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Timothy P. Noonan

Open Weaver Banks

Timothy P. Noonan is a partner in the Buffalo and New York offices of Hodgson Russ LLP, and Open Weaver Banks is a partner in the firm's Hackensack and New York offices.

In this installment of Noonan's Notes, Noonan and Banks discuss New York's recent desk audit initiative targeting New Jersey residents with New York-source income and provide insights into the mechanics of the credit that New Jersey residents may claim to offset any additional taxes paid to New York as a result of these desk audits.

Garden State residents have reported a bumper crop of audit notices from New York in recent months. All these notices have one thing in common: The state wants to review how New Jersey residents with New York-source income allocated their income to the Empire State on their 2020 New York personal income tax returns. These notices — and New York's generally aggressive response to post-pandemic tax enforcement — are sure to create a host of multistate tax problems and the potential for double taxation. This article considers the next steps for New Jersey residents responding to the New York notices, including the availability of offsetting credits on their New Jersey returns.

New York Perspective

So what's happening in New York? As chronicled in a recent column, COVID-related telecommuting has created significant state tax issues, with tens of thousands of workers — possibly hundreds of thousands — leaving New York and working remotely out of state.[1] New York believes its preexisting "convenience of the employer rule" allows it to continue to tax those remote workers even though the work is being done outside the state, and even though there was often extreme necessity for doing so (government-related office closure, employer office closure, etc.).

Indeed, when New York updated a frequently asked questions section of its website in July 2020 by indicating that it would continue to apply the convenience rule during COVID,[2] we certainly expected this to be an area of enforcement for the State Department of Taxation and Finance on future nonresident allocation audits. But we didn't expect it to happen this quickly.

As taxpayers filed 2020 nonresident tax returns with New York over the past few months, a familiar pattern emerged. These taxpayers — and this apparently applies to all who claimed a 2020 change of residency or reduction in their nonresident allocation percentage — have

[1] Timothy P. Noonan and Emma M. Savino, "New York's Convenience Rule: Under the COVID Microscope," *Tax Notes State*, May 31, 2021, p. 893; and Noonan and Savino, "COVID-19: The Year of the Great Migration," *Tax Notes State*, Mar. 1, 2021, p. 897.

[2] New York State Department of Taxation and Finance, "Frequently Asked Questions About Filing Requirements, Residency, and Telecommuting for New York State Personal Income Tax," updated June 30, 2021.

received letters from New York's desk audit unit asking for more information about their 2020 tax return filings.[3]

It is no surprise that New York is sending notices to taxpayers who reported a change in residency in 2020. More unusual is the immediate focus on verifying the New York income allocation of historic nonresidents — specifically New Jersey residents who worked in New York before the onset of COVID work-from-home requirements imposed by Gov. Andrew Cuomo (D).

The New York notices sent to New Jersey residents state that the tax department needs to "verify the amount of income you allocated to New York State." The notices explain New York's convenience rule:

> If you are a nonresident or part-year resident whose assigned primary work location is in New York State, days you worked at a location outside New York State may be considered New York State work days. In particular, days you telecommuted from a location outside New York State are considered New York State work days unless your employer has established a bona fide employer office at your telecommuting location.

The New York notices then ask New Jersey residents to verify their income allocations on their 2020 returns by providing a copy of the federal W-2, a breakdown of the number of working days versus nonworking days (weekends, holidays, vacations, sick days), and the total number of days worked from home. In addition to focusing on work location, the notices require New Jersey residents to provide "a full description of the composition of your wages (base compensation, bonuses, stock options, sick pay, vacation pay, severance pay, gambling income, unemployment compensation, etc.)."

This is a new program in New York. Rarely have we seen a coordinated desk audit campaign like this, and never has the tax department endeavored to handle complicated income allocation issues through its desk audit program. But clearly, the agency realizes that 2020 was an unusual year, and it is sparing no expense to make sure that workers who fled New York in 2020 don't take their tax dollars with them.

New Jersey Perspective

The good news for New Jersey residents is that in most situations, if their New York tax goes up as the result of an assessment or refund denial, New Jersey will provide an offsetting credit in the form of a refund of taxes paid to New Jersey. And because both states' tax rates are high,[4] it will often be a near wash. Indeed, New Jersey's credit for taxes paid to other jurisdictions (the resident credit) was designed to protect residents from double taxation. And New Jersey's rules provide significantly more protection for its residents than other states' similar credit provisions.[5]

Good legislative intentions notwithstanding, the resident credit usually does not provide total relief from double taxation — and the credit mechanism is full of traps for the unwary.

What Is the New Jersey Credit for Taxes Paid to Other States?

