

2013

# Nonresident Allocation Guidelines

*State of New York – Department of Taxation and Finance*

*Income Franchise Field Audit Bureau*



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## I. INTRODUCTION

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These guidelines explain the tax law and regulations concerning income allocation, discuss audit policies and procedures regarding the subject, and address various technical and complex issues through examples and explanations.

They have been established to ensure uniformity and consistency in the examination of nonresident returns. The procedures and techniques apply to Articles 22 and 30-B (Yonkers) of the New York State Tax Law.

Guidelines are issued primarily to provide general guidance to audit staff. According to regulation 2375.12, they have no legal force or effect nor do they establish precedent in the particular subject matter. They are generally binding on audit staff who are expected to follow the rules and procedures outlined in the guidelines when conducting an audit.

That being said, the Department recognizes that there may be situations encountered on audit where such rules and procedures may not be appropriate. In these situations, it is up to the supervisor and auditor to work together to ensure that the spirit of the guidelines is carried out when interacting with taxpayers and their representatives. This requires flexibility in applying the guidelines coupled with a commonsense, practical approach in auditing nonresident cases.

***Note: These guidelines do not replace existing law, regulations, case law or informational materials issued by the Department.***

*Throughout the guidelines, references are made to the following sources:*

- The Internal Revenue Code (IRC) and related regulations;
- Articles 22 and 30-B of the New York State Tax Law ;
- Title 20 of the Personal Income Tax Regulations (NYCRR);
- Federal and State Court Cases;
- Administrative decisions of the Division of Tax Appeals;
- New York State Tax Commission decisions (STC);
- Advice of Counsel issued by the Office of Counsel (LBW);
- Advisory Opinions (A Memos) and TSB Memoranda (M Memos) issued by the Department.

***The above sources should be referred to when researching a particular issue. References to the tax law in these guidelines are meant to highlight general points of law and are not meant to be an authority on interpreting the tax law.***

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## II. OVERVIEW

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### A. NEW YORK SOURCE INCOME

Nonresidents are taxed only on what we call *New York Source Income* which is defined in *Tax Law Section 631* and *Part 132 of the income tax regulations*.

The more common forms of New York source income are:

- distributive share of partnership income or loss; **631(a)(1)(A)**
- pro rata share of New York S corporation income or loss; **631(a)(1)(B)**
- share of estate or trust income or loss; **631(a)(1)(C)**
- ownership of real or tangible personal property located in New York; **631(b)(1)(A)**
- ownership of real property also includes an interest in a partnership, LLC, S corporation, or non-publicly traded C corporation which owns real property in NY with a FMV of 50% or more of the entity's total assets on the date of sale of the interest; **631(b)(1)(A)(1)**
- income from a business, trade, profession or occupation carried on in New York; **631(b)(1)(B)**
- New York State lottery winnings in excess of \$5,000; **631(b)(1)(D)**
- gains from the sale of shares of stock in cooperative housing corporation; **631(b)(1)(E)**
- income from a business, trade, profession or occupation previously carried on in New York including, but not limited to, a covenant not to compete or termination agreement; **631(b)(1)(F)**
- income from stock options, stock appreciation rights and restricted stock. **631(g)**

### B. TAXATION OF NONRESIDENT EMPLOYEES

NYCRR 132.4(b) provides, in part:

*“The New York adjusted gross income of a nonresident individual rendering personal services as an employee includes the compensation for personal services entering into his Federal adjusted gross income, but only if, and to the extent that, his services were rendered within New York State. Compensation for personal services rendered by a nonresident individual wholly without New York State is not included in his New York adjusted gross income, regardless of the fact that payment may be made from a point within New York State or that the employer is a resident individual, partnership or corporation.”*

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### 1. Income Wholly Earned In New York

A nonresident's income may have been earned wholly within New York State, in which case the income would be fully reportable to New York. In *Carpenter v. Chapman* (276 AD 634), a nonresident attorney who was licensed to practice law only in New York was not allowed to allocate income outside the state. In determining that his income was wholly earned in New York, the State Supreme Court concluded that:

*“Petitioner’s right to perform legal services in places other than in the State of New York is primarily based entirely on the fact that he is admitted to practice law in this state. The record indicates that any services he performed without the state were in connection with his New York practice. Indeed it could scarcely be otherwise. He was not engaged in any ordinary business which he could legally transact anywhere. To the contrary he could lawfully hold himself out as only entitled to practice law in the State of New York, and services performed elsewhere were incidental to the practice he maintained in this state.”*

This case was later cited by the State Tax Commission in *Petition of John E. and Annette M. Fitzgerald, TSB-H-83-226(I)* in similarly holding that a nonresident attorney’s income was derived wholly from New York.

### 2. Income Earned Totally Outside New York

Conversely, compensation for personal services rendered by a nonresident individual which were required by the employer to be performed wholly outside New York State is not included in New York source income, “regardless of the fact that payment is made from a point within New York State or that the employer is a resident individual, partnership or corporation” as mentioned earlier. In *Gleason v. State Tax Commission* (76 AD2d 1035), it was determined that an officer and stockholder of a family corporation operating two taverns in New York City did not receive taxable income from New York sources for administrative services performed entirely at the stockholder's home located in New Jersey. The home office was provided for and maintained by the New York corporation.

### 3. Income Earned Partly Within And Without New York

For many individuals, however, income may have been earned partly from within New York State and partly from without the state. In order to determine a nonresident taxpayer's correct New York State taxable income, a proper allocation of income must be made. In the case of a nonresident employee or officer required by the employer to perform services both within and without New York State, the earnings will be allocated by the so-called days in and out allocation method as prescribed in **NYCRR**

**132.18** based on a ratio of the number of days worked in New York State to the total number of days worked both within and without the State. This method will be discussed in more detail in the next chapter.

## C. TAXATION OF BUSINESSES

NYCRR 132.4(a)(2) provides, in part:

*“A business, trade, profession or occupation...is carried on within New York State by a nonresident when such nonresident occupies, has, maintains or operates desk space, an office, a shop, a store, a warehouse, a factory, an agency or other place where such nonresident’s affairs are systemically and regularly carried on, notwithstanding the occasional consummation of isolated transactions without New York State. This definition is not exclusive. Business is carried on within New York State if activities within New York State in connection with the business are conducted in New York State with a fair measure of permanency and continuity.”*

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### 1. Allocation by the Books and Records

In the case of an unincorporated business such as a partnership or a sole proprietorship conducting business both within and without New York, the books and records of the business must be used for allocation if they truly reflect the business activities to the satisfaction of the Commissioner. This is also referred to as the direct accounting method.

### 2. The “Three-Factor Method”

If such books and records do not truly reflect the business activities within and without New York an allocation must be made in the manner prescribed in the regulations at NYCRR 132.15 commonly referred to as the three factor method. The use of an allocation formula when the books and records do not reflect the correct portion of income and deduction attributable to New York State was affirmed in an Appellate Division case *Matter of Donald E. Ward et al. v. State Tax Commission*, (97 AD2d 640). The Court stated:

*“It is clear that the petitioners neither sought nor were granted prior approval to use the direct accounting method on their tax returns, nor did their books and records fairly and equitably allocate the correct amount of income and expenses attributable solely to New York. The regulations provide that when the books and records do not disclose to the satisfaction of the Tax Commission the appropriate proportion of business allocable to New York State, the three-factor method must be used.”*

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[The above methods will be explained later in Chapter IV.]



## D. REAL OR TANGIBLE PERSONAL PROPERTY LOCATED IN NEW YORK

New York source income of a nonresident individual includes items of income, gain, loss and deduction entering into his Federal Adjusted Gross Income which are attributable to the ownership of any interest in real or tangible personal property located in New York State in accordance with **Tax Law Section 631(b)(1)(A)**.

### 1. Real Property

A nonresident individual who receives rental income from an apartment or home located in New York State would include the net rental income or loss in his New York source income. The gain or loss recognized from the sale of such rental property would likewise be included in New York source income. The income or loss is taxable whether it is received directly by the individual or through a partnership. The income from the rental of real property, and the gain or loss from the sale, exchange or other disposition of real property, **are not subject to allocation** but are considered as entirely derived from or connected with the SITUS of such property in accordance with **NYCRR 132.16**.

If a nonresident receives a note as consideration for the sale of real property located in New York State, the interest income received from the note would not be taxable to New York, provided the note is not held in connection with a business, trade, profession or occupation carried on within New York State. The principal payments on the note would remain taxable under NYCRR 132.16.

The definition of what constitutes real property was expanded in 2009 to include an *interest* in a partnership and limited liability company or *stock* in an S corporation and non-publicly traded C corporation which owns real property located in New York. This is explained further in **Chapter IV, Allocation - Nonresident Partners and Partnerships**.

### 2. Tangible Property

With regard to tangible personal property, if the property is located in the state on a temporary basis and is not connected with a trade or business, any gain or loss resulting from its sale would not be included in New York source income. For example, if a nonresident consigns a piece of artwork to a New York auction house or gallery for sale and the individual is not a dealer in artwork, any gain resulting from the sale is not treated as New York source income and would not be taxable. The sale of the same piece of artwork, if it were located in the nonresident's New York residence for an extended period of time, however, would represent the sale of tangible personal property and the gain from the sale would properly be included as New York source income on a nonresident tax return.

In *Matter of Henry A. and Marianne Ittleson, DTA No.819283*, nonresident taxpayers were held to be taxable on the gain from the sale of a painting that had been displayed in their New York City apartment for all eleven years prior to its sale with the exception of the final two months. The taxpayers originally purchased the painting in 1986 when they were residents of New York State and City. Although it was determined that the taxpayers had changed their domicile in December 1996, the painting remained in their apartment until March 1997 when it was consigned to an auction house. It was sold two months later at a gain of nearly \$7 million.

In ruling that the gain was not New York source income, the ALJ had determined that after the taxpayers changed their domicile the painting remained in New York only on a temporary basis.

In reversing the ALJ, the Tax Appeals Tribunal looked to the entire eleven year period in deciding whether the gain was from New York sources. Citing *Matter of Huckaby (4 NY3d 427)*, the Tribunal stated that the presence of the painting in New York for a substantial period before the sale constituted the “minimal connection” with the state that was necessary for the gain to be taxable.

#### **E. OTHER METHODS OF ALLOCATION – NYCRR 132.35**

Where the above methods of allocation do not result in a nonresident’s income or loss being allocated in a fair and equitable manner, **NYCRR 132.25** allows the Department to require the taxpayer to use an alternate method as long as the method results in a fair and equitable apportionment and allocation.

Alternatively, the taxpayer may propose another method provided it is fully explained on his nonresident return and is approved by the Department.

### III. ALLOCATION - EARNINGS OF NONRESIDENT EMPLOYEES AND OFFICERS

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The allocation provided for in **section 132.18** of the New York State Personal Income Tax Regulations is the proportion of total compensation, for services rendered, which the total number working days employed in New York State bears to the total number of working days employed both within and without New York.

#### A. DAYS IN AND DAYS OUT

Only items of income, gain, loss and deduction entering into the Federal Adjusted Gross Income of a nonresident individual which are derived from or connected with New York State sources are included in New York source income. If a nonresident individual has performed services partly within and partly without New York State, an allocation must be made in accordance with the provisions of **NYCRR 132.18**. The allocation provides for a distribution of income determined by the ratio of the number of working days employed in New York State to the total number of working days employed both within and without New York State.

In the computation of the allocation there is no consideration of nonworking days. Generally, nonworking days consist of Saturdays, Sundays, holidays, days of absence due to illness or personal injury, vacation or leave with or without pay.

***Example:***

A nonresident taxpayer is employed as a manager of a corporation located in New York State. The taxpayer earns \$150,000 in wages and the normal duties require travel throughout the country. During 2005 the taxpayer spent 200 days at an office in New York and 25 days at the corporation's offices in Boston, Chicago and Denver. During the year the taxpayer attended a 5 day business convention in Orlando, Florida and a 5 day professional management meeting in Aspen, Colorado. After each meeting, the taxpayer extended the trip by a week for a personal vacation. During 2005 the taxpayer did not work any Saturdays or Sundays and observed 11 holidays. Five days were lost due to illness. What portion of the wages, if any, must the taxpayer allocate to New York State?

**The New York source income is determined as follows:**

Total days in the year		365
Nonworking Days:		
Saturdays and Sundays	104	
Holidays	11	
Sick Days	5	
Vacation	10	
Total nonworking days		<u>130</u>
Total Days Worked		235
Less: Days worked outside New York State		35
Days worked in New York State		200

The allocation formula to determine New York source income is as follows:

*200 (days in New York) /235 (total work days) = 85% x \$150,000 (salary) = \$127,500 New York source income.*

The above computation represents an allocation of income to New York State. If the nonresident individual performed duties in the City of Yonkers, a similar computation would be made to allocate the correct portion of income to that jurisdiction.

**B. ALLOCATION BY FRACTION OF A DAY**

A nonresident employee, who works for the same employer and who wishes to apportion and allocate such income on the basis of hours or fractions of a day worked within and without the state, may do so provided that the taxpayer can document the hours, or fractions of a day worked within and without New York State.

*ADVISORY OPINION OF SAMUEL FRANK, TSB-A-83(1)I.*

***Example:***

A nonresident employee works for a corporation based in New York State and earns \$250,000. His job duties require him to regularly meet with clients some of whom are located in New Jersey. The employee will occasionally perform services both in New York and New Jersey on the same day. In 2008 he provided documentation showing that on 44 days he worked approximately half the day in each state. The total days worked that year, both full and half days, were as follows:

Location	Full days Worked	Part days Worked	Total
New York	56	44 half days = 22	78
New Jersey	100	44 half days = 22	122
<i>Total</i>	156	44	200

Based upon the above information, the taxpayer would allocate his earnings as follows:

Percentage of time worked in New York (78) / (200) = 39%

New York Percentage x Total Earnings = Amount Allocated to NY

$$39\% \times \$250,000 = \$97,500$$

*When using an allocation method based on fractions of a day, it would be permissible to use either half days as in the example above, or quarter days. In any case, it should be remembered that some work must be performed both within and without New York on the same day in order to allocate by fractions of a day. Thus, if the taxpayer worked only two hours in New York on a given day and that was the only work performed on that day, it would be considered a full New York work day.*

### C. NONWORKING DAYS

The allocation formula utilizes working days only. All nonworking days are subtracted from the total days in the year to arrive at total days worked. Nonworking days generally consist of but are not limited to:

- Saturdays and Sundays (those not worked),
- Holidays,
- Days off for religious observance,
- Days of absence due to illness,
- Vacation days,
- Days off for personal reasons,
- Days of house hunting,
- Moving days,
- Sabbatical leaves.

Therefore, in the determination of an allocation of income, based on days worked within and without New York, nonworking days must be accounted for but are not part of the actual formula to determine the allocation of compensation to New York State.

**Example:**

A nonresident is employed by a company with offices in New York City. The taxpayer received wages of \$500,000 during 2005. When preparing a 2005 New York State Nonresident Return (IT-203), the taxpayer counted 202 workdays in New York State. The taxpayer's calendar indicated 38 days worked outside New York State. An allocation of \$420,000 to New York State based on a formula showing 202 New York work days over 240 total work days was made. A review of the calendar, at a later date, shows that 10 days of the 38 days counted as out of state work days were actually vacation days. What effect would this have on the taxpayer's allocation of wages to New York State?

The income allocated to New York State is understated since the total number of workdays includes 10 days which should correctly be designated "nonworking days."

The correct formula should be as follows:

<b><i>Days Worked in NY / Total Work Days x Earnings = Amount Allocated to NY</i></b>				
<b><i>202</i></b>	<b><i>/</i></b>	<b><i>230</i></b>	<b><i>x</i></b>	<b><i>\$500,000 = \$439,130</i></b>

A careful analysis of all days, both workdays and nonworking days, should be made when confronted with an allocation issue. As you can see, a change in the denominator by a reclassification of a working day to a nonworking day can have a similar effect as the identification of additional days worked in New York.

When contemplating a change in the nature of a day from a nonworking day to a workday, the auditor should identify the type, the nature, and the amount of the work which would necessitate the change in character.

Presumably, an employee need not work the whole day in order for a day to be a working day; attending a business meeting, making phone calls, sending emails or text-messaging would suffice, even if they are relatively brief in nature. The auditor needs to apply common sense when making a judgment as to how much work must be done to make a day a working day. A two-minute phone call may not be enough to convert a nonworking day into a working day. On the other hand, if a person has a number of different phone calls during the day, perhaps this would be enough to make that day a working day. In any event, the auditor should apply the same standards to non-New York days as they would to New York days. If a few phone calls are sufficient to make an in-State day a working day, they should also suffice to make an out-of-state day a working day.

### 1. Travel on a Nonworking Day

A day spent by an employee in travel status, if such travel was at the direction of his employer, is considered as a working day, even if such day is a Saturday, Sunday, or other usual nonworking day. The day spent in travel status however may not be a New York day unless services were performed in New York State. This is illustrated in *Matter of Kenneth J. Cort, DTA No. 811179*, where days spent traveling through New York by a nonresident were considered workdays but not necessarily New York workdays. Only if services were performed in New York would a day be considered a New York workday.

***Example:***

An employee who usually does not work on Saturdays or Sundays is directed by his employer to be present in Chicago for a meeting which will commence early on Monday morning. The employer has made arrangements for the employee to leave for Chicago on Sunday morning, with the return trip for Monday night. Although the employee usually does not work on Sunday, when allocating income the employee will count the Sunday traveled as a working day outside New York since the trip to Chicago was made at the direction of the employer.

