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Heads They Win, Tails You Lose: Resident Credit Problems

by Timothy P. Noonan and Elizabeth K. Pascal

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A few months ago, this column focused on the potential expansion of state resident credit rules to protect against the double taxation of individual income tax payers.[1] But lurking just below the surface has been another article-worthy topic to discuss regarding resident credits. This is not a residency issue. Instead, it deals with practical problems that practitioners like us have seen in recent years in connection with personal income tax audits in New York, Connecticut, and elsewhere.

Resident Credits: The Big Picture

Let's start at the beginning. As has been noted before in this column, state taxation of residents is pretty simple. Residents are taxed on only one thing: *every*thing. Thus, a taxpayer paying taxes in several states faces the potential problem of double taxation. Fortunately, however, that problem is usually alleviated by resident tax credits. Under the basic resident tax credit statute, a resident is given credit for taxes paid to other states. The devil is in the details, however. In some states, like New Jersey, the resident credit provision is fairly broad. Under New Jersey's rules, a resident taxpayer can claim credit against income taxes due for income taxes paid to other states or even to subdivisions of a state.[2] If you are a resident taxpayer of New Jersey and some of your New Jersey taxable income is taxed by another state, New Jersey will allow a credit.

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But the rules are not as simple in other states. Both New York and Connecticut limit their resident credit provisions to so-called earned income. And in determining whether taxes paid to another state were paid on earned income, each state generally will apply its own sourcing rules to determine if tax is properly paid.[3] Let's look at each state statute to break this down further.

Under Tax Law section 620(a), a New York resident taxpayer is entitled to a credit for taxes paid to another state, to the District of Columbia, or to a province of Canada "upon income both derived therefrom and subject to tax under this article." The regulations clarify that income derived from sources in that jurisdiction is limited to compensation for personal services performed in the other jurisdiction; income from a business, trade, or profession carried on in the other jurisdiction; and income from

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[1]"An Easier Fix to New York's Statutory Residency Problem" *State Tax Notes*, May 9, 2011, p. 425, *Doc 2011-8930*, or *2011 STT 89-6*.

[2]N.J. Rev. Stat. section 54A:4-1(a).

[3]This aspect of resident credit rules was in the spotlight a few years ago when the convenience of the employer rule battles were raging in New York. New York nonresidents who were hit with tax based on the convenience rule were unable to receive resident credits from Connecticut, and the Connecticut Department of Revenue made its objections clear. *See, e.g.*, Gene Gavin and Stacey Pavano, "The Long Arm of the Empire State: Convenience Rule Discourages Interstate Telecommuting," 12 *Journal of Multistate Taxation* 6 (Mar./Apr. 2002). (Gene Gavin was then the commissioner of the Connecticut Department of Revenue Services, and Stacey Pavano was a tax attorney in the legal division.)

real or tangible personal property situated in the other jurisdiction.[4] Connecticut's statute is almost identical, limiting the credit for taxes on income sourced to the other jurisdiction based on the same categories as New York and limited to income that would be taxed under Connecticut's rules.[5]

The last Noonan's Notes on this topic addressed one problem that arises because of the limitations inherent in these credit statutes. If a taxpayer is deemed a resident of both New York and Connecticut, double taxation will exist to the extent of taxes on unearned income, since both states will claim a resident was properly taxed on that income. But we have already whined about . . . er . . . discussed that problem in prior articles. What we focus on here is more a practical problem that arises in audits of residents in both New York and Connecticut.

New York's Resident Credit Audits

The New York issue is fairly straightforward. In recent years, the Department of Taxation and Finance (one upstate district office in particular) has been opening up personal income tax audits of resident taxpayers. That is a bit of a departure from normal residency audits, which generally focus on a nonresident's potential status as a resident. But these resident audits focus on one thing: the amount of resident credit claimed by the taxpayer for taxes paid to other states.

