Personal Income Tax Update: Residency, Nonresident Allocation & Flow Through Entities

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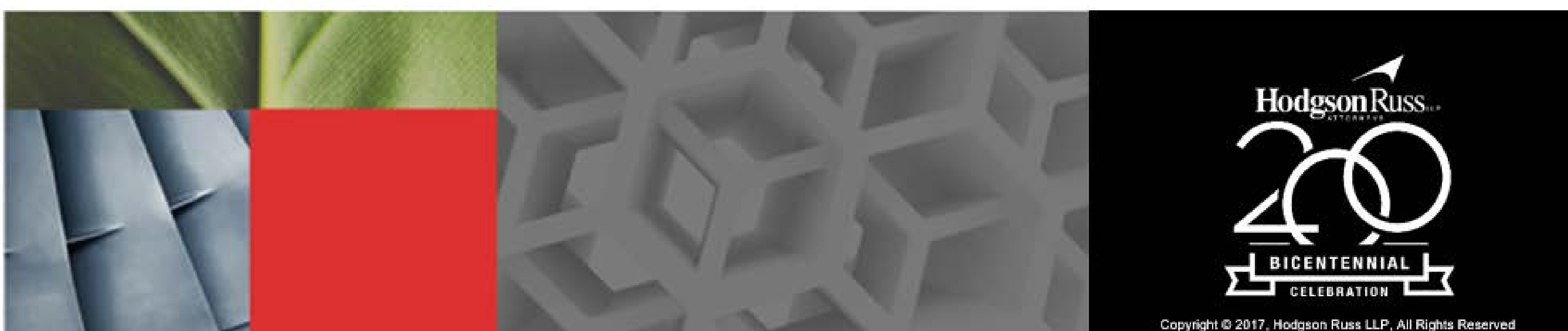

Topics

- Residency Rules Refresher.
- Case Studies (Ever hear of *Gaied*? Just kidding).
- Resident Credit Issues/*Wynne* Update.
- Nonresident Allocation Issues
- Flow-Thru Entity Issues

Residency

Residency – Facts and Figures

- **2016 NYC Comptroller Report:** ***The Increasing Concentration of High Income Taxpayers in the New York Economy***
  - 43% of US Taxpayers with income > $10MM reported some NY source income
  - In 2014, *half* of NY taxpayers with > $720K income were (or claimed to be) nonresidents!
  - Nonresidents earned more than $90B in NY income in 2014 ($68B in NYC alone)!
- **What could this mean?**
  - More audits? Are these folks really nonresidents?
  - Even more taxpayers? How many other non-filing nonresidents are there?
  - Re-birth of NYC nonresident tax?

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Residency Audits
How they find you!

Year of residency change — almost automatic

Substantial difference between federal and state income

Answer to “living quarters” question

Number of days in NY on return

Past audit history

Cross-check with real property records

Any STAR or NYC parking exemptions

NY addresses reported on a Form 1099 or K-1

All press is not good press

Unhappy ex-spouse

Audits of related parties, partners, etc.

Whistleblower

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Residency Basics

- **Importance of Residency Status**
  - Residents: The One Thing
  - Nonresidents: NY source income
  - NYC tax: All or nothing

- **The Two Residency Tests**
  - Domicile
  - “Statutory” Residency

Domicile: What is it?

Domicile – General Principles

- Burden of Proof: “Clear and Convincing Evidence”
- The 5 Factors
- KEY: Focus on change in lifestyle, and tell a compelling story. See *Blatt* (ALJ, Feb 2016).
- Foreign domicile changes could be tougher? But, maybe not. See *May* (ALJ, Jan 2015).
- And if you can’t do it, look to 30-day rule or 548-day rule!

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Statutory Residency - Overview

➢ The Statutory Residency Test: 2 Components

1. 183 days

   AND

2. A Permanent Place of Abode (“PPA”)

+

Statutory Residency – Day Count

- Factor #1: Day Count

1. A “day” in New York: a minute is a day

   -- Part day = full day*: Zanetti v. NYS Tax Appeals Tribunal*, 8 NYS3d 733 (3d Dept. 2015)

2. Only two exceptions: travel & medical
3. Burden of Proof: the importance of record keeping (see next slide)
4. Use of testimony/statements

Statutory Residency
Day Count Records

Credit card statements	ATM usage	Personal diary	Outlook calendar
Flight records (frequent flyer reports)	EZ Pass	Limo logs	Landline phone
Cell phone logs!!	IP address?	**Monaeo**	**Swipe Card records**

Statutory Residency – Permanent Place of Abode (PPA)

- Factor #2: A “Permanent Place of Abode”
  - Any type of dwelling
  - The “11-month” rule
  - “Unfettered” access: habitability issues; no key?
- Cases/Rulings
  - *Knight*: girlfriend’s place/corporate apartment
  - *Barker*: vacation cottage = PPA
- Gaied v. NY
  - Enough already . . . .