### D. CONVENIENCE RULE – NYCRR 132.18(a)

Any allocation claimed by a nonresident employee for days worked outside New York State must be based upon the performance of services which obligate the employee to be outside New York because of the *necessity of the employer* rather than the *convenience of the employee*. This concept is commonly referred to as the **convenience rule**. Such duties are those which, by their very nature, cannot be performed in New York State. Typical examples would be attending business meetings outside New York, and meeting with clients or customers located out of state.

The convenience rule generally becomes an issue when a nonresident employee is claiming an allocation for days worked outside New York at the employee's home. This is increasingly becoming an issue with the popularity of telecommuting as more and more employees are working at home for most or part of the work week. Indeed, Tax Department employees are able to telecommute on a regular basis. Nevertheless, days worked at home are generally deemed to be for the convenience of the employee and cannot be used as a proper basis for the allocation of income by a nonresident (but, see the changes for years after 2005 described at the end of this section).

Justification for the disallowance of days worked at home for the convenience of the employer lies in the fact that since a New York resident would not be entitled to a special tax benefit for work done at home, neither should a nonresident. (*Simms v. Procaccino*, 47 AD2d 149; *Speno v. Gallman*, 35 NY2d 256 ). In this regard, no consideration should be given to work done at home so as to be free of interruptions or distractions. This has been termed by the courts as an "executive risk" and with competent office staff and adequate office surroundings this risk can be reduced. In *Burke v. Bragalini*, 10 AD2d 654, the Appellate Division stated:

*"The personal convenience of an employee is not the test. It is understandable that many people--living within and out of the State--may on occasions find it more advantageous to work at home, either during the regular working hours or extra "home work" after hours. Such a person living in the State is not entitled to special tax benefits and, intriguing as it may be, the commuter from outside the State is entitled to no such special benefits. There is no showing that a research library could not be made available at the New York office and as to interruptions it is part of an executive risk, bulwarked by competent office personnel. Any allowance claimed for work outside the State must be for those purposes that of necessity--as distinguished from convenience--obligate the employee to out of State duties in the service of his employer."*

*Days worked at home are generally considered to be for the employee's convenience and not for the employer's necessity. These days are not allowed for allocation as a day worked outside New York and would be reclassified as New York work days.*

In some instances the reclassification of days worked in a taxpayer's home outside New York to days worked in New York provides a substantial change in the allocation percentage as can be seen in the following example.

**Example:**

In the example set forth in "C" (page 14), if a further review of the taxpayer's calendar revealed that an additional 10 days indicated as "out of New York days" were actually time spent working at home for his own convenience, then a further change in the allocation would be required. A reclassification of the 10 days from "out of New York" to "New York" work days must be made. The formula would then be:

<b><i>Days Worked in NY / Total Work Days x Earnings = Amount Allocated to NY</i></b>				
<b><i>212</i></b>	<b><i>/</i></b>	<b><i>230</i></b>	<b><i>x \$500,000</i></b>	<b><i>= \$460,870</i></b>



The following list contains reasons advanced by nonresident individuals to support working at home which were eventually deemed to be for the taxpayer's convenience and therefore did not qualify for allocation as a day worked out of the state.

- A nonresident taxpayer worked at home due to a physical disability. The court ruled that the days worked at his out of state home must be allocated to New York because they were for the taxpayer's convenience and not the employer's necessity. *Matter of Arthur B. Churchill, 38 AD2d 631.*
- Employer did not provide an office for a TV reviewer. *Matter of Marvin Kitman, 92 AD2d 1018.*
- Taxpayer, a resident of Florida, managed his business half the year from his New York office and the other half by phone from his Florida home. He maintained no office in Florida. *Matter of Alan & Margaret Uhl, TSB-H-82(109)I.*
- Tenured professor at a New York college allocated income to his New Jersey residence, where he wrote scholarly publications because his N.Y. office was inadequate for that purpose. *Matter of Morton D. & Gloria Davis, TSB-H-82(334)I.*
- Professor conducted research at New Jersey home because of cramped office facilities. *Matter of Saul N. Brody, 141 AD2d 907.*
- Employee spent days pursuing activities having both social and business purpose, such as playing golf and duck hunting. *Matter of Charles E. McCarthy, TSB-H-87(19)I.*

More recently, the state's highest court, the New York State Court of Appeals, upheld the constitutionality of the convenience rule in two separate cases. In *Matter of Edward A. and Doris Zelinsky, 1 NY3d 85*, a law professor commuted three days a week to New York City where he taught classes and worked at home in Connecticut on the other two weekdays where he graded tests and conducted scholarly research. What is interesting about this case is that the taxpayer was not claiming that the work at home was out of necessity but rather that he was being subjected to double taxation by his home state of Connecticut and his work state of New York. This was a result of the different taxing schemes employed by the two states since Connecticut bases its tax on a physical presence test while New York uses the convenience rule. Since Connecticut considers the income from the days worked at home to be earned within its borders, it would not allow a resident credit for taxes paid to New York.

In rejecting Zelinsky's constitutional arguments, the Court stated that the economic justification for taxing his income derives from the fact that the income was generated from a law school located in New York. "As a law professor," the Court noted "the taxpayer is primarily engaged in the business of teaching" and therefore "it matters not when or where he performs his ancillary functions."

Allowing Zelinsky to allocate his income for days worked at home in Connecticut “would enable him to avoid paying taxes that his colleagues who do that work at home in New York- or at the law school- pay.”

In the other case, *Matter of Thomas Huckaby*, 4 NY 3d 427, the Court of Appeals narrowly concluded that work done in the taxpayer’s home in Tennessee was for his own convenience. The taxpayer was a computer programmer who worked for a New York employer primarily at his home in Tennessee. Over a two year period he worked only 25% of the time in New York and the rest of the time in Tennessee.

By a 4-3 margin, New York State’s highest court concluded the convenience rule was constitutionally applied in taxing 100% of the taxpayer’s wages. The court found that the taxpayer’s activities in New York rose to the level of the “minimal connection” required by due process to justify state taxation.

In the following case, however, a nonresident was able to show that the work he performed at home could not have been performed at his New York office. In the *Matter of Myron Fass*, 68 AD2d 977, the taxpayer tested, analyzed and investigated new products in several specialty lines and reported on them in articles for various magazines. These specialty areas include sports cars, motorcycles, firearms, home improvements, dogs and horses. To perform his duties, the taxpayer had a variety of specialized facilities installed at his residence in New Jersey; a firing range with ballistics equipment and storage facilities, a garage to store automobiles and motorcycles for testing and evaluation; and a stable and a kennel to house the horses and dogs he analyzes and photographs. The Court held that:

*“...the work the petitioner performed at the New Jersey locations concededly could not have been performed at his employers’ New York City office. Moreover, the record discloses that petitioner’s out-of-state activities were engaged in for his employers’ necessity. Petitioner has thus qualified for an allocation of his income. As a matter of law, we reject the position that an allocation of income should be disallowed merely because the specialized facilities could have been set up somewhere in New York State.”*

For tax years beginning on or after January 1, 2006, the Department has modified the convenience of the employer test. It is the Department’s position that in the case of a taxpayer whose assigned or primary office is in New York State, any normal work day spent at a home office will be treated as a day worked outside the state if the taxpayer’s home office is a bona fide office of his employer.

There are two separate tests to determine if a home office qualifies as a bona fide employer office. Using the rationale in the *Fass* case discussed above, a home office will qualify as a bona fide employer office if the employee's duties require the use of specialized facilities that are not available or cannot be made available at the employer's place of business. **TSB-M-06(5)I** gives the example of an employee whose duties required the use of a race track to test new cars that was not available nor could be made available at his New York office.

To qualify as a bona fide employer office under the second test, the home office would have to meet four of six secondary factors and three of ten other factors. These factors are explained more fully in the TSB memo.

The auditor should not, however, confuse days worked at home for the individual's own convenience with work being conducted at a legitimate non-New York work site. For example, a physician who lives in Connecticut, has an office in New York, and also has a fully-equipped office at his home in Connecticut where he regularly sees patients for two days a week, would be considered as conducting business both within and without New York rather than working at home for his own convenience.

Moreover, it is important to remember that the convenience rule does not apply where an employee works entirely out of state and performs no services within New York. Thus, in the *Matter of Arthur Hull Hayes, 61 AD2d 62*, a nonresident formerly employed in New York performed consulting duties at his home in Connecticut. He no longer had an office in New York and performed no services in New York. In determining that he was not subject to New York taxation, the State Supreme Court stated:

*“A nonresident who works in another state but who performs no work in New York is not subject to New York State tax liability no matter for whose convenience or necessity he performs the work.”*

#### **E. ALLOCATION FOR A PERIOD OF LESS THAN A YEAR**

The formula for allocating wages and salaries is generally based on a 365-day year. However, if a nonresident is employed for any period that is less than a full year, and performs services in connection with his employment in and out of New York, his allocation formula must be based upon the total number of days he was employed during such a period. An allocation in this format would be used when an employee terminates his contract with one employer and commences employment with another separate and distinct employer. It does not matter if the two employers are related or totally unrelated. The denominator of the fraction will represent the total number of work days during the abbreviated part of the year the employee worked for the specific employer.

In the *Petition of Arthur W. Kelly, State Tax Commission, July 2, 1974 (CCH 1971-1979 New Matters Transfer Binder paragraph 99-963)* a nonresident individual employed for eight months of the taxable year in a position requiring work both within and without New York State, and the remaining four months by a different employer working entirely outside New York was permitted to allocate income for New York purposes, only on the basis of the first eight months. No allocation was permitted for the remaining four months since the individual was not required to work in New York State.

**Example:**

A nonresident performed services for the Delta Corporation during the period January 1 through June 28, for which the taxpayer received total compensation of \$55,000. The taxpayer performed services for the Delta Corporation a total of 120 working days during this period, of which 90 days were attributable to services performed wholly within New York State and 30 days were attributable to services performed wholly without New York State. The taxpayer terminated employment with Delta Corporation at the close of business on June 28 and went to work for the Omega Corporation on July 1. For the period July 1 through December 31 the taxpayer received total compensation of \$90,000. The individual performed services for Omega Corporation for 120 working days during this period, of which 60 days were attributable to services performed wholly within New York State and 60 days were attributable to services performed wholly outside the State. New York Adjusted Gross Income includes compensation for personal services in the amount of \$86,250, computed as follows:

Delta Corp. 90/120 x \$55,000	=	\$41,250
Omega Corp. 60/120 x \$90,000	=	<u>\$45,000</u>
Total allocated to New York		\$86,250

**F. MORE THAN ONE EMPLOYER**

A nonresident who works for two employers concurrently would allocate the wages received from each based on the days worked within and without New York for each specific employer.

In *Matter of Morris D. Crawford, JR. and Dorothy B. Crawford, TSB-H-82(7)I*, a taxpayer was the Chairman and CEO of a New York bank. At the same time he served on a Presidential Commission which required him to work outside the state. In allocating the wages from the bank he included the 18 days he worked outside New York for the commission.

The State Tax Commission concluded that these days should not have been included in the allocation since these were days worked for another employer. Moreover, although the taxpayer had included these days in the allocation, he omitted the compensation he received from the commission.

**G. OTHER CONDITIONS WHERE AN ALLOCATION IS REQUIRED – NYCRR 132.4(c)**

The days in/out method described in this chapter is normally computed for the same year in which the compensation is received by a nonresident. Thus, an employee receiving wages in 2010, for example, would allocate the income to New York using the days worked in and out of New York for that employer in 2010.

In some situations, however, this could lead to an inequitable result. For example, a nonresident could receive a bonus in January 2010 for services performed in the prior year. If the individual performed no services in 2010, he could maintain as a consequence that the bonus is not taxable to New York despite the fact that the income was clearly derived from New York sources.

To prevent this outcome, NYCRR 132.4(c) states, as follows:

*“If personal services are performed within New York State, whether or not as an employee, the compensation for such services includible in Federal adjusted gross income constitutes income from New York State sources, regardless of the fact that (1) such compensation is received in a taxable year after the year in which the services were performed,...”*

As a result of this provision, the employee in the above example would be required to allocate the bonus received in 2010 by the days worked in and out of New York in 2009. (For more on bonuses see Chapter V.)

NYCRR 132.4(c) states further that the income would be taxable even if,

*“... (2) such compensation is received by someone other than the person who performed the services.”*

Married couples who live in community property states and file separate Federal returns are required to report one-half of the total income on each spouse’s return regardless who earned or received the income. For New York purposes, both spouses would be required to file separate nonresident returns even though only one has income from New York sources as a result of this provision.

***Example:***

Mary and Mike Monroe are residents of California, a community property state. They filed separate federal returns in 2010, each reporting one-half of the total income. That year Mary earned \$200,000 in wages of which 60% was allocable to New York. Mike had no income from New York sources. Nevertheless, each spouse would be required to file a nonresident return for 2010 reporting one-half of the total New York source income of \$120,000, or \$60,000 each.

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## IV. ALLOCATION – NONRESIDENT PARTNERS AND PARTNERSHIPS

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### A. DEFINITION OF A BUSINESS

#### 1. Regulations and Case Law

The regulations distinguish between personal services performed by a nonresident **employee** and a “business, trade, profession or occupation” carried on in New York State by a nonresident individual acting in a noncorporate capacity such as a **sole proprietor or partner**. In the last chapter we discussed how an employee allocates income partly derived from New York sources. In this chapter we will focus on nonresident partners although the allocation methods discussed apply to self-employed individuals in general.

**Tax Law Section 631(a)(1)(A)** states that New York source income includes a nonresident’s “*distributive share of partnership income gain, loss and deduction.*” In order for a nonresident partner to be taxable, the partnership itself must be doing business in New York. It was noted earlier that **NYCRR 132.4(a)(2)** states that a business is carried on in New York State by a nonresident when he

*“occupies, has, maintains or operates desk space, an office, a shop, a store, a warehouse, a factory, an agency or other place of business where such nonresident’s affairs are systematically and regularly carried on...”*

This term, “*systematically and regularly carried on,*” is used further in NYCRR 132.14 in discussing when business is carried on partly outside New York as well. The regulation states that business is carried on in New York and elsewhere when “one or more of the activities” described above is “systematically and regularly carried” on in New York and one or more of these same activities is systematically and regularly carried on outside New York.

Note, however, that the definition of doing business in New York is not limited to having an actual physical location in New York. To continue with the language of NYCRR 132.4(a)(2),

*“business is carried on within New York State if activities within New York, in connection with the business, are conducted in the state with a **fair measure of permanency and continuity.**”*

In the following case, the Court of Appeals further elaborated on what it means for a partnership to be doing business in New York. In *Vogt v. Tully (53 NY2d 580)*, a

nonresident limited partner was allowed to deduct his distributive share of loss from a partnership engaged in the business of buying and leasing railroad tank cars for use outside New York. Although all the partnership property was located and operated outside the state, the Court of Appeals found that “the partnership activities were directed and supervised” by a general partner from the partnership’s only office, in New York City. It was because of this **active management** that the Court concluded that the nonresident was engaged in a business that was systematically and regularly carried on in New York as opposed to being involved in a mere **passive investment**.

Once it has been determined that a partnership is conducting business in New York, it is necessary to determine what portion of the income is taxable to the nonresident partners. This will be covered in the next section on pages 27-32.

## 2. Purchase and Sale for Own Account - Tax Law Section 631(d)

While the courts have wrestled with the definition of what constitutes doing business in New York, the tax law provides one example of what is **not** doing business in New York. Tax Law Section 631(d) states the following:

*“A nonresident, other than a dealer holding property primarily for sale to customers in the ordinary course of his trade or business, shall not be deemed to carry on a business, trade, profession or occupation in this state solely by reason of the purchase and sale of property or the purchase, sale or writing of stock option contracts, or both, for his own account.”*

In other words, nonresident partners of certain investment partnerships would generally not be considered to be engaged in a trade or business in New York and consequently would not be taxable on their distributive share of income. This so-called “purchase and sale for own account” exemption is predicated on two conditions: the **nature** of the partnership’s activity in New York AND whether this constitutes the **sole** activity of the partnership. ***These conditions are discussed below:***

### ▪ ***Nature of Activity***

For the exemption to apply, the activity of the partnership must be limited to buying and selling securities for its partners. Thus, the exemption would not extend to either a dealer in securities or a market maker in securities, both of whom have customers.

In the ***Kenneth S. Davidson Advisory Opinion, TSB A-88(11)I***, the exemption was broadened to include both the purchase and sale of futures contracts and the



writing of options on futures contracts for the partnership's own account.

The New York source of partnership income is determined at the partnership level, which carries over to the nonresident partners. Thus, if the partnership is engaged in a trade or business in New York, the nonresident partners will be subject to tax. Conversely, if the partnership meets the "purchase and sale for own account" exemption, it is not deemed to be conducting business in New York and the nonresident partners would be exempt from tax.

In the *Paul Singer Advisory Opinion, TSB-A-92(2)I*, a trading partnership had two general partners, a nonresident individual and a limited partnership. Both were compensated for their services to the trading partnership in the form of guaranteed payments. The opinion concluded that "*partnership income is determined by the activity of the partnership.*" Since that activity involved trading securities for its own account, the income was not New York source. It further concluded that

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*"This characterization of (the partnership's) income as non-New York source will remain intact despite the existence of a tiered partnership arrangement..."*

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Thus, in addition to the individual general partner being exempt from tax, so, too, were the partners of the limited partnership, the other general partner.

■ ***Sole Activity***

It is the Department's position that for a partnership to meet the definition of purchase and sale for own account under Tax Law Section 631(d) and the resulting income received by the nonresident partners be exempt from tax, the activity must constitute the *sole* activity of the partnership. This issue was addressed in an Advice of Counsel dated April 21, 2005 (LBW-8672) which involved several variations on the theme.