> ***Some New York resident audits focus on one thing: the amount of resident credit claimed by the taxpayer for taxes paid to other states.***

Here is a typical scenario: Joe Taxpayer lives in Westchester, N.Y., and works for a company just over the state line, in Stamford, Conn. Although Joe is generally a 9 to 5, Monday through Friday employee, every few weeks he takes a business trip to visit an affiliate company in Florida. Those trips usually last a few days. By the end of the year, Joe has about 250 total workdays, with around 30 of them spent in Florida. He also took the occasional trip into New Jersey or New York City for meetings. Joe's employer withholds full Connecticut tax on his wages, and Joe files a nonresident return in Connecticut, reporting and paying full tax on his wages. He also claims a credit for the Connecticut taxes on his New York resident return.

Enter the New York auditor. Of course, the first question the taxpayer is going to ask is, "Why is New York bothering me?" The taxpayer filed as a New York resident and paid tax on all his income. Well . . . almost all his income. My guess is the tax department dislikes that the taxpayer was able to significantly reduce his New York resident tax liability by claiming credits for taxes paid to Connecticut. So the New York auditor is questioning whether those credits were appropriate. And the New York auditor is focused like a laser on one question: Was the tax paid in Connecticut on purely Connecticut-source income? The answer is actually obvious — no, it was not. Although Joe did work for a Connecticut employer and was based primarily in Connecticut, he also worked in some other locations. He spent a few weeks in Florida every year, he took the occasional trip into New Jersey for a meeting, and he took more regular trips into New York City for a meeting here or there. Herein lies New York's problem. New York's position is that the taxpayer *overpaid* his tax in Connecticut because, as a nonresident, he was liable to pay Connecticut tax only on income derived from workdays in Connecticut. Thus, New York will limit the claimed resident credit to the amount of tax that New York believes *should have been paid* to Connecticut. To do that, they will examine the taxpayer's expense reports, calendar, credit cards, and so on — all to glean how many days the taxpayer did not work in Connecticut.

Surprisingly, we aren't really going to take aim at the New York tax department's position on this issue. We get it. The tax department is simply applying the rules as they exist on the books. That said, it's obvious that this can be a real hassle. For instance, in my example above, it's one thing to say that Joe Taxpayer should not get credit for taxes paid to Connecticut in connection with the several weeks a year he spends working in Florida. That is understandable. But it gets difficult when the New York auditor starts querying whether and to what extent the taxpayer "popped in" to New York City (or state) for a meeting, or for a dinner, an event, and so on. In these cases, you might have a taxpayer stopping into the New York office for a one-hour meeting in the morning or for a company event in the evening. In the audit, the auditor will claim that no tax should have been paid to New Jersey or Connecticut as a result of that day — or a portion of that day — because a portion of the day was "worked" in New York. So this can end up being a real hassle. Again, we're talking about taxpayers who are paying resident tax on all their income and simply requesting a credit. Do you start allocating

[4]20 NYCRR 120.1(a)(2); 20 NYCRR 120.4(d).

[5]Conn. Gen. Stat. section 12-704(a); Conn. Agency regs. 12-704(a)-4(a)(3).

days based on hours? Or half days? Be on the lookout for these difficult audit issues.

Twice as Taxing: Problems in Connecticut

But we have seen a more frustrating problem arise in Connecticut. As outlined above, Connecticut's statute is similar to New York's: Connecticut will allow residents a credit for taxes paid to another state, but only to the extent the tax was paid on income sourceable to that other state, under Connecticut's sourcing rules. In the normal situation in which a Connecticut taxpayer files returns in various states and pays taxes on source income, my guess is that this is not much of a problem. The problem we are seeing relates more to after-the-fact credit claims, normally arising after the taxpayer is audited by another state and pays taxes there. And of course, no news flash here, most of the time we are dealing with those unlucky fellows who were audited by New York and forced to pay some additional tax after audit. Undoubtedly, those taxpayers will go back to their home state of Connecticut and claim a credit for taxes paid to New York. Here's where we find the problem.

