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OUTSIDE COUNSEL

By Eli Uncyk

Exempting Income of New York Non-Residents

Non-residents of New York State are subject to income tax on income earned within the state.[1,2]

Many non-residents who work for New York employers apportion their compensation; that is, allocate a portion of their work to time spent outside New York State, based on the number of days they worked within and outside the state. The compensation based on work performed outside the state is then claimed to be exempt from New York income taxes.

This allocation is frequently challenged by the New York State Department of Taxation based on the general rule that work performed outside of the state "must be based on services which *of necessity, as distinguished from convenience, obligated the employee* to out-of-state duties in the service of his employer." (Emphasis supplied.)[3] The principle will continue to apply to New York City taxes which were collected or assessed before the elimination of the city non-resident income tax.

The "convenience-necessity test" has been applied generally when the New York employer could have accommodated the employee in the employer's New York offices, even if this required some effort. The burden of proof to pass this test is a very difficult one for taxpayers to carry, as is demonstrated by several cases that have reached the Court of Appeals, whether by way of appeal or denial of a motion for leave to appeal after a determination in the Appellate Division, Third Department. (State Income Tax cases are always heard in the Third Department pursuant to an Article 78 Proceeding to review the determination of the Tax Appeals Tribunal.)

One extreme in which the courts found in favor of a taxpayer was *Matter of Fass*.[4] In that case, the taxpayer edited and published several magazines dealing with a wide variety of special areas, including sports cars, motorcycles, firearms, home improvements, dogs and horses. The taxpay-

Eli Uncyk *is a partner with Uncyk, Borenkind & Nadler LLP in New York.*

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er in that case required access to highly specialized facilities which he maintained at his home and farm in New Jersey, including ballistics equipment, a firing range, garages, stables and kennels for sophisticated testing and evaluations. The Appellate Division held that, "as a matter of law, we reject the position that an allocation of income should be disallowed merely because the specialized facilities herein could have been set up somewhere in New York State."[5] The Court of Appeals affirmed.

On the other end of the spectrum was the taxpayer in *Matter of Kittman v. State Tax Commission*,[6] whose job included watching television and writing criticism for the newspaper *Newsday*. That taxpayer, who had to generate five columns weekly, claimed that watching television at home was essential, because he had to do it at all hours, often watched more than one television at a time and depended on input from his family when writing. He also testified that watching television at work might interfere with other employees. The Court likened that case to *Matter of Wheeler v. State Tax Commission*,[7] in which the taxpayer claimed he had to work at home on weekends because the alarm system at his office was not disabled and mail was not sorted. In both of these cases, the taxpayers' allocation of income was disallowed.

Most recently, the Third Department, despite a very articulate dissent, held that a non-resident bond hedger who worked from an office set up by his employer at the taxpayer's home, could not allocate his time outside New York in order to avoid New York taxes on income attributable to the days he worked outside the state.[8] The taxpayer testified that the employer, Shearson Lehman, had set up an office in the taxpayer's Pennsylvania home, since the company had not engaged in bond hedging before hiring him, and had no facilities in its New York offices for the activity. The employer installed over 25 telephone lines, information systems, faxes and computers in the taxpayer's home-office. In addition, the employer listed the address of the home-office in the Pennsylvania telephone directory under the name of Shearson Institutional Capital Funding. The taxpayer came to the New York offices several times a week to interact with bond traders and to participate in meetings and instructional sessions with salespersons. While in the New York office, the taxpayer said he was able to execute some hedge trades and accommodate clients, although he had to do it above the din of traders' cross-office shouting and had to exercise great efforts to maintain the confidentiality of his own trades (since bond traders could benefit from knowing which hedges were being used).

The Appellate Division nevertheless found that this taxpayer's claim of necessity was "nowhere as compelling as that set forth in *Matter of Fass*,"[9] and that, in fact, the taxpayer had been able to conduct his business in the New York office.

An interesting sidelight is the fact that while the *Phillips* case was winding its way through the Tax Commission audit and review procedures, the Tax Appeals Tribunal issued a decision in *Matter of O'Connell*,[10] which involved a municipal bond salesman who was a non-resident of New York. The taxpayer testified that he did not have a private office in New York, but was supplied with a desk and telephone in his employer's New York office. He was required to travel as a condition of his employment and his compensation was based solely on commissions from sales and purchases of bonds he made on behalf of his customers. The taxpayer used the physical location of his customers as the basis for allocating commissions he earned within New York and outside New York, so that only commissions earned from customers with New York offices would be subject to New York income tax.

The Division of Taxation disallowed that allocation. The Division re-allocated his income based on the days the taxpayer actually spent within and outside New York. On appeal, the Tax Appeals Tribunal reversed and held in favor of the taxpayer, finding that the allocation system he used was reasonable. Since the sales calls were the basis for the transaction, the fact that customer telephone calls to implement the sales were made to the New York office, was not sufficient basis on which to set aside the reasonable method of allocation used by the taxpayer.