In the first scenario, a partnership whose primary activity is trading for its own account receives a small part of its income from transactions with customers. The conclusion was that the partnership does not qualify for the exemption under Tax Law Section 631(d). According to Counsel,

*"The fact that the partnership engages in transactions with customers, even if such transactions are ancillary to its primary purpose of trading on its own account, will preclude*

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*the partnership from claiming that it is not carrying on a business, trade, profession or occupation in this State.”*

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Thus, the receipt of even a small amount of business income from customers would taint the income from self-trading and theoretically subject a nonresident partner to tax on all the income. The opinion went on to emphasize, however, that as income from intangibles it would only be taxable “*to the extent such intangible income is from property employed in a business, trade, profession or occupation carried on in this State as set forth in Tax Law Section 631(b)(2)*.” For example, it is the Department’s position that intangible property is employed in a business if it is used as collateral for a business loan. This is explained further in Chapter V, Section F, Intangible Personal Property

In another scenario, an investment partnership trading for its own account is a partner in another partnership which conducts business in New York. The issues are whether the business income retains its source and character as New York source income *and* whether its receipt by the investment partnership would subject its income from trading activities to taxation as well.

On the first point, the opinion concluded that the business income *does* retain its source and character and would be taxable to the nonresident partners in accordance with NYCRR 137.6 (which will be discussed later in this chapter). As to whether it would taint the income of the investment partnership depends on its status as a general or limited partner.

If the investment partnership was a *general* partner in the business partnership, it would be “deemed to be actively involved in the day to day business activities” of that partnership. Thus, it would be prevented from claiming exemption under 631(d) and consequently the income from its trading activities would constitute New York source income. As in the prior scenario, however, the income would only be taxable to the nonresident partners to the extent that the intangibles were employed in a trade or business in New York.

On the other hand, if the investment partnership was a *limited* partner in the business partnership, the income from the trading activities would not be taxable to the nonresident partners. As stated earlier, only the income it received from its investment in the business partnership would be taxable to the nonresident partners.

### 3. Public Law 86-272

Public Law 86-272 restricts a state from taxing entities whose only activities within the state consist of solicitation of orders for sales of tangible personal property provided that:

- the orders are sent outside the state for approval and
- the goods are shipped from outside the state.

Thus, a partnership which does not have an office in New York and whose **only** activity within the state is sending salesmen into New York to solicit orders for tangible property, would not be deemed to be doing business in New York.

Consequently, nonresident partners would not be subject to tax on their distributive shares of income from a partnership whose only activities within New York State fall within the scope of Public Law 86-272.

*Advisory Opinion TSB-A-08(4)I*

## B. ALLOCATION OF BUSINESS INCOME

Once it is determined that a partnership is carrying on a business both within and without New York State, an allocation of its income to New York State must be made in order to determine the proper amount taxable to the nonresident partners. This allocation must be on a fair and equitable basis in accordance with approved methods of accounting.

### 1. Allocation by the Books

If the books of the business are kept so that they disclose, to the satisfaction of the Commissioner, the proper proportion of the net amount of the items of income, gain, loss and deduction derived from New York State, then the books must be used as the basis for the allocation to New York State.

***Example:***

ABC Partnership is a law firm with offices in New York City, Chicago and Los Angeles. In calendar year 2010, each location reported the following net income based on its own set of books and records:

NYC	Chicago	Los Angeles
\$500,000,000	\$200,000,000	\$300,000,000

John Marshall is a partner working out of the Chicago office with a 10% capital and profits interest. His taxable share of New York source income for tax year 2010 would be \$50 million ( $\$500,000,000 \times 10\%$ ). Note that this would be the same result

regardless of which office he worked in since as a nonresident he is taxable only on the amount from New York sources, which is the amount generated by the New York office.

The use of the books and records method was upheld as proper by the Court of Appeals in *Matter of Russell T. Weil, et al.*, 70 NY2d 783, involving nonresident partners of a New York law firm who worked exclusively in the Washington office. The allocation was based on the separate accounts of the income and expenses kept by each of the firm's offices.

## 2. Allocation by the Three-Factor Method

If the books and records of the business do not disclose, to the satisfaction of the Commissioner, the proper proportion of the net amount of the items of income, gain, loss and deduction attributable to business activities in New York State, such proportion must be determined by the three factor formula prescribed by **NYCRR 132.15**. The use of the three factor method instead of other "alternative allocation formulas" was upheld in the State Tax Commission's decision in the *Matter of the Petition of Jack P. Blume, TSB-H-82(58)I*, when it stated that:

*"...if a nonresident individual is a member of a partnership which carries on a business both within and without this State, there must be apportioned to this State a fair and equitable portion of the items of income, gain, loss and deduction attributable to such business within the meaning and intent ... of the Tax Law .... The "Direct Accounting" method is to be used unless a "fair and equitable" apportionment of net income/loss cannot be determined by that means.... This method does not fairly reflect the partnership's net income from this State; accordingly the use of such method is not allowed. The next recourse is the three-factor allocation formula in accordance with the meaning and intent...of the Tax Law.."*

*(Conclusion of Law A)*

*That petitioners have failed to sustain their burden of proof ... to show that the three factor formula is inequitable. Therefore, said method is to be used in determining that portion of the petitioner Jack P. Blume's partnership distribution required to be included in New York income."*

*(Conclusion of Law B)*

The three factor formula consists of property, payroll and gross income percentages, which are discussed below:

**Each of the three factors are as follows:**

**(1) Property Percentage**

The property percentage is computed by dividing (i) the average of the values, at the beginning and the end of the taxable year, of real and tangible personal property connected with the business and located within New York State, by (ii) the average of the values, at the beginning and end of the taxable year, of all real and tangible personal property connected with the business and located both within and without New York State. For this purpose, real property includes real property RENTED to the taxpayer and used in the business as well as owned real and tangible personal property (**including inventory**).

*Note: In computing the property percentage, exclude property that is either sold or rented out during the year and the income is being reported pursuant to **NYCRR 132.16**. Thus, if a partnership sells an office building it owned during the year and recognizes a capital gain (or loss), its value would not be used to compute the property factor either at the beginning or end of the year. This is true whether the building was located in New York or elsewhere.*

**RENTAL REAL PROPERTY.** The fair market value of real property, both within and without New York State, which is rented to the taxpayer is determined by multiplying the gross rents payable during the taxable year by eight (8).

**GROSS RENT**, as used in this paragraph, is the actual sum of money or other consideration payable directly or indirectly by the taxpayer or for his benefit for the use or possession of the property and **INCLUDES:**

- any amount payable for the use or possession of real property, or any part thereof, whether designated as a fixed sum of money or as a percentage of sales, profits or otherwise;
- any amount payable as additional rent or in lieu of rent, such as interest, taxes, insurance, repairs or any other amount required to be paid by the terms of a lease or other arrangement;
- a proportionate part of the cost of any improvement to real property made by or on behalf of the taxpayer which reverts to the owner or lessor upon termination of a lease or other arrangement, based on the unexpired term of the lease commencing with the date the improvement is completed (or the life of

the improvement if its life expectancy is less than the unexpired term of the lease); provided, however, that where a building is erected on leased land by or on behalf of the taxpayer, the value of the land is determined by multiplying the gross rent by eight, and the value of the building is determined in the same manner as if owned by the taxpayer. The proportionate part of the cost of an improvement (other than a building on leased land) is generally equal to the amount of amortization allowed in computing New York adjusted gross income, whether the lease does or does not contain an opt of renewal.

**GROSS RENTS DO NOT INCLUDE:**

- any portion of a payment or credit, to the proprietor of the business or to a partner in the partnership conducting the business, for the use of real property;
- amounts payable as separate charges for water and electric service furnished by the lessor;
- amounts payable for storage, where no designated space under the control of the taxpayer as a tenant is rented for storage purposes; or
- that portion of any rental payment which, in the discretion of the Commissioner, is applicable to property subleased by the taxpayer and not used by him in the carrying on of the business.

*If the method described above results in valuations which are not fair and equitable, another method may be adopted either by the Commissioner or the taxpayer. A request by a taxpayer for an alternative method may be made at the time the New York State nonresident personal income tax return is filed and is subject to the approval of the Commissioner.*

**See NYCRR 132.15(d)(3) for more information.**

**(2) Payroll Percentage**

The payroll percentage is computed by dividing (1) the total wages, salaries and other personal service compensation paid or incurred during the taxable year to employees, in connection with business carried on within New York State, by (2) the total of all wages, salaries and other personal service compensation paid or incurred during the taxable year to employees in connection with the business carried on both within and without New York State. This formula does not include payments for independent contractors, independent sales agents, etc. Compensation paid for services is considered to be in connection with operations carried on in New York State if the employee works in or travels out of an office or other place of business located in New York State.

**(3) Gross Income Percentage**

The gross income percentage is computed by dividing (1) the gross sales or charges for services performed by or through an office, branch or agency of the business located within New York State, by (2) the total of all gross sales or charges for services performed within and without New York State. The sales or charges to be allocated to New York State include all sales **negotiated or consummated**, and charges for services performed by an employee, agent, agency or independent contractor chiefly situated at, connected by contract or otherwise with, or sent out from, offices, branches of the business, or other agencies, situated within New York State.

***Calculating the Average Percentage***

The percentage which each New York factor bears to the corresponding total factor is to be determined, and an average of the total of such percentages is to be computed. This average is the percentage of the total net earnings from a business, trade, profession or occupation which is subject to New York tax.

***Example:***

In the case of a manufacturer, whose plant is located in Connecticut, the bulk of the sales are made in New York State through a sales office in New York City from which traveling salesmen cover New York, New Jersey, and Pennsylvania. For the purpose of breaking up the case lots for deliveries of small quantities to customers, an owned warehouse is maintained in New York City. The following illustrates the application of the "allocation formula" provided the business is organized as either a partnership or sole proprietorship.

A	B	C	D
Description Of Items Used As Factors	Total Factors Within and Without the State	New York State Factors	Percent Column C is of Column B
1. Value of real and tangible personal property of the business. (Average of the value at the beginning and the end of the year.)	\$500,000	\$35,000	7%
2. Wages, salaries and other personal service compensation paid during the year.	\$400,000	\$140,000	35%
3. Gross Sales or charges for services during the year	\$1,200,000	\$972,000	81%
4. Total Percentage in Column D			123%
5. Average of Percentages			41%

The three separate percentages determined from the Real and Tangible personal property factor, the Payroll factor, and the Gross income factor are averaged together to determine the percentage of net business income allocated to New York State. In this example if the net income of the business was \$250,000, then the appropriate amount of business income to allocate to New York would be as follows:

Net Business Income		Percentage Determined by Three Factor Method		NYS Income
\$250,000	x	41%	=	\$102,500

**Note:** In this example, all sales made by the New York City sales office and the salesmen sent from that office, no matter in what city or state they may make the sales, are allocated to New York. The compensation paid to the salesmen traveling out of the New York City office is included in the formula as New York State payroll regardless of whether the individuals travel outside the state to make sales.

**C. TIERED PARTNERSHIPS- NYCRR 137.6**

In addition to receiving income from their own operations, partnerships may also receive flow through income from other partnerships in which they are invested. Thus, a nonresident individual may be a partner in a partnership, which we will call “A,” which in turn is a partner in another partnership, or “B.” In such situations A is generally referred to as the “*upper tier partnership*” while B is called the “*lower tier partnership*.”

In a typical tiered entity arrangement, a nonresident’s distributive share would be comprised of components of income and loss from several partnerships, not all of which may be conducting business in New York.

Income tax regulation 137.6 provides that partnership distributive share of income and loss at each level retains its source and character as it flows up the chain to the ultimate recipient, the nonresident partner. As the regulation states,

*“Such source and character are not changed by reason of the fact that such item flows through the upper tier partnership to such member.”*

Thus, the New York source income (or loss) generated at each tier is determined by using the business allocation percentage calculated for that partnership. The resulting figure is **not** combined with the income generated by the next tier. Instead, the income at each tier remains separate and distinct.



In the above example, let us say that Partnership A was not engaged in a trade or business in New York but that Partnership B was. Mary is a nonresident partner of A from which she receives a distributive share of income. Even though the partnership of which she is a direct partner is not carrying on business in New York, it nevertheless has New York source income from the distributive share it received from partnership B, which is carrying on business in New York. Therefore, Mary's distributive share from Partnership A will consist of both taxable and non-taxable components.

**To illustrate this point, let us assume the following facts:**

- Partnership B conducts business solely in New York and has ordinary income of \$120,000, all from New York sources;
- Partnership A is a 50% partner in B. Therefore, its distributive share of income from B would be \$60,000 ( $\$120,000 \times 50\%$ );
- In addition to its distributive share from B, Partnership A also has income of \$40,000 from its own operations, none of which is carried on in New York. Its total ordinary income for the year is \$100,000 ( $\$60,000 + \$40,000$ );
- Mary is a nonresident who is a 20% partner in A. Her distributive share for Federal purposes is \$20,000 ( $\$100,000 \times 20\%$ ).

Although Mary is a direct partner of A which does not conduct business in New York, she has New York source income from B which *does* do business in New York. As a result of NYCRR 137.6, the source and character of partnership income is determined at each tier and *retains its source and character* as the income flows from Partnership B through Partnership A to the ultimate recipient, Mary. As Partnership B reported \$60,000 to A, Mary is taxed on her 20% share, or \$12,000.

In the following ALJ determination, nonresident partners of a Florida partnership were held to be taxable on the sale of New York real estate by a lower tier. Three nonresidents were partners in the partnership known as JAHE which maintained no offices, owned no property, and conducted no business in New York. JAHE's only activity was the holding of its partnership interest in another Florida partnership, SHAJE.

SHAJE similarly maintained no offices, owned no property and conducted no business in New York. Its only activity was investing in other real estate partnerships.

In 1986, SHAJE received a distributive share from one of its investments representing a capital gain from the sale of real property located in New York. SHAJE, in turn, distributed its portion of the gain to JAHE which distributed its portion to the nonresident

partners, all of whom failed to report the gain for New York purposes. Noting that the property had a situs in New York, the ALJ concluded that,

*“Since each item of income retains the same character in the hands of the partner that it had in the hands of the partnership (IRC 702(b)), the gain in this instance is attributable to New York.”*

*Conclusion of Law L*

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*Matter of Jerry & Elayne Wittels, Alan & Dorothy Cohen, and Joel & Rita Cohen, DTA Nos. 812105, 812192, 812193.*

It is this reasoning that underlies the basis for NYCRR 137.6, which was not in effect during the year at issue.

## D. NONRESIDENT PARTNERS

### 1. Distributive Share of Income and Loss

Nonresident partners are taxed on their distributive shares of partnership income or loss but only to the extent they are connected with New York sources according to **Tax Law Section 632(a)(1)**. In determining the portion that is connected with New York sources, the allocation formulas discussed previously are used. Thus, the method used by the partnership to allocate its business income to New York, determined either by the books and records or the three factor methods, will also determine the amount of the nonresident partner’s distributive share of income (or loss) that is taxable to New York.

Because partners are not employees, they cannot allocate their share of partnership income by the days in/out method applicable to employees as explained in Chapter III.

The following two cases decided at the Appellate level illustrate this point:

- (1) A nonresident partner who worked primarily out of his firm’s Washington, D.C. office was not allowed to allocate his share of partnership income by the days he worked within and without New York. In requiring him to use the partnership’s higher New York business allocation, the State Tax Commission concluded that the partner’s *“share of partnership income is considered to be derived from the same sources as from which the firm’s income is derived. This is true even for a partner who spends all of his time in only one location whether in or out of New York State.”* In affirming the decision, the Appellate Division highlighted the difference in the tax treatment between an employee and a partner by noting that

*“...it is the portion of that distributive share attributable to New York sources, not the value of his personal services here, which is properly subject to taxation by this jurisdiction.”*

*Thomas M. Debevoise, 52 AD2d 1023*

(2) In rejecting a partner’s allocation for days worked outside the state servicing his firm’s foreign clients, the court noted that the partner’s *“situation is readily distinguishable from that of a salaried corporate employee who works out of state.”*

*Matter of Robert P. Knapp, Jr., 67 AD 2d 1024*

In both of the above cases, there was no dispute that the taxpayers were partners and that the income in question was a distributive share of partnership income. The issue in both was how to allocate such income.

In the next series of cases, the taxpayers questioned their characterization as partners, contending that they were instead employees and the income they received represented wages and not partnership income.

- *Matter of Faulkner, Dawkins and Sullivan, 63 AD2d 764*, concerned a brokerage firm that paid its registered representatives commissions which it deducted as wages for purposes of computing the unincorporated business tax. These representatives were actually given a nominal interest in the profits of the firm *“mainly for the cosmetic purpose of bestowing more prestige”* on them. In concluding that they were partners and not employees, the Appellate Division stated,

*“Petitioner chose to designate them as partners and even gave them a small proprietary share in the business. Petitioner is held to the tax ramifications of such a decision.”*

- In a similar case, a taxpayer’s contention that he was not a partner because, among other things, he had only a 1% profits interest and that his designation as a partner served only to enhance his reputation and attract clients, was rejected by the Appellate Division as unpersuasive. Citing *Faulkner*, the Court stated that since the taxpayer *“chose to be designated a partner, he must accept the tax consequences of this decision.”*

*Matter of Bernard Weinflash, 93 AD2d 369*

- In *Matter of Stanley A. Marks, TSB-H-86(125)I*, the State Tax Commission concluded that the taxpayer was a partner and that the commissions he received and reported as wages represented a distributive share of partnership income. The taxpayer was designated as a “special limited partner” in the partnership agreement and entitled to share in the profits and losses.