David and Karen Sobotka (ALJ, 8/20/15)

- Statutory residency does not trump domicile!
- Taxpayer moved into NYC in August 2008, but also (allegedly) maintained a PPA for the whole year and spent more than 183 days here.
  - Is he a stat res?
  - ALJ holds that the “statutory” resident provision in the Tax Law (Tax Law § 605[b][1][B]) only applies to taxpayers who are “not domiciled in New York,” and since it is undisputed that Mr. Sobotka was domiciled in New York during part of 2008, one of the three requirements of the statutory resident test is not met.
  - Only days in the nonresident period of the year can be “counted” towards the 183 day rule.
- Tax Department did not appeal; taking contrary position in current audits.

Residency Case Studies

Resident Credit Issues
Wynne Update

Resident Tax Credits
The Basics

- States generally tax their own residents on all income, regardless of source
  - Residents are taxed on <u>one thing</u>
- Nonresidents only taxed on income from in-state sources
  - Wages for in-state services
  - Income from in-state business
  - Income from in-state property

Resident Tax Credits
The Basics

- Important Limitations
  1. Different sourcing rules
     - Example
       - NY will only give credit for taxes paid to other states on income from sources in that state — determined under NY's sourcing rules!
     - Convenience Rule Problem
     - Taxes paid on flow-through income? Questions of sourcing look to whether the *type* of income is taxed, not *how* it is taxed.

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Resident Tax Credits
The Basics

- Important Limitations
  2. Statute of Limitations Issues
     – NY audits can drag on…and on.
     – Pay attention to state of residence's rules regarding amending resident credit claimed.
     – Common pitfall: was a resident credit claimed on originally-filed return?
  3. Resident Credit on Intangibles?
     – New York says no credit for tax paid to other states on non-source income.
     – Application of *Matter of Wynne?*

Wynne v. Maryland, 2015
US Supreme Court Decision

- **Facts**: Taxpayer lived in MD, had S corp income from lots of states; MD allowed credit for tax paid to other states against STATE tax, but not against LOCAL tax
- **Held**: The double tax arising from Maryland's resident credit scheme was unconstitutional, in violation of US Commerce Clause; first time Court applied Commerce Clause to pure income tax scheme
- **NY Implications?**
  - Double taxation of NYC stat residents? (*See Chamberlain v. NYS*, pending in Albany county supreme court)
  - No resident credit against NYC tax?

Nonresident Allocation

Director’s Comp.

- Generally paid on 1099 and reported on “other income” line.
- Auditors don’t seem interested in understanding whether there are different components of compensation (i.e., standard fees, stock-based awards, etc.).
- New York requires nonresidents to allocate board compensation like a W-2, salaried employee (days in/out during the current year).
- However, generally only count the days where there are board meetings and not time spent preparing for board meetings.
- Some inconsistency in audit treatment here, but seems most auditors do not count out-of-state attendance by telecommuting as a New York day.

Convenience Rule

- Continued area of interest for auditors.
- Generally rule is pretty straightforward, nonresident taxpayers who work for a New York-based employer must count the days worked from their non-New York home for their own convenience as New York workdays when allocating wage income.
- Seeing some interesting audit issues here:
  - Someone who works from their residences both within and without NYS.
  - Multiple bona-fide offices.
  - Telecommuters who rarely (or never) visit NY home office.
- Remember the potential resident tax credit implications if the taxpayer is a resident of a state that does not have the convenience rule (i.e., Connecticut).

Multi-year Allocation

- Counting Days
  - All W-2 compensation gets allocated based on workdays in New York over total workdays during the relevant sourcing period.
  - Rules for counting days here different than for statutory residency. Part days are allowed, but some work must be performed in two locations to receive part-day treatment.
  - Often, taxpayers receive W-2 compensation that was earned over the course of multiple tax year.

- Form IT-203-F – new form issued by NYS in 2015 for use in allocating multi-year compensation. Big improvement over IT-203-B, which didn't really allow for this.

Multi-year Allocation

- Deferred Compensation
  - First question should always be "is it exempt retirement income under 4 USC 114?"
  - If not, it is allocable to NYS to the extent prior services were performed in NYS.
  - Sourcing period for workdays will depend on what type of compensation it is.
- Stock-based compensation (i.e., restricted stock or options)
  - Taxed as ordinary income in the year of vest.
  - Allocated to New York based on workday allocation formula during the grant-to-vest period.
- Termination Pay/Severance/Non-Compete
  - Like deferred comp, allocable to the extent prior services were performed in NYS.
  - NYS takes the position that it gets allocated on a comp-to-comp method over year of termination + 3 prior years. But is that right?

Flow-Through Entity Issues

Flow-Through Topics

- New York State Taxation of S Corporations and their owners
- New York State Taxation of Partnerships/LLCs and other owners
- Other Flow-through Issues

Taxation of Resident Individual Owners

- Easy! Residents are taxed on one thing
- Resident owners are taxed on federal taxable income with state modifications

Taxation of Nonresident Individual Owners (S Corporations)

- Allocation and Apportionment
  - Use Article 9-A rules to determine source of income
    - Single-factor, receipts-only apportionment
  - Comparison with LLC/Partnership Rules
    - More on this below
  - S Corporations have the obligation to withhold and remit estimated taxes on behalf of nonresident owners who will have a tax liability to New York form flow-through items of at least $300
    - Waivers are available
    - Tax Law 658(c)(4); TSB-M-04(1)I; Form IT-2658.