Notwithstanding the Tax Appeals Tribunal decision in *O'Connell* (which the Division of Taxation may not appeal), state tax auditors have not readily accepted the principle that allocation based on customer location is appropriate in every case where the salesman works on commission and spends some time in a New York office servicing clients outside New York. Tax practitioners need to face the possibility that, even if they follow *O'Connell* methodology in allocating state income taxes, auditors may still not accept the conclusion and force the taxpayer into costly proceedings to set aside an assessment.

A related issue arises when the employee is assigned to a "temporary workplace,"[11] and the employer pays for the employee's transportation from home to that "temporary workplace." For federal income tax purposes, the travel reimbursement will not be considered income to the employee, but this determination is not related to the state's convenience-necessity test. The taxpayer's burden of proof in the "convenience-necessity" test is greatly alleviated if he/she can show that the employer required attendance at a "temporary workplace" outside the state. Reimbursing the employee-taxpayer for travel costs will also carry some weight.

Advising Clients

What can tax advisers tell their clients when they consider taking jobs with New York State employers (besides not to do so)? Has the Division of Taxation considered that the difficult problems created by the burden of proving allocations would drive employees out of the state? Are employers ready to create offices in another state for certain employees in order to help those employees avoid New York State income taxes?

An article in the May 2000 issue of *Forbes* magazine entitled "Telegrab"[12] lamented that New York State's taxing power might not end with ordinary citizens. The article questioned whether the state could tax President Clinton's income, since the federal government had offices at Federal Plaza in New York and could, with some effort, accommodate the president in New York.

The first line of defense for taxpayers is to keep a careful and detailed record of the days or parts of days spent working outside New York. Unless the Department of Taxation is satisfied with the records the taxpayer kept, the taxpayer will have to prove, before the Division of Tax Appeals, that the days allocated outside New York are accurate.

With the heavy burden of proof placed on the taxpayer, this may become an insurmountable task, even if the convenience-necessity test can be passed. The best beginning would be to keep a daily log or diary which tracks appointments and other information or details that would give weight to the taxpayer's claims of working outside the state. If there are telephone bills or logs, airline tickets, passport entries or other similar items that would substantiate the claim, these items should be retained with the calendar, presented during the audit and introduced in evidence at the hearing before the Division of Tax Appeals.

The convenience-necessity issue is more difficult to deal with when taxpayers claim a home-office as their out-of-state base. The bond hedger whose employer set up an elaborate office in the taxpayer's home, could not overcome the apparent bias against home-offices, even though the employer listed the taxpayer's address in the telephone book as the employer's. If the employer has an out-of-state office that the taxpayer reports to, or if the employer assigns the employee to a "temporary workplace", the burden of proof may be less difficult to carry if the employer cooperates. The employer may agree to testify or at least to supply a detailed affidavit (which the Division of Tax Appeals may accept in evidence) that the employer requires the employee to be at the out-of-state office. The taxpayer's record-keeping becomes crucial in this regard; and the *O'Connell* rules[13] may apply if sales resulting from out-of-state customers can be identified and related to compensation, such as commissions earned.

Non-residents who spend part of their time working outside New York State must deal with more paperwork and run substantial risks if they choose to allocate part of their earnings from New York State employers to their work outside the state. If the taxpayer lives in a low-tax state (compared to New York), the effort may be worthwhile. If the taxpayer lives in a high-tax state and would have to pay income taxes on his/her income to that state, the issue is less pressing, since other states will give credit for income taxes paid to New York State. The money may not be going where it should be going, but the taxpayer will not get to spend it in either case.

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(1) Tax Law sec. 631.

(2) Under a recent decision of the New York Court of Appeals, non-residents of New York City are no longer subject to any New York City income tax. *City of New York v. State of New York*, 94 NY2d 577, 709 NYS2d 122 (2000), WL 343886

(3) Tax Regulations, 20 NYCRR 132.18 (formerly 131.18).

(4) *Matter of Fass v. State Tax Commission*, 68 AD2d 977, 414 NYS2d 780 (3rd Dept., 1979), aff'd 50 NY2d 932, 431 NYS2d 526 (1980),

(5) 414 NYS2d, at 782.

(6) 92 AD2d 1018, 461 NYS2d 448 (3rd Dept., 1983), lv den 59 NY2d 603 (1983).

(7) 72 AD2d 878, 421 NYS2d 942 (3rd Dept., 1979).

(8) *Matter of Phillips*, 267 AD2d 927, 700 NYS2d 56 (3rd Dept., Dec. 30, 1999), lv den __ NY2d __ (April 6, 2000)

(9) See footnote 4, above.

(10) Tax Appeals Tribunal, TSB-D-97 (18) I, March 6, 1997.

(11) Federal Rev. Rul. 99-7, 1999-5 IRB 4.

(12) *Forbes*, May 2000, "Telegrab," Peter Spiegel.

(13) See footnote 10, above.