## 2. Guaranteed Payments – Tax Law Section 632(b)

In addition to, or instead of, receiving a distributive share of the partnership’s income or loss, a nonresident partner may receive a payment determined without regard to the income of the partnership. This is called a *guaranteed payment*. Guaranteed payments are allocated by nonresident partners in the same manner as a distributive share of partnership income or loss in accordance with **Tax Law Section 632(b)**, which states, in part, that no effect is given to a provision in the partnership agreement which,

*characterizes payments to the partner as being for services or for the use of capital.*

*The following cases illustrate this section:*

- In *Matter of Herbert Jablin, 65 AD2d 891*, the Appellate Division ruled that commissions paid to a nonresident partner of a brokerage firm were taxable by the partnership’s business allocation percentage. The commissions were in the form of a guaranteed payment and were paid to the taxpayer in addition to his distributive share of income. The Court rejected the partner’s argument that the commissions were for services performed outside New York, citing the forerunner of current section 632(b)(1) that no effect is given to an agreement characterizing payments to a partner as being for services.
- A partner was not allowed to re-characterize a portion of his distributive share of partnership income as direct payment for services which should be allocated outside New York since the partnership made no such allocation.

*Matter of Robert Scobey, 95 AD2d 905*

- A nonresident partner received two separate distributions from a partnership only one of which was allocated to New York. The other was reported as a guaranteed payment on the K-1 schedule and was not allocated by the partner who claimed it was payment for services rendered in Florida. The State Tax Commission cited both *Jablin* and the forerunner of Tax Law Section 632(b)(1) in ruling that the payment was allocable to New York by the partnership’s business allocation percentage.

*Matter of Morris & Stephanie Engelberg, TSB-H-85(70)I*

- The Appellate Division rejected a nonresident partner's argument that a payment he received upon liquidation of his partnership interest represented the sale of his interest, which would not be taxable, rather than a guaranteed payment. The partnership deducted the payment as a guaranteed payment and reported it as such on the K-1 schedule to the partner. As the Court noted,

*“Having structured the termination of Spencer’s partnership interest as a liquidation, petitioners cannot now restructure it as a sale.”*

*Matter of Sash A. Spencer, 251 AD2d 764*

*Note, however, that guaranteed payments are only taxable to New York to the extent that they are includible in Federal adjusted gross income. Thus, a partner who is classified as a nonresident alien for Federal purposes would generally not be taxable on a guaranteed payment for Federal purposes unless he performed some services in the United States. In such cases, the payment would likewise not be taxable for New York purposes.*

**Advisory Opinion of Francis Fitzherbert-Brockholes, TSB-A-93(2)I**

Tax Law Section 632 also has two other provisions which are meant to prevent nonresident partners from manipulating income and losses to reduce New York source income. They provide that no effect is given to a provision in the partnership agreement which

- (1) allocates to the partner more income outside New York than the partnership itself allocates to sources outside New York;
- (2) allocates to the partner a greater proportion of a partnership loss or deduction from New York sources than the partnership itself allocates to New York.

**The following case illustrates this section:**

A partner was barred from allocating 40% of his partnership income to sources outside New York since the partnership did not allocate, in accordance with the forerunner of Tax Law Section 632(b)(2). The Appellate Division stated that he “*could not unilaterally make a different allocation.*”

*Matter of Gordon B. Spivak 135 AD2d 940*

### 3. Anti-Abuse Rule – Tax Law Section 632-a.

Tax Law Section 632-a was enacted in 2007 to combat the use of personal service corporations or S corporations to avoid or evade tax. This has particular importance for the Department's ability to tax nonresident partners.

For example, prior to 2007 a nonresident partner of a New York partnership assigned to an office outside the state could essentially escape taxation by incorporating as a personal service corporation (PSC). Under this scheme the distributive share of income flowed to the PSC which expensed it in the form of a salary to the individual. While the PSC generally paid only minimum franchise tax to New York, the individual largely avoided personal tax altogether on the salary unless he performed some services in New York.

Effective with 2007, however, the commissioner can reallocate the income between the corporate entity and the individual owners in order to prevent this outcome. In the above example, the employee/owner of the PSC would be required to allocate his salary by the business allocation percentage of the partnership and not by the days in/out method. If the individual received the income in any form other than as salary, such as a fee, the business allocation method would still be used.

**Note that this reallocation can be done regardless of what the intention was in forming the PSC or S Corporation as long as the effect is to avoid or evade New York income tax.**

**For more information see TSB-M-07(8)I.**

### 4. Interest on Capital Contributions

In *Matter of Sidney Rosenthal, Deceased, et al.*, (102 AD 2d 325), the Appellate Division ruled that a nonresident partner was taxable on the interest income he received on his capital contribution but not on securities he loaned to the partnership.

The State Tax Commission cited the above ruling in likewise holding that interest income received in connection with a nonresident partner's capital account was taxable.

*Matter of Rosalie L. Goldblatt, TSB-H-85(132)I.*

Interest income received on a nonresident partner's capital contribution consisting of both cash and securities was determined to be income from intangible property employed in a business carried on in New York.

*Petition of Joseph T. Raebuck, State Tax Commission. May 6, 1976*

## 5. Sale of Partnership Interests

An interest in a New York partnership which either owns real or tangible property in New York State or conducts a trade or business in this state is intangible personal property. As a result of the Administrative Law Judge decision in **John L. and Karin Loehr, DTA No. 807015**, the Department revised its policy regarding the sale of partnership interests by nonresident partners. **TSB-M-92(2)I** states that the gain or loss on the sale of a partnership interest in a New York partnership does not constitute gain or loss from New York sources and would not be taxable to a nonresident.

The memo makes clear, however, that a nonresident who employs a partnership interest as an asset in a New York trade or business, such as a broker-dealer in securities, would be subject to tax on the gain or loss from the sale of the interest.

With the enactment of **Tax Law Section 631(b)(1)(A)(1)** in 2009, however, gain or loss on the sale of an interest in a partnership or limited liability company may be taxable to a nonresident under certain conditions.

The law amends the definition of an interest in real property to include gains or losses from the sale of an interest in a partnership or limited liability company as well as stock in an S corporation or non-publicly traded C corporation with 100 or fewer shareholders. For the gain (or loss) to be taxable, 50% or more of the fair market value of partnership's assets on the date of sale must be attributable to real property located in New York.

To prevent an entity from acquiring assets in anticipation of a sale to get below the 50% threshold and thus avoid the tax, the law has a two-year look back period. All assets acquired in the two years prior to the sale are disregarded in computing the *denominator* of the percentage. If the entity owns real property in New York State and ALL of its assets were acquired within two years of the sale date, the 50% threshold is deemed to have been met.

Note that the 50% test determines only *whether* the gain or loss is taxable to a nonresident partner and not necessarily the *amount* that is reported for New York purposes. For this we need to multiply the total gain or loss for federal purposes by a fraction. The numerator of the fraction is the same as determined above, i.e., the FMV of New York real property. The denominator, however, is the FMV of *all* partnership assets, including those acquired within two years of the date of sale. See example 1 in **TSB-M-09(5)I** for more information.

The law applies to all sales occurring on or after May 7, 2009.

## 6. Retirement Payments

In 1996 Congress enacted Public Law 104-95 which bars states from taxing nonresident employees on most forms of retirement payments. In 2006 the law was retroactively amended to include payments from nonqualified plans to nonresident partners as well.

**To be exempt, the payments must meet the following three conditions:**

- (1) The payments must be made pursuant to a written plan that was in effect prior to the nonresident partner's retirement;
- (2) The payments must be in recognition of the partner's prior service to the partnership;
- (3) The payments must be paid in substantially equal payments, at least annually, over the life expectancy of the partner or at least 10 years.

**For more information see TSB-M-07(2)I.**

## 7. Limited and Nonequity Partners

It should be noted that the above partnership rules apply to LIMITED partners as well as general partners. The Tax Appeals Tribunal concluded that a limited partner was a partner for the purposes of applying Tax Law Section 632(a)(1), and that sufficient nexus existed with New York for him to be taxed. *Matter of Paul O. and Natalie I. Koether, DTA Nos. 801737 and 804085*. The Tribunal stated:

*“The simple fact of the matter is that the Tax Law treats partners differently than employees. Having chosen to become a limited partner in a New York partnership, petitioner must bear the consequences.”*

Similarly, a nonresident who was a nonequity partner of a law firm which did business in New York and elsewhere, was held to be taxable on payments received from the partnership. The taxpayer argued that he was not subject to tax because he practiced law only in New Jersey and, as a nonequity partner, had no capital account, did not share in partnership profits and losses, and exercised no management responsibilities. In rejecting these arguments, the Tax Appeals Tribunal in *Matter of Robert & Frances Tosti, DTA No. 822915*, noted that he was treated as a partner by the partnership which reported the payments to him as guaranteed payments on schedule K-1. The Tribunal concluded that the payments were properly taxable by the partnership's business allocation percentage.



A prior advisory opinion, *Michael Sastre, TSB-A-06(9)I*, similarly concluded that a nonequity partner was subject to tax on guaranteed payments by the business allocation percentage.

## 8. Penalties

In *Matter of Kenneth R. and Cheryl Ethredge, DTA No. 803820*, the Tax Appeals Tribunal reversed the finding of the ALJ and reinstated the imposition of penalties on a nonresident partner for failing to file tax returns. Mr. Ethredge was a partner of a New York brokerage firm who worked out of its office in Texas where he resided. He claimed to be uneducated in tax matters and relied on his accountant who was unfamiliar with New York law. The Tribunal concluded that his reliance on his Texas accountant rather than the partnership's New York accountant did not constitute grounds for reasonable cause for waiving penalties.

## 9. Change of Residence

For tax years effective 2004, partners and shareholders in New York S corporations who change residence during the year are generally required to prorate their distributive shares of income between their resident and nonresident periods per Tax Law Section 639(f). The partner or shareholder determines his pro rata share of income based on the number of days he was a resident and nonresident within the reporting period of the entity. Thus, for fiscal year entities, the taxpayer would compute his taxable income based on the number of resident and nonresident days within the entity's fiscal year and not the individual's calendar year.

While proration is the general rule, the Department may require or the taxpayer may elect to use a direct accounting method whereby income is sourced to the taxpayer's resident and nonresident periods that reflects when the income was actually received or accrued.

For more information consult **TSB-M-05(2)I**.

## 10. Statute of Limitations

When auditing a partnership the auditor must be cognizant of the statute of limitations for the partners, both individual and corporate. This is because any adjustments made at the partnership level will flow to the partners. Therefore, it may be necessary to obtain waivers for the partners depending on when they filed their own returns.

The need to obtain waivers also extends to any nonresident individual partners who are included on a group return. According to **NYCRR 151.17(e)**,

*“The filing of a group return will be considered as a group of separate returns which will meet the individual filing requirements of this Part.”*

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Since the partnership itself does not pay tax, the IT-204 partnership return is considered to be an informational return. Therefore, it is not necessary to obtain a waiver for the partnership.

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## V. SPECIFIC CATEGORIES OF INCOME *(Arranged Alphabetically)*

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### A. BONUSES

As mentioned in Chapter III, **NYCRR 132.4(c)** states that compensation for personal services performed within New York is taxable even if “...received in a taxable year after the year in which the services were performed...” This would include bonuses or awards received by a nonresident for services performed in a previous taxable year. The bonus or award should be allocated on the same basis as the wage or salary income was allocated for that year. If the bonus is received for services performed wholly in New York, the entire amount of the bonus should be included in the employee’s New York source income.

This would also be true in cases involving a change of residence. In determining that nonresidents would be allowed to allocate bonuses and awards earned in a year when the taxpayers were residents but paid the following year when they were nonresidents, an *Advisory Opinion, Union Carbide Corporation, TSB-A-81(8)I*, concluded that:

*“...the residence of the officers and employees at the time of payment of the awards and bonuses is determinative. The residence of the officers and employees at the time the services were rendered is irrelevant.*

*Accordingly, since the officers and employees are non-residents at the time of payment of the awards and bonuses, the awards and bonuses are included in their New York adjusted gross income to the extent derived from or connected with New York sources.”*

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The same treatment would apply where the bonus was received in the same year that the change of residence occurred. Thus, in another *Advisory Opinion, Susan Byrne Montgomery, TSB-A-95(7)I*, a taxpayer was inquiring how to allocate a bonus paid at the end of 1990 when she had become a nonresident but based on services performed throughout the year during the resident and nonresident periods. The opinion stated that:

*“...when determining the portion of the bonus that is attributable to Petitioner’s services rendered within New York State..., the total number of working days employed within New York State and employed within and without New York State are computed based upon the entire calendar year 1990.”*

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*Note* that in both of the above opinions, it was either stated or implied that the bonuses were NOT accruable to the resident period.

## B. COOPERATIVE APARTMENTS

Prior to January 1, 2004, a capital gain arising from the sale of a cooperative apartment was not taxable to a nonresident. Cooperative apartments are owned by corporations in which there are individual shareholders. The sale of stock therefore represented the sale of an intangible asset and was considered intangible income.

Note, however, that the gain from the sale of stock in a cooperative apartment used partly for business purposes was taxable to the extent the income was from property employed in a business carried on in New York State. Thus, nonresidents who claimed 12.5% of the expenses of a cooperative apartment as a business deduction were held to be taxable on 12.5% of the capital gain from the sale. See *Advisory Opinion of Licia Albanese Gimma, TSB-A-88(6)I*.

For tax years beginning on or after January 1, 2004, the New York source income of a nonresident will include the gain, to the extent included in federal adjusted gross income, from the sale, conveyance, or other disposition of shares in a cooperative housing corporation. The gain is includable in New York source income if the gain is in connection with the grant or transfer of a proprietary leasehold by the owner of the shares, where the cooperative is located in New York State. The amendment is applicable whether the nonresident owns the shares in the cooperative housing corporation directly, by a partnership, in trust, or otherwise. The gain must be included in New York source income whether or not the cooperative unit represented by such shares is used in a trade or business.

*For additional information, see TSB-M-04(5)I.*

## C. COVENANT NOT TO COMPETE

**Note: The discussion below applies to tax years prior to January 1, 2010. With the enactment of Tax Law Section 631(b)(1)(F), nonresidents are taxable on income from covenants not to compete received after December 31, 2009 to the extent they previously performed services in New York State. See TSB-M-10(9)I.**

The Tax Appeals Tribunal ruled in separate cases, *Warren and Rosemary Haas (DTA No.812971)* and *Nicholas Penchuk (DTA No.812646)*, that a covenant not to compete was NOT taxable to a nonresident. Although the Tribunal determined that the covenant was ordinary income to the taxpayers, it was not attributable to a business, trade, profession or occupation carried on in New York. In fact, the Tribunal stressed that payments for the covenant were made “*not to perform competing services in New York and elsewhere.*”

As a result of these decisions, compensation in exchange for a covenant not to compete is generally no longer taxable to a nonresident. It must be determined, however, whether the income at issue is actually compensation for entering into a covenant not to compete or compensation for past services performed in New York which would be taxable.

A termination agreement or other contract arising from the sale of a business or separation from an employer may contain multiple clauses aside from a covenant not to compete. The entire contract or agreement should be analyzed by the auditor to determine whether or not the consideration attributable to each clause is taxable to New York.

Two Tribunal decisions highlight the importance of carefully reviewing the underlying contracts. In *Matter of Michael J. and Anna C. Colitti, DTA No. 818210*, income earned by a nonresident taxpayer pursuant to noncompetition provisions of his termination agreement with his former New York employer was not subject to tax. The taxpayer gave up his rights to incentive shares under incentive stock option (ISO) agreements and acquired new rights to incentive stock that were contingent upon his fulfillment of the noncompetition provisions of his termination agreement. Therefore, the income at issue was paid pursuant to the termination agreement rather than the ISOs and, as a result, was not attributable to the taxpayer's former New York employment.

In *Matter of Anthony L. and Jill A. Clapes, 34 AD3d 1092*, various payments were made by an employer to a nonresident taxpayer with respect to his termination. It was determined that stock options, salary, incentive pay, and accrued vacation were taxable as New York source income because they were secured or earned in connection with the taxpayer's provisions of service to the employer in New York.

The facts in this case were distinguishable from Colitti as Colitti gave up his right to incentive stock options and acquired new rights to options subject to a covenant not to compete. Clapes did not give up his rights to stock options and incentive awards that he had received nor were they inextricably linked to a covenant not to compete.

#### **D. DIRECTOR'S FEES**

A nonresident allocates compensation received from serving on a corporate board of directors in a manner similar to that of an employee who performs services both within and without New York. Instead of using a day's worked in/out formula, however, a nonresident board member would allocate the compensation by the number of board meetings attended in New York divided by the total number of board meetings attended in New York and elsewhere. Note that the proper basis for any allocation should be actual board meetings attended and not days spent at the taxpayer's home preparing for a meeting. See the State Tax Commission decision in *Matter of J. Stanford Smith (deceased) and Elaine S. Smith, TSB-H-87(136)I*.

Each board that a taxpayer serves on is treated as a separate employment and a separate allocation schedule should be prepared for each

A nonresident employee working in New York could at the same time sit on a board as Director of a corporation which has its board meetings either partly or wholly in New York. If that is the case, separate allocation schedules should be completed for both the wages and the board fees.

If an individual sits on a Board located outside New York, the days allocated outside New York State for the New York employer should be reviewed to determine whether the days spent at the other corporation's out-of-state Board meetings are used in the allocation formula for the salary paid by the New York employer as days worked outside New York State. Generally, these days should not be included in the denominator as working days for the New York employer since the taxpayer is paid separately for this service.