New Jersey residents are taxable on their gross income regardless of whether it was earned within or outside New Jersey.[6] That raises the possibility that residents will be subject to double taxation if they have income that is also taxed by the source state. The resident credit of N.J. Stat. Ann. section 54A:4-1 provides:

> (a) A resident taxpayer shall be allowed a credit against the tax otherwise due under this act for the amount of any income tax or wage tax imposed for the taxable year

[3] We have seen notices issued to taxpayers with annual incomes as low as $4,000! And even taxpayers who did not change residency status (who were New Jersey residents before the pandemic required working from home) and who continued to follow New York's convenience rule have been hit with these desk audit notices.

[4] In 2020 New York's top rate on individuals was 8.82 percent, while New Jersey's top rate was 10.75 percent.

[5] As an example of New Jersey's more generous resident credit rules, in the area of compensation for personal services New York limits its resident credit to income tax imposed by another state upon compensation for personal services *performed in the other state*. 20 NYCRR section 120.4(d). New Jersey's resident credit is not subject to the same limitation. N.J. Stat. Ann. section 54A:4-1. New Jersey provides a credit for taxes imposed by New York on compensation that is also taxed by New Jersey, even though the New Jersey employee may have actually performed some of the services from a New Jersey location.

[6] N.J. Stat. Ann. section 54A:5-1.

> by another state of the United States or political subdivision of such state, or by the District of Columbia, with respect to income which is also subject to tax under this act, except as provided by subsections (c) and (d) of this section.[7]

The goal of the resident credit "is to avoid double taxation of money taxed and actually paid to both New Jersey and a foreign jurisdiction."[8]

Is There a Statute of Limitations on New Jersey Resident Credit Refund Claims?

In enacting the resident credit, the New Jersey Legislature carved out an exception to the general statute of limitations rules for individual returns. Normally, an individual's refund claim in New Jersey must be filed within the later of either (1) three years from the time the return was filed or (2) two years from the time the tax was paid.[9] However, for a readjustment of the tax paid to another state, the law provides that if an individual's credit for taxes paid to another jurisdiction ultimately ends up being more or less than what was originally reported, then "the taxpayer shall send notice of the difference to the director who shall redetermine the tax for any years affected regardless of any otherwise applicable statute of limitations."[10]

On its face, the resident credit provision appears to provide that New Jersey residents should not have to worry about running out of time to increase their New Jersey credit as a result of a New York audit. However, more than one taxpayer has been denied a resident credit refund for filing a late refund claim. Most recently, in the unpublished *Bernard* opinion,[11] the New Jersey Tax Court dismissed a refund claim as untimely because the taxpayer first reported 2002 taxes paid to New York more than three years after the date of the filing of his original 2002 New Jersey return.

In *Bernard*, the taxpayer was a New Jersey resident who did not claim any credit for taxes paid to other states on his original 2002 New Jersey income tax return. Fredric Bernard filed his New Jersey return on April 15, 2003. New York audited him and asserted a tax deficiency for the 2002 year. Bernard ultimately made a large settlement payment to New York in August 2006. Later, in September 2007 he filed an amended 2002 New Jersey return to claim a credit for the taxes he paid to New York.

If Bernard had filed an amended return based on a math error on his original return, there is no question that his claim would have been filed outside the statute of limitations and therefore been invalid. He argued that his amended return seeking a resident credit refund was timely filed because the resident credit statute states that the director shall redetermine the tax "regardless of any otherwise applicable statute of limitations."

The tax court upheld the Division of Taxation's denial of Bernard's refund claim, finding that he only had until April 15, 2005, to claim a refund for overpayment of his New Jersey taxes. The result sounds incompatible with the plain language of the statute.

However, the reason for the tax court's ruling was that the language in the resident credit statute that eliminates the statute of limitations restrictions only applies to readjustments. The subsection is titled "Readjustment of the tax of another state or political subdivision thereof." And according to New Jersey courts, a readjustment only occurs when the taxpayer claimed the resident credit on the originally filed New Jersey return.

On Bernard's appeal, the New Jersey Appellate Division upheld the result and explained:

> In our view, the plain language of the statute makes it clear that only those who actually claimed a credit for out-of-state taxes on their New Jersey return may seek its protection from application of the statute of limitations under N.J.S.A. 54A:9-

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[7] Paragraphs (c) and (d) provide:

> (c) No credit shall be allowed against the tax otherwise due under this act for the amount of any income tax or wage tax imposed for the taxable year on S corporation income allocated to this State.
>
> (d) No credit shall be allowed for the amount of any taxes paid or accrued for the taxable year on or measured by profits or income imposed on or paid on behalf of a person other than the taxpayer, whether or not the taxpayer may be held liable for the tax.

