options exercised in 2006 and later years are straightforward. Under new regulations, stock option income must 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. 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.[18] For years before 2006, refund opportunities existed for nonresidents — particularly nonresidents who exercised options postretirement — based on the tribunal's decision in *Matter of Stuckless*,[19] but most of those cases are either resolved or past the three-year statute of limitations for refund.

Director's Fees

According to the allocation guidelines, a nonresident board member who works in New York for a corporation doing business in New York has to allocate board compensation based on the location of board meetings. For those purposes, a board meeting obviously counts as a workday. The guidelines also seem to permit allocation of other board-related work, but they do reference application of the convenience rule in making that determination.[20]

Gains or Losses From Real Property

Until recently, the rules in this area were clear. If you sold property located in New York state or otherwise had income or loss associated with the ownership of property in New York, that income or loss got sourced to New York. If the income or loss was related to real property located elsewhere, it didn't get sourced to New York. However, legislation enacted last year changes those rules. Under the new legislation, the phrase "real property located in

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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 IRC on plans to which any of these sections apply.

[13] *See* P.L. section 109-264.

[14] Tax App. Trib. (Sept. 15, 1994).

[15] *Matter of Brophy*, Tax App. Trib. (Dec. 7, 1995).

[16] *Matter of Haas*, Tax App. Trib. (Apr. 17, 1997); *Matter of Penchuk*, Tax App. Trib. (Apr. 24, 1997).

[17] *See, e.g.*, Noonan and Jack Trachtenberg, "Stock Options — The New York Tax Department's Effort to Undermine Stuckless," *State Tax Notes*, Apr. 23, 2007, p. 279, *Doc 2007-9696*, or *2007 STT 79-7*.

[18] 20 NYCRR section 132.24.

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

[20] Nonresident Income Allocation Guidelines, para. .6.E

this state" as defined in Tax Law section 631 is redefined to include interests in a partnership, limited liability company,[21] S corporation, or closely held C corporation (that is, with 100 or fewer shareholders) owning real property located in New York state if the value of the real property exceeds 50 percent of the value of all of the assets in the entity. There is a two-year lookback rule to avoid taxpayers' "stuffing" assets into an existing entity before a sale. For sales of entity interests occurring on and after May 7, 2009, any gain recognized on the sale of an interest in that an entity will be allocated among the assets in the entity, and the amount allocated to New York real property will be treated as New York-source income.

Business Income

The taxation of business income necessarily varies based on the vehicles through which it is earned. For sole proprietors and partners, the regulations provide that items of income, gain, loss, and deduction attributable to that business, trade, profession, or occupation must be apportioned and allocated to New York state on a fair and equitable basis in accordance with approved methods of accounting.[22] According to the regulations, that "fair and equitable" allocation must be done using one of two methods. First is an "actual" method, if the book and records disclose the in-state and out-of-state income "to the satisfaction of the Tax Commission." Absent that, the regulations set forth what basically is a three-factor formula comprising property, payroll, and receipts of the business or partnership from in-state and out-of-state sources. That is similar to the three-factor method that used to apply to article 9-A corporations. That same allocation would apply for nonresident members of LLCs.

Interestingly, though, shareholders of S corporations allocate differently. Under the tax law, S corporation shareholders determine the New York-source portion of their pro rata share of the corporation's income or loss based on the rules applicable to regular business corporations under article 9-A of the Tax Law. When that was enacted, the article 9-A rules used a three-factor formula, similar to that applicable in 20 NYCRR section 132.15. But recently the state amended the article 9-A allocation rules to call for a single-factor allocation, based on receipts only. So that rule creates somewhat of an uneven playing field for taxpayers involved in flow-through entities.

Conclusion

Be on the lookout for these types of issues, because they arise in almost every residency audit that the tax department undertakes. Unlike issues about domicile and day count, these questions may not be at the forefront of the auditors' minds, and they are often overlooked in residency planning situations. But given New York's high tax rates, even for nonresidents, these questions are often hugely important in day-to-day residency audits. ✰

Noonan's Notes on Tax Practice is a column by Timothy P. Noonan, a partner with Hodgson Russ LLP, Buffalo, N.Y.

[21]The bill actually refers to a "limited liability corporation." That is probably a typo and should be "limited liability company."

[22]20 NYCRR section 132.15.