*Other State Tax Commission cases in which director's fees were held to be taxable:*

- **BAIRD, DAVID G. and MILDRED B., TSB-H-82(270)I**
- **FISCHER, HUGO T. and MARY P., TSB-H-82(213)I**
- **MOLLOY, ERNEST L. and JULIA A., TSB-H-78(112)I**
- **PETERSEN, LEROY A. and HELGA A., TSB-H-82(169)I**

#### **E. FIDUCIARY FEES**

The Court of Appeals in *Matter of James G. Oxnard (15 NY2d 593)* ruled that commissions paid to a nonresident executor of an estate of a New York resident were not taxable since the services were performed wholly outside New York and he maintained no place of business in the state.

#### **F. INTANGIBLE PERSONAL PROPERTY**

Items of income, gain, loss and deduction attributable to intangible personal property of a nonresident individual, including annuities, dividends, interest and gains from the disposition of intangible personal property, do not constitute items of income, gain, loss and deduction derived from or connected with New York State sources, except to the extent attributable to property employed in a business, trade, profession or occupation carried on in New York State.

**Example:** A nonresident owns 100% of the stock of a corporation which operates a store in New York State. In 2002, the corporation pays the taxpayer a salary of \$175,000, all of which was earned in New York State, and a dividend of \$80,000. The taxpayer's income from New York State sources includes the salary of \$175,000. Since the

dividend is not income derived from New York State sources because of its intangible nature, the receipt of the dividend income is not taxable for New York State personal income tax purposes.

### 1. Stock Exchange Seats

Stock exchange seats have been characterized by the U.S. Supreme Court as intangible property. (*People ex rel. Whitney v. Graves*, 299 U.S. 366.) Thus, a nonresident who employs a seat on the New York or American Stock Exchange to buy and sell stocks for customers would be employing intangible personal property in a “business, trade, profession or occupation” in New York State. He or she would be taxable on the income generated by the seat as well as on any gain from the sale.

What about a nonresident who simply leases an exchange seat to someone else for use in a trade or business? Would he or she be taxable on the rental income? In an Opinion of Counsel dated June 1, 1993, the Office of Counsel concluded that the mere leasing of a single seat would not constitute a trade or business and, therefore, any rental income would not be taxable to a nonresident.

However, per **TSB-A-05(5.1)I**, it was stated that entering into several leases during the tax year, whether for several seats or just one seat, usually constitutes a trade or business for purposes of section 631(b) since the activity would not be a casual or incidental activity. It also states that the determination of whether the Petitioners activity connected with entering into one or more leases of a stock exchange seat or seats, or selling seats pursuant to one or more contracts of sale has the requisite continuity and regularity to constitute a trade or business is a question of fact that must be answered on a case by case basis following a careful review of the facts and circumstances of each case.

### 2. Stock

Stock in a C corporation is an item of intangible personal property. Therefore, income from the ownership of such stock whether as an active owner or a passive investor would normally not be taxable to a nonresident. This would include dividends as well as capital gains from the sale.

Thus, a nonresident was held not to be taxable on the gain from the sale of stock in a C corporation in which he was an executive vice-president and 13% shareholder.

***Matter of Chester Carity, TSB-H-81(300)I.***

Nonresident shareholders in S corporations, however, are taxed on their distributive share of items of income, gain, loss and deduction to the extent such items are derived from New York sources. This would also include investment income from the S corporation. ***Advisory Opinion of David L. Lieb and Co., TSB-A-85(5)I.***

A nonresident shareholder is not subject to New York State tax on gain or loss from the sale of stock in a S or C corporation unless the stock itself was employed in another business carried on in New York State. This will be explained further in the section on “Employed in a Trade or Business.”

This is also true for any gain or loss from the exchange of stock in an S corporation when the election under IRC 338(h)(10) has been made. This election would treat the acquisition of stock in an S corporation as though the S corporation had sold its assets followed by a deemed liquidation of the corporation. Any gain or loss resulting from this so-called deemed asset sale would be taxable to the nonresident shareholders of the S corporation. The gain or loss resulting from the deemed liquidation of the S corporation stock, however, is intangible and would not be included in New York source income.

**See TSB-M-10(10)I for more information.**

### 3. A Change In Character

When a nonresident individual sells real or tangible personal property located in New York State and, as a result of such sale receives intangible personal property (e.g., a note) which generates interest income, the interest income does not constitute income derived from or connected with New York State sources. Three Appellate Division cases illustrate this: *Matter of Arthur Delmhorst*, 60 NY2d 628; *Matter of Edwin E. Epstein et al.*, 89 AD2d 256; and *Matter of William Katz*, 110 AD2d 1029.

*In DELMHORST*, a taxpayer sold a seat on the New York Stock Exchange on the installment basis while a resident but received payments, including interest, after he had become a nonresident. The Court of Appeals ruled that while the taxpayer was required to accrue the principal payments to the resident period, the interest was not taxable to a nonresident because “*the income-producing intangible personal property was the installment note, upon which the interest was paid, and not the stock exchange seat covered by the note...*”

*In EPSTEIN*, a nonresident sold an apartment building located in Queens and received a mortgage note as consideration. In determining that the interest received from the note was not taxable, the Appellate Court similarly concluded that “*the income-producing intangible personal property is the mortgage note, upon which the interest was paid, and not the real estate apartment building covered by the mortgage...*”



In *KATZ*, the petitioners sold their interests in a property, which was leased to an automobile dealership for unsecured notes that were paid on the installment basis. Interest was ruled not taxable because there was no evidence that “*the unsecured notes themselves were ever used in a New York trade or business.*”

Where the instrument used to generate interest income as a result of a sale of real or tangible personal property located in New York State is employed in a business, trade, profession or occupation carried on in New York State, the interest income does constitute income derived from or connected with New York State sources.

#### 4. Employed in a Trade or Business

As stated at the beginning of this section, income from intangible personal property is not taxable to a nonresident unless, according to Tax Law Section 631(b)(2), “such income is from property employed in a business, trade, profession or occupation carried on in this state....” Questions have periodically come up requesting clarification when intangible personal property would be deemed to be “employed in a trade, business, profession or occupation.”

Unfortunately, there is not much guidance in this area. **TSB-M-92(3)I** which was issued to clarify the Department’s policy regarding New York financial institutions, does contain a helpful example that illustrates the concept of property employed in a business. A nonresident operates a sole proprietorship in New York. In order to pay his business expenses he maintains a business checking account in a New York bank. Since the account is used in the conduct of a New York business, any interest generated by the account would be taxable to a nonresident.

**PUBLICATION 35 (3/00), NEW YORK TAX TREATMENT OF S CORPORATIONS AND THEIR SHAREHOLDERS**, contains an example of when stock would be employed in a New York business. A nonresident buys 50% of the stock in a S corporation that raises poultry to insure a steady supply of poultry for his wholesale business which he operates entirely within New York State as a sole proprietor. Since the shares of stock are an integral part of his wholesale poultry business, the conclusion is that the stock is employed in a New York business.

An *Advisory Opinion, Ronald Van Der Horst, TSB-A-00(5)I*, discussed whether stock owned by a partnership was employed in a trade or business. The partnership, which conducts business within and without New York, realized a substantial capital gain from the sale of its 20% interest in a corporation which did not have any offices in New York State. The issue is whether the stock in the corporation was employed in the business of the partnership for the gain to be taxable to the nonresident partners. While the opinion refrained from answering this question, it did emphasize that mere

ownership of the stock by the partnership was not proof in and of itself that it was employed in a business carried on in New York by the partnership.

An earlier Administrative Law Judge determination also grappled with the issue of whether stock owned by a partnership was employed in a trade or business. That case, *Matter of Krumland et al., DTA Nos. 806987, 806988, & 806989*, involved a family partnership that was organized to operate real property in New York as well as to invest in stocks and other intangible investments on behalf of the family members who were all nonresident partners. In order for the income from the stocks to be taxable, the stocks themselves would have to be employed in the real estate business. One way in which this requirement would be satisfied according to the ALJ is if the stocks served as collateral for a business loan. In concluding that the income was taxable, however, the ALJ emphasized that “*the burden was on petitioners to show that the intangible personal property was not employed*” in the New York business.

Although the latter is not precedential, it is useful in reaffirming two important points. One is that for income from intangible personal property to be taxable to a nonresident, the property itself has to be employed in a trade or business. Secondly, this is a factual issue for which the burden of proof is generally on the taxpayer to show otherwise.

## G. LIFE INSURANCE COMMISSIONS

Renewal commissions paid to nonresident life insurance agents are taxable to the extent they had conducted business in New York. Such commissions are typically paid to the agent who originally sold the policies when they are subsequently renewed by the policy holders. In *Matter of Louis A. Cerf, 237 AD 283*, the court held that such payments were taxable to a retired taxpayer because they “*were earned by him entirely by his business efforts in New York State.*” The court stated:

*“It is not necessary to earn the income in the year of its receipt, nor is it necessary that the person be engaged in business in the State at the time of its receipt.”*

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Note that this is the rationale underlying NYCRR 132.4(c).

## H. MOVING EXPENSES AND REIMBURSEMENTS

Moving expenses incurred in connection with a job transfer, and any associated reimbursements, are generally sourced to the new work location.

In *Matter of Michael J. Golden v. Tully (88 AD2d 1058)*, a nonresident employee who worked in New York was not allowed to deduct moving expenses incurred in his move to New Mexico on his nonresident return. In ruling that the deduction was not derived from “a business, trade, profession or occupation carried on “ in New York, the Appellate Division stated,

*“The purpose behind the moving expense deduction is to permit a taxpayer to reduce his income by the amounts which are necessarily expended as a prerequisite to earning his income, and, generally, when the move is to another State, these expenses should be allowable to earnings generated at the new location.”*

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The decision was affirmed by the Court of Appeals (*58 NYS2d 1047*).

In a subsequent case, *Matter of James F. Tao (125 AD2d 879)*, the issue was not the deductibility of moving expenses but rather the taxability of income received by a nonresident employee from his employer for relocating from Connecticut to Rochester. The Appellate Division cited *Matter of Golden* in concluding that the payment was taxable, stating

*“We have not been made aware of any compelling reason why a reimbursement payment for moving expenses, attributable to employment, which in our view is conceptually similar to moving expense deductions ascribable to that employment, should be treated any differently.”*

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## I. PENSIONS AND OTHER RETIREMENT COMPENSATION

Before January 1, 1996, when a pension or other retirement benefit did not qualify as an annuity, it was compensation for personal services and, if the individual receiving it was a nonresident, it was taxable for New York State personal income tax purposes to the extent that the prior services were performed in New York State.

Effective with tax years after 1995, Public Law 104-95 (4 USC 114) enacted at the federal level prohibits New York and other states from taxing most forms of retirement income received by nonresident employees and partners. Included in the definition of retirement income are all qualified plans such as pensions, IRAs (including Roth IRAs),

and deferred compensation such as 401(k) plans, and most nonqualified plans with certain exceptions.

Retirement income, regardless of whether payments are periodic, generally falls under the following plans:

- a. Plans qualified under IRC 401 are qualified pension, profit sharing, stock bonus or annuity plans that are funded by employers or employees. Profit-sharing and stock bonus plans are defined contribution (money-purchase) plans whose benefits are whatever the contributions will provide. A defined benefit plan promises benefits that are established under a formula and makes the contributions according to actuarial records.
- b. Plans qualified under IRC 408(k) known as Simplified Employee Plans or “SEPs”. These are employer sponsored IRAs which allow contributions of up to 25% of compensation subject to a maximum amount.
- c. IRC 403(a) annuities. These are similar to plans qualified under IRC 401, but are funded by annuity contracts.
- d. IRC 403(b) annuities. These are “tax sheltered annuity” plans for employees of tax-exempt educational organizations or state or local governments.
- e. Individual retirement accounts (IRA) under IRC 408(a) and individual retirement annuities under IRC 408(b).
- f. IRC 457 plans for state and local governments and tax-exempt organizations only.
- g. Governmental plans as defined in IRC 414(d).
- h. IRC 501(c)(18) which covers trusts created before June 25, 1959.

*Also included* in the definition of retirement income are distributions from NONQUALIFIED plans described in IRC 3121(v)(2)(C) meeting any *one* of the following criteria:

- Payments are made at least annually and spread over the actual life expectancy of the beneficiary; OR
- Payments are spread over at least a ten-year period; OR
- Payments are made after termination of employment under a plan maintained solely for the purpose of providing retirement benefits in excess of limitations imposed under IRC Sections 401(a)(17) and 415.

Any payments made, as described above, to a nonresident would also be exempt from New York taxation after 1995.

*Even if a pension or other retirement benefit does not meet the requirements to be excluded under Public Law 104-95, it may still be excluded for New York purposes if it meets the definition of an annuity under NYCRR 132.4(d)*

**See TSB-M-07(2)I.**

### **Pension and Annuity Exclusion**

Under Tax Law Section 612(c)(3-a), employees who have reached the age of fifty-nine and one-half are allowed a subtraction modification of up to \$20,000 from pension and annuity income. Although nonresidents are generally no longer taxable on most forms of pension income, the subtraction would still be allowed in the federal column.

Note that the subtraction modification is available only to retired employees. Thus, nonresident partners would not be allowed to claim the \$20,000 exclusion in either the federal or state column as a result of the Tribunal decision in *Matter of Leonard A. Blue, DTA Nos. 809244, 809245, and 809246*, which was later affirmed in *Matter of Maximilian and Miriam Schein, DTA No. 818771*.

## **J. PRIZES, AWARDS AND SIMILAR PAYMENTS**

Prizes, awards and similar payments are derived from or connected with New York State sources as long as they are incidental to the nonresident's presence or other activities in New York State.

Before October 2000, New York State lottery payments were not taxable to nonresidents. After September 30, 2000, lottery prizes are taxable as New York source income if the prizes exceed \$5,000. For withholding purposes, such winnings are treated as if they were wages paid by an employer.

For resident taxpayers who depart the state there must be an accrual of anticipated income on the final New York State return if the individual fails to post a bond or fails to properly file Form IT-260.1 with a copy of Form W-2G showing New York taxes were withheld on the Lottery winnings (Regulation Section 154.11 and Tax Law Section 639(a).)

## **K. PROFESSIONAL SERVICE CORPORATION SHAREHOLDERS**

Until 1988 New York State required professional service corporation shareholders to make an add-back modification to federal adjusted gross income for those years they contributed to qualified plans in amounts that were in excess of deductible limits for a Keough plan. These previously taxed amounts should be deducted from federal adjusted gross income when computing state adjusted gross income to avoid double

taxation when distributions are received from the qualified plan (Tax Law Section 612(c)(12)). This is covered in more detail in **TSB-M-82-(3)I Rev. and TSB-M-89-(4)I**.

#### **L. PUBLIC PENSION EXEMPTION**

The New York Constitution exempts from taxation pension benefits received from the state, municipal or federal retirement systems. (See Tax Law Section 612(c)(3) and also *Davis v. Michigan Dept. of Treasury*, 489 U.S. 803.)

#### **M. RESTRICTED STOCK**

A form of equity compensation in which employees or directors are awarded stock in a corporation subject to certain restrictions. These restrictions prevent the individual from selling or otherwise disposing of the shares until certain conditions are met, typically working a minimum number of years. Once the individual satisfies these conditions the stock is said to **vest** and he or she is free to sell the shares.

Restricted stock awards are taxable for federal purposes under IRC 83 as ordinary income in the year the stock becomes substantially vested, i.e., when the shares are no longer subject to a substantial risk of forfeiture. The amount taxable is the difference between the fair market value of the stock at the time the stock becomes substantially vested and the amount, if any, paid for the stock. Alternatively, if the taxpayer makes an election under IRC 83(b), the value of the stock at the date of the award (less any amount paid) is recognized as taxable income even though the shares have not vested. Any further appreciation in the stock would be investment income subject to long-term capital gains treatment.

The amount taxable as ordinary income for federal purposes represents taxable compensation to a nonresident for New York purposes. If the nonresident performed services both within and without New York, the income would generally be allocated by the days worked within and without New York from the date of the award to the date the shares became substantially vested. If the 83(b) election is made, the nonresident would use the regular allocation in the year the restricted stock was received.

**For more information, see NYCRR 132.24 and TSB-M-07(7)I.**

#### **N. ROYALTIES**

In general, royalty income would be considered intangible. The Second Court of Appeals stated in *Boulez v. Commr.*, 83 TC 584 (1984), that an individual must have an ownership interest in the property before the income can be classified as royalties. Royalty income would therefore not be taxable to a nonresident unless the property itself was employed in a business, trade, profession or occupation carried on in New York.

If, however, an individual does NOT have an ownership interest in the property generating the royalties, e.g., an invention, patent, recording, etc., the payments do not represent income from intangible personal property. The payments, instead, are for personal services performed in New York and would be taxable to a nonresident.

This was the conclusion in two State Tax Commission cases, *Matter of Tony Bennett, November 19, 1976, and Matter of Stanley Sawyer and Corinne Sawyer, TSB-H-83 - (21)I*. The former involved fees received by the popular singer for recordings made in New York based on the number of records sold, while the latter involved an announcer who received payments designated as residuals each time a commercial he recorded in New York was aired. In both cases, the payments were held to be taxable compensation for services performed in New York.

## O. SICK PAY

Compensation for sick leave, holidays and vacation in connection with New York employment is taxable to a nonresident in the same proportion as the days worked within and without New York throughout the year. Salary paid for sick leave and other non-working days is treated as a form of wage continuation. *Advisory Opinion of Robert E. Clausi, TSB-A-81(3)I*.