[8] *Mannino v. Director, Division of Taxation*, 24 N.J. Tax 433, 442 (Tax 2009).

[9] N.J. Stat. Ann. section 54A:9-8.

[10] N.J. Stat. Ann. section 54A:4-1(e).

[11] *Bernard v. Director, Division of Taxation*, Dkt. No. 014563-2012 (Dec. 4, 2013), *aff'd*, No. A-1445-13T4, 2014 WL 7896547, at *1 (N.J. Super. Ct. App. Div. Feb. 23, 2015).

> 8. Its use of the phrases, "readjustment" affecting taxpayers heretofore "allowed credit" for payment of out-of-state taxes paid, plainly supports the conclusion that the Legislature only intended to provide an avenue for readjusting a credit already allowed — not a new opportunity for claiming a credit not sought earlier.[12]

Bernard is bad policy, but it is *probably*[13] the law in New Jersey. New Jersey residents who think they may have exposure to New York personal income taxes but did not pay any taxes to New York in 2020 (and therefore did not claim the resident credit on their New Jersey returns) should consider amending their original New Jersey returns within the three-year statute of limitations to preserve a protective refund claim.

The Resident Credit Does Not Relieve Double Taxation Caused by Timing Issues

Timing issues can also undermine a resident credit claim when New Jersey recognizes an item of income in a different year than the other taxing state. In *Guzzardi*,[14] the taxpayer — while a Pennsylvania resident — sold two parcels of real estate located in Pennsylvania in 1981. The taxpayer elected to report the gains on the installment basis even though Pennsylvania did not recognize the installment method of accounting. As a result, the taxpayer was subject to Pennsylvania personal income tax on the entire gain in 1981. The taxpayer later relocated to New Jersey.

In 1988, while still a New Jersey resident, the taxpayer recognized the installment gain from the sale of the real estate for both federal and New Jersey income tax purposes. The taxpayer sought, but was denied, a resident credit for the taxes paid to Pennsylvania in 1981 on the same sale. The tax court found that the taxpayer was not entitled to a credit in 1988 for tax paid on the income to Pennsylvania in 1981.[15] According to the court, "the resident credit is available only when double taxation by New Jersey and another state occurs in the same taxable year."[16]

A similar timing issue could result from the application of New York's accrual rule,[17] which requires taxpayers changing their residency status to use an accrual method of accounting to determine amounts sourced to New York before and after the change in status. This accrual rule essentially transforms all cash-basis taxpayers into accrual-basis taxpayers for the year when a residency change occurs. If an individual changed residence from New York to New Jersey in 2020, the accrual rule could accelerate recognition of income in New York to 2020 — even if the income is not actually received until 2021. That could create a *Guzzardi* scenario in which the double taxation does not occur in the same year because New York would argue the income is taxable on the 2020 part-year resident return, but New Jersey would not tax the income until it was actually received — in 2021.

The Resident Credit Computation Is Complicated

Every New Jersey resident who paid income taxes to New York in 2020 should have completed the NJ-COJ ("Credit for Income or Wage Taxes Paid to Other Jurisdiction"). The NJ-COJ is essentially a worksheet to complete the math that determines the size of the resident credit. The first line of NJ-COJ asks for "income properly taxed by both New Jersey and other jurisdiction." There probably isn't a thornier question in New Jersey tax law.

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[12] *Bernard v. Director, Division of Taxation*, No. A-1445-13T4, 2014 WL 7896547, at *1 (N.J. Super. Ct. App. Div. Feb. 23, 2015).

[13] The logic of *Bernard* is so problematic that it may be worth challenging the interpretation. However, *Bernard* was not the first decision to find the statute of limitations applied to block an increase in the resident credit. The New Jersey Tax Court reached a similar conclusion 20 years earlier in *Bonanno v. Director, Division of Taxation*, 12 N.J. Tax 552 (Tax 1992). The only glimmer of hope for challenging *Bernard* and *Bonanno* lies in the fact that the tax court comprises multiple judges, and the opinion of one judge is not binding on the other judges in the absence of an en banc opinion. N.J. Rule 8:8-6.

Over the years, numerous tax court judges have issued opinions "respectfully disagreeing" with the opinions of other judges. *See Fairfield Dev v. Totowa Borough*, 27 N.J. Tax 306, 310 (Tax 2013); *Suecharon v. Director, Division of Taxation*, 20 N.J. Tax 371, 378 (Tax 2002); and *Hapag-Lloyd A.G. v. Director, Division of Taxation*, 7 N.J. Tax 108, 117 (Tax 1984), *aff'd*, 8 N.J. Tax 323 (App. Div. 1986).