First, however, it is important to note one helpful and taxpayer-friendly aspect of Connecticut's resident credit provisions. Connecticut has a three-year statute of limitations; an amended return or refund claim must be filed within three years of the due date of the return or the date the return was filed. But Connecticut provides for an extension of time in situations in which a taxpayer is attempting to claim a credit for taxes paid to other states after an audit. Connecticut allows a taxpayer to file a refund claim at any time if it is because of taxes paid to another state after audit, as long as that amended return or refund claim is filed within 90 days of the close of the other state audit.[6] As Bill Murray's character, Carl Spackler, said in *Caddyshack*, at least Connecticut's got that going for it, which is nice.

> ***What's not so nice is how Connecticut treats its residents after they have endured a long and difficult New York audit.***

But what's not so nice is how Connecticut treats its residents after they have endured a long and difficult New York audit. Here's an example of a specific situation we have seen numerous times over the past few years:

> **Example:** Jill Taxpayer lives in Connecticut and works for a company headquartered in New York. Her main office is in New York, but she does some traveling throughout the year to other offices. On her New York return for the 2008 tax year, she allocated 60 percent of her wage compensation to New York, claiming 150 out of 250 workdays in New York. She computed this workday fraction after reviewing her calendar at the end of 2008, giving a pretty close approximation of what she felt were the number of workdays inside and outside New York during the 2008 tax year. Sure enough, a couple of years later, New York opens up an audit to question whether she properly reported workdays in and out of New York in 2008. And as is often the case, it turns out that under closer examination of the taxpayer's calendar, credit cards, E-ZPass, expense reports, and so on, Jill understated the number of days she worked in New York. So as a result of the audit, the New York tax department determined that since Jill could not prove she was working in other states on 40 of the claimed 100 workdays claimed outside New York, she owed some additional tax to New York.
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> So what happens next? Jill Taxpayer files an amended return in Connecticut, claiming an increased resident credit for the taxes paid as a result of the New York audit. And undoubtedly Connecticut immediately opens up an audit of this taxpayer to address general items on the return as well as to focus on the amount claimed as credit for taxes paid to New York. In the past, those queries focused specifically on the convenience rule problem, to determine if the taxpayer was attempting to claim credit for days taxed by New York under the convenience rule. But now the queries are even more specific, with auditors wanting proof that the taxpayer actually was working in New York on the additional 40 days picked up in the New York audit.

And here is where the situation gets ridiculous: The reason why the taxpayer paid additional taxes to New York as a result of the New York audit was because the taxpayer could not prove *she was working somewhere else* on the days in question. By default, therefore, since she was based in New York, the days get treated as New York days, even if there is no specific evidence of New York work. But when Connecticut gets the case, it will deny the taxpayer credit for the tax paid in New York unless she can affirmatively prove *she was working in New York* on the specific 40 days in question! That, of course, is often difficult, because there might not always be specific proof of New York work on a regular day worked in the office. Also, the taxpayer was just taxed by New York because she couldn't prove she

[6]Conn. Gen. Stat. section 12-704(b).

was working outside New York. If Jill couldn't prove she took a work trip on a particular day, wouldn't that mean she was working in her New York office?

It is diabolical. And to us it seems as if states are going too far in their aggressive attempts to extract more revenue from their own residents. And, by the way, our view is that Connecticut's position is actually inconsistent with its own statutory provisions. As we discussed earlier, Connecticut uses its own rules to determine if income is sourceable to another state and subject to income tax. Those rules tell us that if a taxpayer has a primary work location in the state and can't show that she worked elsewhere, the day will be treated as a Connecticut day. New York has the identical rules. So in Jill Taxpayer's case, if New York is treating "unknown" days as days worked at her primary work location in New York, Connecticut should abide by that finding, since it has the same rules.

Conclusion

Even for tax nerds like us, sometimes it's hard to get excited about the fascinating world of resident credits. But when tax administrators start taking the rules to the extreme, it's time for attention. It's already bad enough that double taxation arises for taxpayers living or working in multiple states. But it's worse when states take the most aggressive and constricted view of their own resident credit statutes, making it even more likely that double taxation will occur. ✰

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