Paid sick leave received by a nonresident during a year when the taxpayer rendered no services was also held to be taxable. *Matter of Thomas C. Halloran, DTA No. 806902*. In concluding that the income was derived from or connected with New York sources, the Tax Appeals Tribunal emphasized that:

*“...one must look to the substance of the income to ascertain the source from which it was derived. Petitioner’s attempt to characterize the source of his income based on the year it was received misconceives the meaning of the language in Tax Law Section 632(a)(1) (now 631(a)(1)). This language requires us to examine the employment activities of the nonresident during the period in which the benefit was actually secured or earned, not when the benefit was received or realized.”*

The Department’s use of an average consisting of days the taxpayer worked within and without New York during the five years immediately preceding the year in which the sick pay was received to determine the taxable amount was deemed to be fair and equitable.

## P. STOCK OPTIONS

### 1. General

Stock options represent the right to purchase stock at a fixed price, called the *strike price*, usually within a specified period. They are typically given by employers to key

employees as a form of compensation to reward them for past performance and as an incentive to keep performing at that level in the future.

*There are four important dates in the life of a stock option:*

- 1) **Grant Date:** The date the employee is granted options to purchase shares of stock from his employer at a fixed price usually within a specified time

*Example:* April 21, 2004: A nonresident employee is granted options to buy 1,000 shares of stock with a FMV at the time of \$5 a share.

- 2) **Vest Date:** The date the employee has satisfied all employment-related conditions, generally working a minimum amount of time, that make the options nonforfeitable and exercisable.

*Example:* April 21, 2006: The employee has completed the minimum two years required by the company to be able to exercise the options.

- 3) **Exercise Date:** The date the employee actually purchases the stock.

*Example:* May 13, 2007: The employee exercises the options and buys the 1,000 shares of stock for \$5 a share when the stock is selling for \$10.

- 4) **Sale Date:** The date the employee sells the stock.

*Example:* October 25, 2008: the employee sells all 1,000 shares at \$25 a Share.

## 2. Types of Options – Federal Treatment

- **Statutory or Qualified Options:** So named because the tax treatment is governed by specific IRC statute Sections 421 through 423. Incentive stock options (ISO) are an example of statutory options. They are taxed only once, at the time the shares are sold. The character of the gain is capital in nature.

*Example:* Assuming the options in the above example were qualified options, income would be recognized in 2008 when the shares were sold:

Proceeds (1,000 shares @ \$25)	\$25,000
Basis (1,000 shares @ \$5)	5,000
Gain	\$20,000

*Since the shares were held more than one year, the entire gain will be long-term.*

- **Nonstatutory or Nonqualified:** These options are governed by the more general principles of compensation under IRC 83 and related regulations. They are taxed twice: at the exercise date, resulting in ordinary income reportable on a W-2; and again, when the stock is sold, resulting in either a long-term or short-term capital gain for federal purposes depending on how long the shares were held.



*Example:* If, on the other hand, the stock options in the preceding example were nonqualified, there would be two taxable events and two different tax treatments:

| ***When the options are EXERCISED on May 13, 2007:***

FMV (1,000 shares @ \$10)	\$10,000
Amount Paid (1,000 shares @ \$5)	5,000
Income	\$ 5,000

***The income would be ordinary and reported on a W-2.***

| ***When the shares are SOLD on October 25, 2008:***

Proceeds (1,000 shares @ \$10)	\$25,000
Basis (\$5,000 paid + \$5,000 previously recognized)	10,000
Gain	\$15,000

***The gain would be a long-term capital gain.***

### 3. New York Tax Treatment

As a result of the New York State Court of Appeals decision in *Michaelsen v. the New York State Tax Commission*, 67 NY 2d 579, the difference between the option price and the fair market value of the stock at the time the option is **exercised** represents compensation for services to a nonresident. This is true of both statutory options and most nonstatutory options, i.e., those that do not have a readily ascertainable value at the time of grant (usually the case). The compensation is taxable for New York purposes when it is **recognized** for federal purposes. This depends on what type of option it is:

- for Statutory or Qualified options, the income is taxable as of the SALE DATE, when it is recognized for federal purposes;
- for Nonstatutory or Nonqualified options, the income is taxable as of the EXERCISE DATE.

Note that the compensation element of a statutory stock option for a nonresident is limited to the appreciation in the stock between the GRANT DATE and EXERCISE DATE. Any further appreciation from the EXERCISE DATE to the SALE DATE represents investment (intangible) income and is not included in New York taxable income for a nonresident.

#### **How Does a Nonresident Allocate Stock Option Income?**

While *Michaelsen* established that the difference between the option price and the FMV of

the stock as of the exercise date represents the *total* compensation that may be subject to taxation, it did not address how to compute the *taxable* amount for those nonresidents who work within and without New York. As a result, the following rules have been developed to provide guidance on how to allocate stock option income. The taxable amount is determined by multiplying the total compensation attributable to the option by the number of days the nonresident worked within and without New York during the *allocation period*.

The rules for calculating the *allocation period* are explained below:

- ***For tax years 2006 and following:***

The allocation period is the period of time beginning with the date the option was *granted* and ending with the date the option *vested*- the point at which all service-related conditions necessary for the exercise of the option have been met. If the option vested at the time it was granted, the allocation period is the same period of time that applies to regular, non-stock based remuneration for the taxable year the option was *granted*.

*Example:* Continuing with the above example, the *allocation period* runs from April 21, 2004 (GRANT DATE) to April 21, 2006 (VEST DATE). Let us assume that the nonresident employee worked a total of 480 days during the allocation period of which 288 days were worked in New York. The allocation percentage would be 60% (288/480). Applying this to the total compensation determined as of the exercise date results in taxable New York compensation of \$3,000 (\$5,000 x 60%). The income is reportable by the employee on a nonresident return in the same year it is recognized for federal purposes: in 2008 if the options were qualified or in 2007 if the options were nonqualified. In either case, the New York compensation amount is the same.

**See NYCRR 132.24 and TSB-M-07(7)I as well as the chart in the Appendix.**

- ***For tax year 2006 only:***

Instead of the allocation period described above, a nonresident could elect to use the period of time from the date the option was granted to the earliest of: (1) the date the option was exercised, (2) the date the individual's services were terminated, or (3) the date the compensation was recognized for federal income tax purposes. This election was put in place to recognize the fact that individuals may have relied on TSB-M-95(3)I which is now obsolete as a result of the Tax Appeals Tribunal decision in *Matter of Stuckless, DTA No. 819319*.

- ***For years prior to 2006:***

The allocation period is the regular days in-and-out allocation for the year the option was **exercised** in accordance with the *Stuckless* decision.

**See TSB-M-06(7)I.**

#### 4. Change of Residence

In cases involving changes of residence, it is the taxpayer's resident status at the time the income is RECOGNIZED for federal purposes that determines the amount of compensation taxable for New York purposes.

If a taxpayer is granted statutory stock options as a resident but subsequently becomes a nonresident when the stock is sold, the New York compensation is limited to the days worked within and without New York between the *grant and vest dates*.

For nonstatutory stock options that do not have a readily ascertainable market value at the time of grant, it is the taxpayer's resident status when the options are **exercised** that is controlling. Thus, a taxpayer who is a resident when such nonstatutory options are granted but a nonresident when the option is exercised, would calculate the New York compensation by the days worked within and without New York between the grant and vest dates.

#### Q. TERMINATION/SEVERANCE PAY

**Note: The discussion below applies to tax years prior to January 1, 2010. With the enactment of Tax Law Section 631(b)(1)(F), nonresidents are taxable on income from termination agreements received after December 31, 2009 to the extent they previously performed services in New York State. See TSB-M-10(9)I.**

An individual may receive payments upon being terminated by his employer because of a merger, downsizing or for other reasons. These payments may take many forms. It is important, however, for New York State taxation purposes, to distinguish between termination and severance pay. Generally speaking, severance pay is considered to be compensation for PAST services and is taxable to nonresidents. Termination pay, on the other hand, is compensation for FUTURE services and would **not** be taxable to nonresidents.

The implication for New York taxability is dependent on several factors, particularly whether the employee had a guaranty of employment pursuant to an employment contract or was instead an employee at will. The intent of the employer must be identified. The terms 'termination' and 'severance' are often used interchangeably by the employer. The termination agreement must be reviewed to identify specifically what the employee is being compensated for. The consideration must then be attributed to the appropriate clause in order to determine whether or not the consideration is taxable to New York.

In the *Matter of John A. and Deborah D. Laurino, DTA No. 807912*, a lump sum payment was held to be payment for prior services and thus taxable by the Tax Appeals Tribunal. The employee had entered into an employment agreement in which he was entitled to a severance payment equal to one year's salary if a change of control of his company occurred. A change of control did occur and the employee and his employer entered into a termination agreement under which he received the payment pursuant to the employment agreement.

Although the taxpayer did have an employment agreement, he was determined to be an employee at will. The Tribunal quoted *Murphy v. American Home Prods. Corp.*, 58 NY2d 293, as follows:

*“Where an employment is for an indefinite term it is presumed to be a hiring at will which may be freely terminated by either party at any time for any reason or even for no reason.”*

Rather than having a right to future employment, the taxpayer only had a guaranty of employment up to the time that a change of control occurred. Thus, it was the employee’s “*act of continued service...up to the time that a change of control occurred*” that constituted his consideration for the lump sum payment. Because these services were performed primarily in New York, the payment was properly taxable.

This result differs significantly from that in the *Matter of Peter F. and Barbara D. McSpadden, DTA No.810895*, where the Tribunal ruled that a lump sum payment was for future services and therefore not taxable. Because McSpadden, unlike Laurino, involved a specific future contractual right to employment, the payment received by McSpadden represented consideration received in exchange for McSpadden’s surrender of an item of intangible personal property, i.e., the remaining term of his employment contract. Since the intangible was not employed in a trade or business in New York, the payment could not be taxed as New York source income.

In a typical example, an employee may have an employment contract for three years beginning on April 13, 2003, and ending on April 12, 2006. On April 12, 2005, when she still had one remaining year on her employment contract, her employment was terminated and she received a lump sum termination payment.

According to MCSPADDEN, it is important to look at the employment contract and determine if the contract provides for a specified period of employment. Since the employee had an employment contract for a specified term and since she was terminated before the end of that term, she had a right under the contract to future employment for the agreed upon time period remaining on the contract at her termination date. Therefore, the termination payments would be considered payment for the relinquishment of the employee’s future contractual right to employment and would not be taxable. The fact that the services may have continued to be performed in New York is not relevant. As a result of the Tribunal’s decisions in Laurino and McSpadden, whenever a taxpayer receives payments upon termination of employment, it is necessary to look at the consideration given by the employee in exchange for the right to the payments in order to determine their taxability. Thus, in Laurino, the consideration was continued services up to a change of control. Because this was deemed to be for past services performed at least

partly in New York, the payments were taxable. In contrast, McSpadden's consideration was the promise of future services. As an item of intangible personal property, it mattered not whether the services would have been performed in New York. Thus the payments were not taxable.

The determination of whether payments are for past or future services, and thus taxable or not taxable, usually hinges on whether the employee has a guaranty of employment. This can generally be determined by reference to an employment contract. It is preferable that the guaranty of employment be in writing. In some cases, however, there may not be a formal written contract. This was the case in *Matter of Martin and Linda Brophy, DTA No. 812052*.

In that case, Mr. Brophy received separate payments of \$840,000 and \$600,000 in 1988 and 1989, respectively, upon terminating his employment. While the first payment was deemed to be for past services and thus taxable, the second payment was held to be for future services and not taxable even though the taxpayer did not have a written employment agreement. Despite this fact, there was sufficient evidence, such as internal memoranda, attesting to the existence of a three-year employment agreement. Following the reasoning in *McSpadden*, the Tribunal concluded that the \$600,000 was in consideration of the employee's relinquishment of his right to future services and was therefore not taxable.

### ***Tax Treatment***

Where an employee's compensation has been determined to be for past services and the services were performed partly within and partly without New York State, the amount of New York compensation is computed using the formula set forth in Regulation Section 132.20. This consists of comparing the allocated New York salary to the total salary received in the year of termination and the three taxable years immediately preceding the termination.

The allocation must be determined separately for each taxable year, or portion thereof, in accordance with the formula established in the regulations in Sections 132.17, 132.18 and 132.19.

If the individual desires to use a period of time greater than that mentioned above to determine the allocation of a termination benefit, he may do so provided the individual establishes, to the satisfaction of the Commissioner, the amount of his total yearly compensation for the longer period of time and the amount allocable to New York State in each year. It should be noted that the Department cannot use a longer period of time than that specified in the regulations. Only the taxpayer may elect to use a longer period. Where an individual was a resident and subsequently becomes a nonresident and receives a pension

or other retirement benefit, any allocation is determined as if the individual were a nonresident during the entire allocation period.

*Example:*

A nonresident employee performed services both within and without New York State as an employee at will. Each year the taxpayer was to receive a salary of \$120,000. On July 1, 2002, the taxpayer terminates employment with the company and receives a lump sum payment of \$300,000.

During 2002 the wage allocation is based on 30 New York days out of a total of 120. During the three prior years the taxpayer reported an allocation percentage for New York of 50%, 60% and 75%, respectively. What portion of the termination pay is allocable to New York State?

Year	Total Compensation	New York Portion
1999	\$ 120,000	(50%) \$ 60,000
2000	120,000	(60%) 72,000
2001	120,000	(75%) 90,000
2002(6 months)	<u>60,000</u>	(25%) <u>15,000</u>
Total	\$ 420,000	\$ 237,000

$$\$237,000 \text{ (NY Portion)} / \$420,000 \text{ (Total Compensation)} \times \$300,000 = \$169,286$$

In this example, the taxpayer would be required to report on the 2002 New York State Nonresident Tax Return (IT-203), \$169,286 of the termination award to New York State based upon the above formula, as well as the \$15,000 of wages allocated to New York State based on the days in/ days out formula.

For more information about severance pay and the method used to determine New York source income where prior services were performed within and without New York, refer to *Advisory Opinion of Robert M. Braun, TSB-A-05(2)I*.

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## VI. SPECIALIZED OCCUPATIONS

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### A. ATHLETES – NYCRR 132.22

#### *Duty-Days Formula*

In an effort to employ a widely accepted method of allocating the salary of a professional athlete, the Commissioner of Taxation & Finance adopted section 132.22 of the New York State Personal Income Tax Regulations on October 17, 1994, effective for years beginning on or after January 1, 1995.

In general, the regulation defines New York source income of a nonresident individual, who is a member of a professional athletic team, (including but not limited to, any professional baseball, basketball, football, hockey or soccer team) to include that portion of the individual's total compensation for services rendered as a member of the athletic team during the year which the number of DUTY DAYS SPENT WITHIN NEW YORK STATE AND/OR CITY rendering services for the team in any manner during the taxable year bears to the TOTAL NUMBER OF DUTY DAYS SPENT BOTH WITHIN AND WITHOUT NEW YORK STATE AND/OR CITY during the taxable year.

#### **Example:**

Player A, a member of a professional athletic team, is a nonresident of New York State. During the season, A travels to New York State to participate in the annual all-star game as a representative of A's team. The number of days A spends in New York State for practice, the game, meetings, etc., shall be considered to be duty days spent in New York State, as well as included within total duty days spent both within and without New York State.

Assume the same facts as above except that player A is not participating in the all-star game and is not rendering services for A's team in any manner but is instead traveling to and attending such game solely as a spectator. The number of days player A spends in New York State for such game shall not be considered to be duty days spent in New York State. However, the days are considered to be included within the total duty days spent both within and without New York State.

#### **1. What is a Duty Day?**

The term "duty days" shall mean all days during the taxable year, from the beginning of the professional athletic team's official pre-season training period through the last game in which the team competes or is scheduled to compete. Duty days are included in the allocation for the tax year in which they occur, including where a team's official training period through the last game in which the team is scheduled to compete, occurs during more than one tax year.

**Example:**

Shorty Jones is a nonresident of New York who plays for the New York Knicks professional basketball team. His contract requires him to report to the team's training camp and to participate in all exhibition, regular and playoff games. Shorty signed a three-year contract for \$16 million encompassing the 2006-2007, 2007-2008 and 2008-2009 seasons.

To compute his taxable compensation for calendar year 2007, you need to determine (1) the total compensation received; (2) total duty days; and (3) New York duty days. All three figures will encompass parts of two seasons as follows:

SEASONS	Total Duty Days	New York Duty Days
Season 1: Jan 1-May 25, 2007	145	33
Season 2: Oct 1-Dec 31, 2007	92	17
<b>Total</b>	<b>237</b>	<b>50</b>

Assuming that he received \$4.5 million in 2007, the amount taxable to New York is computed as follows:

$$\frac{50}{237} = 21.09\% \times \$4,500,000 = \$949,050$$

Duty days also include days on which a member of a professional athletic team renders a service for a team on a date which does not fall within the official season, e.g., participation in instructional leagues, the "Pro Bowl" or promotional "caravans." Rendering a service includes conducting training and rehabilitation activities, but only if conducted at the facilities of the team.

Included in the definition of duty days shall be game days, practice days, days spent at team meetings, promotional caravans, and pre-season training camps, and days served with the team through all post-season games in which the team competes or is scheduled to compete.

Duty days of a person who joins a team during the period from the beginning of the professional athletic team's official pre-season training period through the last game in which the team competes, or is scheduled to compete, shall begin on the day such person joins the team. Conversely, duty days for any person who leaves a team during such period shall end on the day such person leaves the team.



Where a person switches teams during the taxable year, a separate duty day calculation shall be made for the period such person was with each team.