Also, *Bernard* was an unpublished tax court opinion that was affirmed by an unpublished opinion by the Superior Court of the Appellate Division. Unpublished opinions are not precedential in New Jersey. N.J. Rule 1:36-3 states: "No unpublished opinion shall constitute precedent or be binding upon any court."

[14] *Guzzardi v. Director, Division of Taxation*, 15 N.J. Tax 395 (Tax 1995), *aff'd*, 16 N.J. Tax 374 (App. Div. 1996).

[15] *Guzzardi* at 405.

[16] *Id.*

[17] N.Y. Tax Law section 639(a).

Under N.J. Stat. Ann. section 54A:4-1(b), the credit may not exceed the proportion of the tax otherwise due that the amount of the taxpayer's income subject to tax by the other jurisdiction bears to the taxpayer's entire New Jersey income. From this language the New Jersey credit ratio was born. The resident credit is determined by multiplying the total New Jersey taxable income by a fraction — the numerator of which is the income actually taxed by both New Jersey and the other jurisdiction, and the denominator of which is the income subject to tax by New Jersey.

The numerator of the credit ratio has long been a source of dispute in New Jersey. Taxpayers want the numerator to be as high as possible to increase their resident credit. But the tax court has held that the numerator cannot include income that was not taxed in New Jersey (because of a New Jersey deduction, for example).[18] The court has also rejected the argument that income should be in the numerator merely if it was "subject to tax" without regard to whether it was actually taxed or offset by a deduction.[19] Similarly, the numerator cannot include income that was not taxed in the other jurisdiction.[20]

What happens to the credit ratio numerator when both New Jersey and the other taxing state have unique deductions? In *Mannino*,[21] the tax court rejected the division's position that the numerator has to be reduced by the sum of the unique deductions allowed by New Jersey and the other taxing state.

Philip Mannino was a New Jersey resident employed by a partnership with business across the country. As a result of the partnership's business activities, Mannino incurred and paid tax on his share of its income in 38 states. On his New Jersey return, Mannino calculated his numerator by including all income taxed by both states, less deductions allowed in California that are not allowed in New Jersey. On audit, the division argued that the numerator should be further reduced by deductions allowed in New Jersey that are not allowed in California.

The tax court held that to avoid double taxation of the same income, the numerator should only be reduced by the greater of the deduction amounts, which were the California deductions.[22] An example illustrates the issue and conclusion in *Mannino*:

> Assume $100,000 of income taxable in both California and New Jersey. Further assume that California offers a unique deduction of $10,000 for all taxpayers who are certified public accountants, while New Jersey offers a unique deduction of $5,000 for all taxpayers who commute more than two hours a day for their jobs. Taxpayer A is a CPA and New Jersey resident with a long commute and income subject to tax in California. Taxpayer A takes the position on his New Jersey return that his total income of $90,000 was taxed by both states because he reduced the numerator by the greater of the two unique deductions.
>
> Applying the division's position in *Mannino*, all of Taxpayer A's unique deductions would be removed from the numerator so that only $85,000 of income would be considered as taxed by both states. The tax court in *Mannino* rejected the division's method on the basis that the agency's math did not work to relieve the double taxation. In this hypothetical, the division's method of computing the resident credit numerator removed an additional $5,000 of income that was taxed by both New Jersey and California.

The issue in *Mannino* arises all the time because states are not consistent in their deductions and exclusions from personal income taxes, making the computation of the numerator of the credit ratio a contentious issue in New Jersey. The division's guidance on the resident credit goes as far as to warn taxpayers that the

[18] *Stiber v. Director, Division of Taxation*, 9 N.J. Tax 623 (Tax 1988) (adjusting the numerator to offset the income taxed by New York by deductions allowed under New Jersey law but disallowed under New York law).

[19] *Kanarek v. Director, Division of Taxation*, 14 N.J. Tax 589 (Tax 1995).

[20] *Berlin v. Director, Division of Taxation*, 13 N.J. Tax 405 (Tax 1993) (adjusting the numerator to offset the income taxed by North Carolina by North Carolina deductions from rental activities).

[21] *Mannino v. Director, Division of Taxation*, 24 N.J. Tax 433, 442 (Tax 2009).