Travel days that do not involve either a game, practice, team meeting, promotional caravan or other similar team event are not considered duty days spent in New York State. However, such travel days shall be considered in the total duty days spent both within and without New York State.

Days for which a member of a professional athletic team is on the disabled list and does not conduct rehabilitation activities at facilities of the team and is not otherwise rendering services for the team in New York State, shall not be considered duty days spent in New York State. However, all days on the disability list are considered to be included in total days spent both within and without New York State and/or City.

***Example:***

Player C, a member of a professional athletic team, is a nonresident of New York State. During the season, C is injured and is unable to render services for C's team. While C is undergoing medical treatment at a clinic, which is not a facility of the team, but is located in New York State, C's team travels to New York State for a game. The number of days C's team spends in New York State for practice, games, meetings, etc., while C is present at the clinic, shall not be considered duty days spent in New York State for player C for that taxable year, but such days are considered to be included within total duty days spent both within and without New York State.

To further illustrate this point assume the same player C is injured and unable to render services to C's team but player C performs rehabilitation exercises at the facilities of C's team in New York State as well as at personal facilities in New York State. The days C performs rehabilitation exercises in the facilities of C's team are considered duty days spent in New York State for player C for the taxable year. However, days player C spends at personal facilities in New York State shall not be considered duty days spent in New York State for player C for the taxable year, but are considered to be included within total duty days spent both within and without New York State.

**2. Who is a Member of a Team?**

The term "member of a professional athletic team" shall include those employees who are active players, players on the disabled list and any other persons required to travel and who travel with and perform services on behalf of a professional athletic team on a regular basis. This includes, but is not limited to coaches, managers, and trainers.

### 3. What is Compensation?

The term total compensation for services rendered as a member of a professional athletic team means the total compensation received during the taxable year for services rendered:

- from the beginning of the official pre-season training period through the last game in which the team competes or is scheduled to compete during the, taxable year; and
- during the taxable year on a date which does not fall within the aforementioned period (e.g. participation in instructional leagues, the "Pro Bowl" or promotional "caravans.")

Compensation shall include, but is not limited to, salaries, wages, bonuses, and any other type of compensation paid during the taxable year to a member of a professional athletic team for services performed in that year. Compensation does not include strike benefits, severance pay, termination pay, contract or option year buy-out payments, expansion or relocation payments, or any other payments not related to services rendered for the team.

**"Bonuses"** which are to be included as "total compensation for services rendered as a member of a professional athletic team" and subject to allocation are:

- bonuses earned as a result of play (i.e., performance bonuses) during the season, including bonuses paid for championship, playoff, or "bowl" games played by a team, or for selection to all-star league or other honorary positions; and
- bonuses paid for signing a contract, unless all of the following conditions are met:
  - (1) the payment of the signing bonus is not conditional upon the signee playing any games for the team, or performing any subsequent services for the team, or even making the team;
  - (2) the signing bonus is payable separately from the salary and any other compensation; and
  - (3) the signing bonus is nonrefundable.

Certain types of income, just by their nature are considered as NOT being generated from New York State sources. A nonresident who receives compensation from one of these sources is not required to allocate any part of it to New York based upon the performance of the services in New York.

**For more on signing bonuses see *Clark v. New York State Tax Commission*, 86 AD2d 691.**

**B. INTERSTATE AIR CARRIERS – NYCRR 132.11(c)**

Compensation paid by an interstate air carrier to an employee who performs regularly assigned duties on an aircraft in two or more states shall constitute income derived from the employee's state of residence and the state in which such employee earns more than 50% of the compensation. For purposes of the preceding sentence, an employee shall be deemed to have earned more than 50 % of the compensation in any state in which the employee's scheduled flight time in that state is more than 50% of the employee's total scheduled flight time in the calendar year. Accordingly, where an individual, who is not a resident of New York State for income tax purposes, is paid a salary by an interstate air carrier for performing regularly assigned duties on an aircraft in two or more states, his compensation will not constitute income derived from New York State sources unless the employee earned more than 50% of the compensation in New York State. This applies to compensation paid on or after July 6, 1990.

**For more information on this topic see TSB-M-91(5)I.**

**C. INTERSTATE RAIL CARRIERS, INTERSTATE MOTOR CARRIERS AND INTERSTATE MOTOR PRIVATE CARRIERS – NYCRR 132.11(b)*****Compensation paid by:***

- (1) a rail carrier providing transportation subject to the jurisdiction of the Surface Transportation Board under subchapter I of chapter 105 of title 49 of the United States Code; or
- (2) a motor carrier providing transportation subject to the jurisdiction of the Surface Transportation Board under subchapter II of chapter 105 of title 49 of the United States Code; or
- (3) a motor private carrier; to an employee who performs regularly assigned duties in two or more states shall constitute income derived from sources within such employee's state of residence. Accordingly, where an individual, who is not a resident of New York State for income tax purposes, is paid compensation as an employee by an interstate rail carrier, an interstate motor carrier or an interstate motor private carrier for performing regularly assigned duties in two or more states, the compensation received by this employee does not constitute income from New York sources, even though the employee performed such services in New York State. This applies to compensation paid on or after July 6, 1990.

**For additional information see TSB-M-91(5)I.**

**D. MILITARY PERSONNEL – NYCRR 132.11(a)**

Compensation paid by the United States for active service in the Armed Forces of the United States, performed by an individual not domiciled in New York State, does not constitute income derived from New York State sources. Accordingly, where a non-domiciliary is paid compensation by the United States for active service in the Armed Forces of the United States, the compensation received by the individual does not constitute income derived from New York State sources even though the service is performed in whole or in part within New York State. For example, a soldier domiciled outside New York would not be taxed on military pay earned while stationed at Ft. Hamilton in Brooklyn. However, any other income a nonresident member of the armed forces receives from New York sources may be subject to tax. This will include any income or gain from property located in New York or income from a civilian job performed during off-duty hours in New York State.

Income earned in New York State by the spouse of a service member is completely exempt from taxation as a result of the passage of the Military Spouse Residency Relief Act effective 2009. Under the Act, the income will be exempt if:

- the military spouse is a nonresident of New York State, and
- the military spouse is in New York State solely to be with the service member and the service member is in New York State in compliance with his or her military orders.

The exemption applies to income earned by the military spouse in New York as an employee as well any business income from a sole proprietorship or partnership carried on in New York.

**Note that the exemption applies only to the military spouse. It does not apply to non-military income earned in New York by the servicemember.**

For more information see **PUBLICATION 361, “NEW YORK STATE INCOME TAX INFORMATION FOR MILITARY PERSONNEL AND VETERANS” AND TSB-M-10(1)I.**

**E. SALESPERSONS – NYCRR 132.17**

If the compensation for services performed by a nonresident traveling salesperson, agent or other employee depends directly on the volume of business transacted, allocation must be made based on the proportion that the volume of business transacted in New York State bears to the total volume of business transacted everywhere. (Regulations 20 NYCRR 132.17) However, if the compensation is not based solely on the volume of sales, i.e., commission plus salary, the allocation shall be based on days worked within and without New York State.

In the Tribunal decision, *Andrew J. O'Connell, DTA No. 811794*, it was found that a nonresident bond salesman, who derived his income solely from commissions, was correct in allocating commission income on the basis of the location of his customers within and without New York. The Tribunal found that this methodology was consistent with Section 132.17 of the regulations, which pertains to salesmen whose income derives solely from the volume of business transacted, i.e., commissions. Allocation on the basis of the location of the customers was considered preferable to allocation on the basis of the taxpayer's whereabouts at the time of a bond trade. The Tribunal pointed out that while a taxpayer cannot manipulate the location of his customers, his own whereabouts at the time of a bond trade may be subject to manipulation.

**F. SEAMAN- NYCRR 132.19**

Effective after November 8, 2000, Section 11108 of Title 46 of the U.S. Code prohibits state and local governments from imposing income taxes on individuals who perform regularly assigned duties on vessels operating on the navigable waters of more than one state unless the individual is a resident of that state.

For additional information see **TSB-M-02(4)I**.

**G. SECURITY AND COMMODITY BROKERS – NYCRR 132.21**

Security and commodity brokers doing business both within and without New York State may elect to allocate income using the three factor method in accordance with NYCRR 132.15(c) as described in Part IV of the guidelines. The election must be made by the due date, including any extensions, of the New York State nonresident personal income tax return.

A taxpayer who fails to make a timely election under this section must use the books and records allocation method prescribed by section 132.15(b). Once the taxpayer uses his books and records to allocate income or elects to allocate based upon the three factor method, the taxpayer must continue to use the allocation method implemented unless, after application in writing to the Commissioner, the Commissioner determines that the method of allocation used no longer reflects income which is fairly applicable to New York State. If the Commissioner permits the taxpayer to revoke the method of allocation of income under this section, a copy of such permission of revocation of election must be attached to the New York State nonresident personal income tax return for the first taxable period to which such a revocation of election is applicable.

Commissions derived from the execution of purchase or sale orders for customers must be allocated and apportioned as follows:

1. If an order is received at the New York State place of business of a broker for execution on an exchange located *within* New York State, and originates at a bona

- bona fide established office of the broker located *within* New York State, 100 % of the commission in the case of stocks, bonds and commodities must be allocated to New York State and constitutes income derived from or connected with New York State sources in the taxable period in which it is executed.
2. If the order is received at the New York State place of business of a broker for execution on an exchange located *within* New York State, and originates at a bona fide established office of the broker located *without* New York State, 20% of the commission in the case of stocks, bonds and commodities must be allocated to New York State and constitutes income derived from or connected with New York State sources in the taxable period in which the order is executed.
  3. If the order originates at the New York State place of business of a broker and is transmitted to a bona fide office of the broker located *without* New York State for execution on an exchange located without New York State, 80% of the commission in the case of stocks, bonds and commodities must be allocated to New York State and constitutes income derived from or connected with New York State sources in the taxable period in which the order is executed.

For taxable periods commencing on or after January 1, 1978, the taxpayer may allocate commission income on the basis of actual experience if such taxpayer can demonstrate to the satisfaction of the Tax Commission that the allocation presented here does not fairly reflect the amount of commission income attributable to New York State.

Commission income derived from over-the-counter transactions must be allocated to New York State in the following manner:

- i. If the order originates at or through a New York State place of business of the taxpayer, 100% of the commission income must be allocated to New York State.
- ii. If the order originates at or through a bona fide established office of the taxpayer located outside New York State, no portion of the commission income is attributable to New York State.

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## VII. TREATMENT OF DEDUCTIONS ON A NONRESIDENT RETURN

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### A. CAPITAL LOSSES, PASSIVE ACTIVITY LOSSES, AND NET OPERATING LOSSES GENERAL

The deductions entering into the federal adjusted gross income of a nonresident from capital losses, passive activity losses and net operating losses are included in the computation of a nonresident's New York source income only to the extent that they are derived from or connected with New York State sources. See Tax Law Section 631(b)(4).

The amount of any deduction under this section must be computed as it would be computed for federal income tax purposes if the New York State items of income, gain, loss and deduction were the only items making up the corresponding federal items of income, gains, loss and deduction for the particular year. Any deduction may, by way of carryback or carryover, affect the computation of New York source income for other years as long as such carryback or carryover is based solely on items of income, gain loss and deduction from New York State sources.

### B. HANDLING A CAPITAL LOSS

***Example:***

A nonresident of New York State for the entire taxable year had a long-term capital gain from sources without New York State (the sale of securities) of \$20,000 on his federal income tax return. The taxpayer also included on the federal income tax return a long-term capital loss of \$8,000 from sources exclusively within New York State from the sale of owned rental property). For federal income tax purposes, the taxpayer has a gain from the sale or exchange of property of \$12,000 (\$20,000 minus \$8,000). On the New York State nonresident personal income tax return, the taxpayer has only a long-term capital loss of \$8,000 as this is the only capital item derived from New York State sources. The taxpayer is allowed to claim a maximum capital loss deduction of \$3,000 in the New York State amount column on the New York State nonresident personal income tax return and is allowed a carryover long-term loss of \$5,000 for the following year for New York State personal income tax purposes even though the federal income tax return will show no capital loss carryover.

Because of the rules concerning source income and the separate computation of gains and losses for New York State income tax purposes, it is possible for a nonresident individual to claim a net operating loss carryback or carryover, or a capital loss carryover, on the New York return even if the federal return does not reflect an actual loss.

***John Graham v. State Tax Commission, 48 AD2d 646.***

### C. NONRESIDENT NET OPERATING LOSS

Where a nonresident has incurred a net operating loss for New York State purposes but not for federal purposes, such net operating loss must first be carried back to the carry back period and any excess carried forward to the carry forward period (as of 2007, 2 and 20 years, respectively). However, the loss may not be carried back or carried forward to a taxable year in which the taxpayer was or is a resident of New York State.

A nonresident individual who incurs a net operating loss for New York State personal income tax purposes but does not incur a net operating loss for federal income tax purposes, may make an election for New York State personal income tax purposes to forgo the entire carryback period and to only carry such NOL forward to each of the 20 years following the taxable year of the net operating loss, to the extent not absorbed. This election is made by filing a New York State nonresident personal income tax return for the year of the net operating loss and attaching a statement indicating that this election to forgo the three-year carryback period is being made. This election must be made by the due date of the nonresident personal income tax return (including extensions of time granted) for the year of the net operating loss. Once an election to forgo the two-year carryback period is made, such election may not be revoked.

A nonresident may carry back a net operating loss to a resident year provided that the loss is included in federal adjusted gross income for that year. In the advisory opinion of *Rocco B. Commisso, TSB-A-96(3)I*, the taxpayer anticipated leaving New York in 1996 and acquiring an interest in a partnership operating exclusively out of state. Any losses that the partnership sustains could be carried back to a resident year to the extent that the loss is includible in federal adjusted gross income for the carryback year. See NYCRR 154.8(c).

### D. PASSIVE ACTIVITY LOSS (PAL)

New York State Tax Law conforms to the passive activity loss rules for federal purposes. However, any deduction for a passive activity loss (PAL) for a nonresident or part-year resident must be recomputed to determine the amount that is allowed if the federal adjusted gross income took into account only items of income, gain, loss, or deduction derived from or connected to New York sources.

Nonresident or part-year resident individuals, estates or trusts must file Form IT-182, Passive Loss Limitations, to report the amount of allowed passive activity loss from New York sources.

It is possible for a nonresident to have a PAL for New York State without having a PAL for federal purposes or to have a New York State PAL that is larger or smaller than the corresponding federal PAL.



If you were a part-year resident, you must recalculate your PAL limitations as if separate federal returns were filed for your resident and nonresident periods using only those items of income, gain, loss or deduction attributable to each period.

Generally, losses from passive activities are subject to other limitations, such as basis and at-risk limitations, before they are subject to the passive loss limitations.

**For more information about reporting of a PAL, refer to the instructions for Form IT-182.**

Note that even if a loss is limited by the passive activity loss rules, a nonresident is still required to make the addition and subtraction modifications associated with the activity contained in Tax Law Section 612(b) and (c).

#### **E. NONRESIDENT ALIMONY DEDUCTION**

As a result of the U.S. Supreme Court decision in *Lunding v. New York State Tax Appeals Tribunal*, 522 US 287, Tax Law Section 631(b)(6), denying an alimony deduction to nonresidents, was held to be unconstitutional. Therefore, a nonresident is entitled to claim an alimony deduction in the same ratio that New York source income bears to total federal income.

See TSB-M-99(2)I

## VIII. THE CITY OF YONKERS ALLOCATION ISSUES

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Note: Effective July 1, 1999, the New York City Nonresident Earnings Tax was eliminated both for New York state residents and nonresidents who work in New York City. (See notice N-00-6) The instructions below apply to taxpayers who work in the city of Yonkers.

### A. GENERAL

An individual who is a nonresident of the City of Yonkers and performs services in or has earnings from self-employment from within that city may have to file a City of Yonkers nonresident earnings tax return. The income to be reported by a nonresident of the City or Yonkers is limited to wages and net earnings from self-employment.

### B. WAGES DEFINED

Wages for purposes of the nonresident earnings tax shall mean wages as defined by section 3401 (a) of the Internal Revenue Code. Wages by this definition include all payments for services performed by an employee for his employer. Section 3401(a) does enumerate the exceptions to what is deemed wages.

Wages also include what is termed other employee compensation. This category of remuneration includes but is not limited to salaries, fees, bonuses, tips, commissions on sales or insurance premiums, pensions and retirement pay (that do not constitute an annuity) paid as compensation for services performed, vacation allowances and severance pay which are subject to withholding under IRC section 3401.

### C. SELF-EMPLOYMENT INCOME DEFINED

Net income from self-employment shall mean the same as net earnings from self-employment as defined in section 1402(a) of the Internal Revenue Code. Such earnings shall consist of gross income from any trade or business carried on by an individual, less the deductions allowed under the Internal Revenue Code which are connected with the trade or business. In addition, this will include any distributive share (whether or not distributed) of income or loss from a partnership of which the taxpayer may be a member.

#### 1. Earnings from Self-Employment not Included

The following items are not included in the definition of net earnings from self-employment subject to tax on a nonresident earnings return for either the city of New York or the city of Yonkers:

- rental income from real estate and from personal property leased with real estate, together with the deductions attributed to it, unless received in the course of a trade or business as a real estate dealer;

- dividends and interest not received in the course of a trade or business as a dealer in stocks or securities;
- gain or loss from the sale or exchange of capital assets, or from the sale, exchange or involuntary conversion of property other than stock in trade;
- any deduction for net operating losses;
- retirement payments received by a partner according to a written plan, if the agreement meets the conditions outlined in Federal regulations section 1.1402(a)-17(b) & (c);
- income, gain, loss or deduction resulting from activities as a dealer or partner doing an insurance business as a member of the New York Insurance Exchange; or
- earnings of a nonresident partner who is a limited partner and does not render any services to the partnership.