[22] *Mannino* at 442.

income taxed by New York is likely to be less than the income taxed by New Jersey. The division's bulletin cautions: "If you are a New Jersey resident who works in New York or earns other taxable income there, you are often taxed on an amount less than your actual New York source income as a result of the deductions allowed by New York."[23]

'Oops — I Made a Tax Payment I Should Not Have Made'

On multiple occasions, the tax court has denied resident credits to taxpayers who made erroneous payments to other jurisdictions. This situation is particularly unfortunate when it is too late for the New Jersey resident to claim a refund in the state where the erroneous payment was made. In *Vassilidze*,[24] a married couple residing in New Jersey made income tax payments to Pennsylvania for work performed in Pennsylvania, even though the two states had entered into a well-publicized reciprocal personal income tax agreement in which each state agreed to cede its authority to impose income tax on the wages earned by the residents of the other state. Under the agreement, New Jersey residents who earned wages in Pennsylvania were not subject to Pennsylvania income tax.

The Vassilidzes mistakenly paid income tax to Pennsylvania on their wage income. By the time they realized the mistake, the statute of limitations on a refund claim in Pennsylvania had closed and they had no ability to recover the erroneous payment from Pennsylvania. When the Vassilidzes sought a resident credit from New Jersey for the taxes paid to Pennsylvania, the claim was denied on the basis that the resident credit is limited to those circumstances in which an income tax is imposed by a foreign jurisdiction. According to the tax court:

> The resulting double taxation on plaintiffs' income — by New Jersey which had an undisputed right to collect its tax and by Pennsylvania which accepted plaintiffs' voluntary payment of tax that was not due — is a consequence of plaintiffs' failure to follow unequivocal law and the operation of Pennsylvania's statute of limitations on refunds, and not the result of any authority imposing tax on plaintiffs' income in two jurisdictions.[25]

The tax court further explained that a tax is considered imposed by a foreign jurisdiction "if the foreign levy is required to be paid by a duly enacted statute, regulation or other exercise of governmental authority."[26]

For New Jersey taxpayers, this interpretation has always raised the question whether the division will look into audit assessments and settlements paid to other states. Could the division take the position that a taxpayer should not have made a tax payment to New York because the assessment was not supported by New York law or was contrary to the U.S. Constitution? It is entirely possible.

S Corporation Income Limitations

Special rules apply for purposes of computing the resident credit relating to S corporation income taxed by New Jersey and another state. By statute, N.J. Stat. Ann. section 54A:4-1(c) provides: "No credit shall be allowed against the tax otherwise due under this act for the amount of any income tax or wage tax imposed for the taxable year on S corporation income allocated to this State." S corporation income is allocated to New Jersey under the same rules that apply to C corporations under the corporation business tax.[27]

Beginning in 2014, New Jersey adopted singles-sales-factor apportionment for corporations. Under current law, corporate receipts from sales of goods are sourced to the destination, while receipts from the sale of services are sourced to where the benefit is received.[28]

What happens if a New Jersey resident is a shareholder of an S corporation that is subject to a different apportionment regime in another

[23] *See* GIT 3-B at 12 (Dec. 2020).

[24] *Vassilidze v. Director, Division of Taxation*, 24 N.J. Tax 278 (Tax 2008).

[25] *Vassilidze* at 283.

[26] *Vassilidze* at 291-92.

[27] N.J. Stat. Ann. section 54A:5-10.

[28] N.J. Stat. Ann. section 54:10A-6.

state? That situation occurred in *Doherty*,[29] in which the taxpayers were shareholders of an S corporation doing business in Pennsylvania and New Jersey. Under Pennsylvania's apportionment provisions, 81.7087 percent of the S corporation's income was attributable to Pennsylvania and 18.2913 percent was attributable to New Jersey. However, under New Jersey's apportionment formula, only 69.5464 percent of the income of the S corporation was attributable to Pennsylvania and 30.4536 percent was attributable to New Jersey.

On their originally filed New Jersey resident return, the taxpayers claimed a credit for the entire personal income tax they paid to Pennsylvania. On audit, the division limited the resident credit by applying the New Jersey apportionment method to determine the portion of the S corporation income that was allocated to New Jersey and therefore not eligible for credit. The tax court upheld the division's adjustment, finding that "it was not the intent of the Legislature to cede its authority to another State. Just because there are different methods of allocation available that may pass constitutional muster, does not mean New Jersey has to substitute the Pennsylvania allocation method and provide the credit."[30]

Conclusion

As New Jersey residents respond to New York's audit initiative, they should bear in mind that the fight with New York is only half the battle. If New York manages to extract additional tax payments from New Jersey residents, New Jersey will provide relief from double taxation — provided residents properly claim the resident credit on their amended 2020 returns. ■

[29] *Doherty v. Director, Division of Taxation*, 30 N.J. Tax 570 (Tax 2018).

[30] *Doherty* at 586.