D. **ALLOCATION OF INCOME SUBJECT TO THE EARNINGS TAX**

Any income, of a nonresident of the city of Yonkers, which is allocable to the city would be allocated in the same manner as income allocable to New York State, by a nonresident of the state. The methods of allocation of Yonkers source income would follow the New York State methods outlined in the Guideline. When referring to a method of allocation for city of Yonkers purposes, any reference to New York State should be read as the city of Yonkers.

## IX. AUDIT TECHNIQUES

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### A. PRE-AUDIT ANALYSIS

#### 1. General

A comprehensive pre-audit analysis is an important aspect of the allocation case. The auditor must review the information available and determine the focus of the audit. A thorough pre-audit analysis can provide the foundation for either a resolved case at the audit's conclusion or a case sustained through the appeals process.

The auditor should review the complete file including the tax return and any correspondence attached. Particular attention should be paid to any New York address which may be identified during the pre-audit analysis. The auditor should make note of any New York address identified and explore the taxpayer's connection to this address during the audit. The auditor should also be aware of the City of Yonkers issues, both residency and allocation, which may arise during the audit.

An analysis of the wage and tax statements (W-2s or Form IT-2) attached to the return will provide a great deal of information to focus the audit.

If the nonresident individual receives income from more than one employer, separate wage and tax statements will indicate that separate allocations may be necessary.

#### 2. Prior Audits

The nature of the nonresident case, especially one involving income allocation, suggests that the taxpayer may be selected for audit more than once. With this in mind, the auditor needs to establish a "GOOD TRAIL" for other auditors (possibly in other district offices) to follow in subsequent years. Workpapers and appeal decisions should be consulted to determine the impact of a prior audit on the current audit.

Situations change constantly, and all available information should be considered when a decision is made as to the scope of the audit.

A Tax Appeals Tribunal decision underscores the benefits of reviewing the prior audit file as part of a thorough pre-audit analysis. In *Matter of Paul J. Mucci, DTA No. 817271*, a taxpayer was claiming an allocation for days worked outside New York in a "satellite office" located in Connecticut. In denying the allocation, the Tribunal noted that a prior audit had revealed that the office was, in fact, the address of the taxpayer's accountants.

For a case involving the allocation of New York income, each year stands on its own, and the auditor should not be unduly influenced by prior audit results. Allocation

issues, in particular, change from year to year and the days allocated to New York in one year may have little bearing on the allocation of days in a subsequent period. However if the work pattern is consistent with the results of the previous audit, then the auditor should exercise good judgment when determining the scope of the audit. Requests for detailed documentation year after year place a heavy burden on the taxpayer.

The auditor should be considerate of this when determining the scope of an audit as well as the extent of the records he or she requests. Where several audits have taken place over the years, perhaps the work patterns or work responsibilities should be explored initially, rather than a verification of days.

For example, if a taxpayer has successfully verified days worked in New York for several years with a diary and supporting documentation and the current year is consistent with the previous year's allocation of income, then the auditor could test check the entries in the diary rather than requesting full substantiation. In another example, if a taxpayer changes employment responsibilities from that of an outside salesman covering several northeast states to a District Sales Manager, with an office in Manhattan, then the auditor would be correct in requesting more detailed documentation or substantiation of the diary entries.

## **B. COMMUNICATING WITH THE TAXPAYER**

The auditor is responsible for scheduling an initial appointment for the newly assigned case, and being at the appointed place on time, if the audit is conducted at the taxpayer's or the representative's office. In order to efficiently utilize the available time and to reduce the inconvenience and disruption caused to the taxpayer's schedule, auditors are encouraged to maximize the use of block time appointments.

Auditors are encouraged to arrange their schedules with the taxpayer or his representative, in such a manner as to spend a sufficient number of consecutive days at the audit site to complete the audit without having to make return visits. Additional information clarifying an issue or substantiating a diary entry can be sent through the mail, if necessary.

Appointments should be arranged to ensure that the auditor, as well as the taxpayer, have sufficient lead time to adequately address the issue. If after the commencement of the audit it appears that the audit cannot be completed before the statute of limitations expires, the auditor must request a waiver extending the statute. An audit is not to be commenced near the end of a statute of limitation period when an insufficient period of time remains to adequately address the issues of the audit.

The auditor, as well as the team leader and section head, must review the audit period on new cases in order to be sure to provide the taxpayer and the auditor with a reasonable period of time to conduct the audit.

*As a general rule, a nonresident allocation audit should not be started unless the auditor and the taxpayer have at least 120 days (without extending the assessment limitation period) to present and review material. Note that this rule will normally not apply in situations where an audit has been ongoing and the auditor is merely updating the audit period. Nevertheless, the auditor should give the taxpayer sufficient notice that the audit period is being extended.*

Developing and maintaining a dialogue with the taxpayer and the representative is essential for the successful conclusion of any case. The taxpayer and the representative must be given the opportunity to fully understand, review and discuss the findings developed during this analysis of the records. A successful auditor is one who listens to the taxpayer and representative and evaluates the information presented. After this evaluation, the auditor should determine if this explanation affects his position in light of the new information submitted by the taxpayer.

### C. ANALYSIS AND ACCUMULATION OF DATA

Income tax regulation 158.1 contains a general recordkeeping requirement applying to every person subject to income tax under Article 22. The importance of this regulation in the context of an allocation audit was highlighted in a case that was affirmed by the Tax Appeals Tribunal, **Matter of Elias H. Attea, Jr. and Karen Attea, DTA Nos. 815201 and 815202.**

The case involved a nonresident who initially refused to make his business records available for audit, claiming that as a licensed Indian trader he was not subject to tax in New York. The ALJ cited the above regulation in upholding Audit's right to request records to verify the accuracy of the returns:

*“This was not a situation where the Division was attempting to impose tax upon a nonresident with no ties to the State. As previously noted, petitioner filed a nonresident return for each of the years at issue and, in so doing, admitted that he had New York source income for these years. The Division was, therefore, entirely within its rights to request from petitioner all applicable returns, schedules, books and records in order to determine whether the returns, as filed, were correct.”*

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The auditor should request that the taxpayer complete the AU-262.5 "Questionnaire - Allocation of Personal Service Compensation" during the early stages of the audit. It would be appropriate to request whatever documentation might be necessary, at this time, to verify the limited number of days worked outside New York. Since the taxpayer often has to refer to back-up documentation when completing the questionnaire, initially requesting this material may prove to be a less intrusive burden on the taxpayer as well as facilitate the completion of the audit.

Diaries and calendars maintained by the individual, or the employer are very helpful in determining the days allocated to New York State and/or Yonkers. Often an individual is asked to provide expense accounts submitted to the employer to verify time spent outside New York, and receipts such as American Express, Diners Club, or other credit cards can be used to substantiate time either in or out of New York. Very often a corporate executive will utilize the services of a specific travel agency to plan not only personal travel but also any business travel needs. Copies of itineraries, airline tickets, and travel schedules can be requested to verify time spent outside New York.

When analyzing records, whether business or personal, the auditor must keep the objective in mind. Unlike other nonresident audits, the allocation case is interested in time spent **WORKING** in New York rather than mere presence. The auditor should look for patterns and request documentation concerning any deviation from those patterns. For example, if it is customary for the individual to conduct a weekly sales meeting in his office in Manhattan on Monday morning, any deviation from this practice should be questioned. Likewise, if the individual indicates in a diary or calendar that he was on vacation for a period of time, and this is verified by the employer, a day without documentation in the middle of the period should not be considered a workday or a New York day without specific evidence to that effect.

Different standards apply when implementing a test for statutory residence (**MERE PRESENCE**) and income allocation (**TIME SPENT WORKING**). For example, if a non-domiciliary spends the night at a New York hotel and leaves for Connecticut at 7:00 a.m. for a business meeting that lasts the rest of the day, the day would be treated as a New York day in applying the statutory residence test but would be considered as a Connecticut working day in allocating income.

The auditor may wish to review corporate board minutes and employment contracts for the business in which the individual is employed. These records may provide insight into the degree of involvement the individual has in a New York business. Board minutes often establish a specific delegation of authority to the individual as well as provide authorization for the use of a corporate apartment, auto, or plane. The authorization to use corporate assets such as an auto or plane may also open up the possibility that there

are corporate records such as a log which can verify the travel requirements of the individual employee. Corporate board minutes and employment contracts often require the individual to represent the company by sitting on the boards of other related or unrelated companies. This information can be useful in determining the allocation of income or the days in or out of New York.

After the initial communication with the taxpayer, it may be necessary to request additional documentation or arrange a subsequent meeting. Such requests of the individual should be modified and streamlined to fit the specific need of the case at hand. This modification will ease the burden placed upon the taxpayer to produce records and documentation which are not essential to the audit.

*There may be situations where taxpayers have not provided the information despite repeated requests to do so. In such situations, it may be appropriate for the auditor to consider the use of a subpoena to obtain the information. The subpoena may be served either on third parties that have access to the information, such as the taxpayer's employer, or directly on the taxpayer himself to produce the necessary books and records. Use of the subpoena is authorized by Article 8, Section 174 of the Tax Law. It should be considered after other methods have not been successful and then, only after consultation with the auditor's team leader.*

**For more information on subpoenas, consult Executive Policy Memorandum No. 100 dated July 12, 2011.**

## **D. CONCLUDING THE AUDIT**

### **1. Making a Determination**

After the auditor has accumulated sufficient information to reach a conclusion, and the information is entered into the in/out program, he should prepare a summary of the facts developed during the audit and compare these facts with Department policy and established case law. The auditor should discuss the findings with the team leader and, if necessary, request assistance from Field Audit Management in interpreting audit policy and case law.

The auditor and the team leader should review the case to determine the appropriateness of penalties. Particular attention should be paid to the negligence penalty, Section 685(b), and the penalty for substantial understatement, Section 685(p). The auditor, when asserting these penalties, must bear the burden in justifying the appropriateness of the penalty assessed. Entries concerning the imposition of penalty should appear in the DO-220.5 or be noted in a separate memorandum attached to the case outlining the reasons for imposing the penalty. The mere size of an assessment or the lack of specific records does not in itself constitute negligence or



substantial understatement, but combined with other factors may warrant the imposition of both of these penalties. As with any program, when the taxpayer demonstrates a flagrant and intentional disregard for New York State Tax Law, consideration must be made for the imposition of fraud penalties or referral to the Special Investigations Bureau for possible criminal prosecution. Team leaders need to keep a watchful eye for cases with fraud indicators. For these cases, referral for criminal action or civil fraud penalties may be appropriate.

In any event, documentation of incidents of negligence or fraud must be outlined in the audit file or in the log in order to support the penalty imposition. With respect to the "p" penalty, an important element to be addressed is the question of adequate disclosure.

## **2. Communicating the Results**

The auditor must present the examination results to the taxpayer and/or the representative at the conclusion of the audit. During the concluding phase of the audit, the auditor should present to the taxpayer and the representative copies of workpapers and schedules, and explain the methodology of the audit as well as Department procedures in plain and simple, nontechnical terms. The findings can also include recommended changes in recordkeeping practices to correct accounting errors found during the audit, as well as an explanation of the proper interpretation of the tax law in areas where errors were made.

Upon the conclusion of an audit, the taxpayer and the representative must be notified of the results of the audit regardless of the outcome. If the audit results in the acceptance of the return filed the taxpayer should be notified of that fact. This notification will protect the individual from subsequent audits covering the SAME ISSUE for the SAME PERIOD and relieve the burden of producing documentation for a period for which a resolution was reached.

*If, on the other hand, it is found that the taxpayer is due a refund, the auditor is required to disclose this to the taxpayer. Section 3004-a of Article 41 of the Tax Law, known as the Taxpayers' Bill of Rights, requires that the Department disclose to a taxpayer all instances of overpayment of tax by such taxpayer discovered during the course of an audit, assessment, collection or enforcement proceeding.*

Once a decision is made, the auditor must communicate the results to the taxpayer and his representative. The proposed adjustment is prepared on the AU-251 "Statement of Audit Changes" and must adequately describe the adjustments. The auditor must provide any supporting documentation such as worksheets from the in/out program along with the proposed adjustment. It is suggested that the auditor

present the audit results to the taxpayer and his representative orally, explaining the adjustments and presenting pertinent case law to support the position. During this oral presentation, it is also appropriate for the auditor to explain to the taxpayer his rights to protest and the appeals process available to him.

The taxpayer should be given sufficient time to review the audit results and present additional information, if possible. The auditor must listen carefully to any additional explanations offered by the taxpayer and evaluate any new documentation submitted. If changes are warranted, the auditor should recompute the additional tax and present a revised statement to the taxpayer as soon as possible. When mailing the AU-251 to the taxpayer or his representative, the Department recommends that the appropriate closing letter be used. Several letters are included in the AFE program, and one is appropriate for each of the various closing situations.

### **3. Closing Conference**

If a disagreement still exists, or the taxpayer is uncomfortable with the auditor's explanation, a closing conference at the district level with the District Audit Manager and the Program Manager should be offered. At this conference, the auditor, with the oversight of the team leader, should be prepared to explain the findings and present examples from prior case law which parallel the taxpayer's situation. In certain instances the section head may also participate in this conference. This airing of the issues has proven to result in the successful resolution of many nonresident allocation cases.

Developing and maintaining a good dialogue with the taxpayer and the representative is essential for the successful conclusion of the case. The taxpayer and the representative must be given the opportunity to fully understand and refute the findings developed during the audit without the necessity of a BCMS conference. A closing conference at the district level with the team leader and section head, who are prepared to explain the audit findings supported, if possible, by relevant case law, could result in the successful resolution of the case.

This is beneficial to both the taxpayer and the Department as well in that collections will be enhanced and litigation costs kept to a minimum. If an issue can be resolved at the audit level, we should strive to do so. Even if the case remains disagreed, the auditor will be in a better position to defend the audit during the appeals process.

#### 4. Work Papers

Throughout the audit, the auditor should have prepared workpapers which adequately support the conclusions drawn upon the completion of the audit. These workpapers will become an integral part of the case file and will be used to resolve any questions the taxpayer has. The workpapers take on a greater significance in a disagreed case when the auditor or team leader will be called upon to defend the Department's position throughout the appeals process.

Notes and comments concerning your discussions with the taxpayer and/or the representative in regard to work patterns, time spent out of state, or travel requirements of the individual's position, etc., should be documented on the DO-220.5 (Field Audit Record). These notes may be used to refresh your memory at a later date as the case proceeds through the appeals process. The timely entry of notes and comments on the Field Audit Record also lends credibility to discussions which take place between you and the taxpayer and/or the representative.

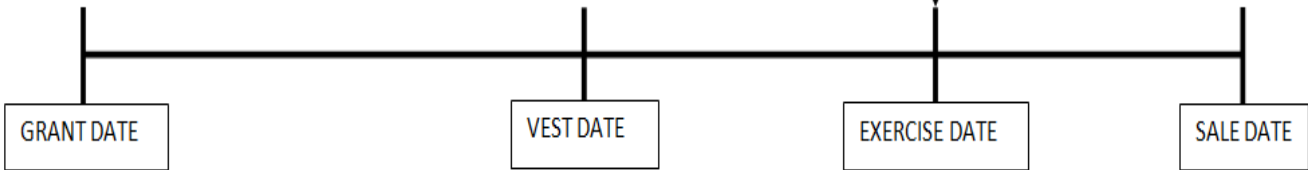
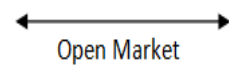
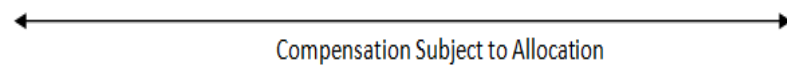
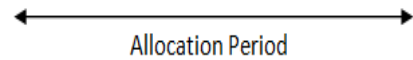
The "Income Tax Audit Report", Form AU-241.26 was designed to provide additional space to explain the assertion of penalty, to explain the results of an informal closing conference, and to identify specific areas of disagreement. The narrative should also include a summary of the Department's position, a listing of areas of disagreement and, finally, a listing of any rebuttal evidence which will refute the taxpayer's position. This audit report, along with the DO-220.5, often provides the reviewer with a picture of what occurred during the audit. These reports often provide the basis of the appeals presentation as well as establish the focus of any future audits.

X. APPENDIX

**The Life of a STOCK OPTION and APPLICABLE NY TAX TREATMENT**

- Starting **January 1, 2006**, all stock options (statutory and non-statutory) are allocated based on the days worked within and without NY from the grant date to the vest date
- Refer to TSB-M-07(7)I for alternate allocation methods for tax year 2006 only

- For **non-statutory** (non-qualified) and restricted options, the ordinary income is recognized when the options are exercised. This is the exercise price less the purchase price
- Appears as compensation in the taxpayer's W-2 (Code V) – this amount is allocable to NY based on the percentage from grant to vest
- For **statutory** options, although the compensation is not recognized for federal purposes until they are sold, the value at the date of exercise less the purchase price is the amount allocable to NY based on the grant to vest allocation period



- For **statutory** options, the gain is not recognized for federal purposes until the option is sold and reported on Schedule D
- For both **statutory** and **non-statutory** options, if the price of the option increases from exercise to sale, the resulting gain is considered a result of the open market and intangible
- For **statutory** options, if the share price decreases from exercise to sale, the amount subject to compensation is limited to the sale price less the purchase price