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2015 Law
Market Based Sourcing for All Receipts

- Services will now be sourced to the location where the services are delivered, not where the services were performed
- If the delivery or access point is unknown, the customer's billing address/zip code can be used
  - Last year's apportionment factor can be used as a last resort
- Digital products and receipts from "other business receipts" sourced as follows
  - Location of primary use
  - Location where product is received by the customer
  - Prior year's apportionment factor for the digital product
  - Current year's apportionment factor for other digital products that can be sourced using the hierarchy

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2015 Law
Special Rules for S Corporations

- Unlike C corporations, S corporations must include <u>all</u> receipts in the apportionment fraction
- This includes income that would otherwise be exempt from taxation but for the 8% limitation on investment income
- Thus, S corporations may have more receipts in the denominator of the apportionment fraction than C corporations

Special Situations
Hybrid Corporations (Federal S/NYS C)

- Taxation of Entity – Hybrids are taxed like regular C corporations under Article 9-A
- 2007 Legislation – Hybrid S corporations are no longer allowed if the S corporation's investment income for the current year exceeds 50% of its federal adjusted gross income
  - Definition of "Investment Income"
  - Because shareholders may not know whether a mandatory S election will be required until the end of the S corporation's tax year, estimated tax rules are relaxed for affected S corporation shareholders
- 2017 Budget Proposal to eliminate hybrids did not pass
- Resident shareholders of hybrid corporations may <u>not</u> take a credit on their personal income tax returns for taxes paid to other jurisdictions on flow-through income

Special Situations
Special Sourcing Rule

- Real Property Sales
  - The sale of an interest in a partnership, limited liability company, S corporation that owns real property located in New York State if the value of the real property exceeds 50 percent of the value of all of the assets in the entity
  - For sales of entity interests occurring on and after May 7, 2009, the gain recognized on the sale of an interest in that entity will be allocable by a fraction. The numerator is the FMV of the property on the date of the sale and the denominator is the FMV of all the assets in the entity on the date of sale.
  - Applies to LLCs and Partnerships too
  - Constitutional issue? *See Corrigan v. Ohio*.

New York State Taxation of Partners/LLC Members

- Taxation of Resident Individual Owners
  - Resident owners are taxed on modified federal taxable income
- Taxation of Nonresident Individual Owners
  - Nonresident owners are taxed (in effect) only on New York source income
    - Allocation and Apportionment – Partners use a *different apportionment approach* than S corporation shareholders
    - Direct Accounting (Preferred Method); OR
    - Three-Factor Formula (property, payroll, gross income)

New York State Taxation of Partners/LLC Members
'Direct Accounting' Example

- ABC Partnership is a law firm with offices in New York City, Chicago and Los Angeles
  - Based on its own books and records

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

- John Marshall is a partner working out 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 x 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

New York State Taxation of Partners/LLC Members

- Three-Factor Method
  - Property Factor
    - Includes real property RENTED to the taxpayer and used in the business as well as owned real and tangible personal property (including inventory).
    - Payroll Factor
      - Does not include payments to contractors
    - Gross income
      - Origin-based, not market-based:

“all sales negotiated or consummated, and charges for services performed, by an employee… or independent contractor chiefly situated at, connected by contract… or sent out from offices, branches of the business or other agencies, situated within NYS.”

Other Issues for Partners/LLC Members

- Special sourcing rule for real and tangible property
  - Gains and losses from the ownership of real and tangible property are allocated (and not apportioned) to the location of the state where the property is located
    - Tax Law Sec. 631(b)(1)(A)
  - This also applies to real estate operated as a business (e.g., a hotel)
    - *Linde* (TAT May 24, 2012)

Other Issues for Partners/LLC Members

- Distributive share of income
  - Partners have to use entity's allocation, NOT their own workdays
- Guaranteed Payments
  - Allocated the same as distributive share
- Retirement Payments to Nonresidents
  - Also covered by special federal exemption
- Limited and "Nonequity" Partners
  - No distinction between Ltd and General partners
  - Nonequity: If you get a K-1, you are a partner (Tosti)

Other Issues for Partners/LLC Members

- Sales of partnership/LLC interests
  - Generally not taxable, as sale of intangible
  - But see prior slide re: real property sales
  - New budget legislation: IRC 1060 Transactions
    - If IRC § 1060 is in effect and buyer gets basis step-up, the gain recognized by the nonresident partner will be treated as New York source income "allocated in a manner consistent with the applicable methods and rules for allocation under this article . . ."
    - Provision went into effect with passage of budget in April

Other Issues for Partners/LLC Members
Statute of Limitations Issues

- From the Guidelines

> "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 files their own returns."

- But if partner being audited, no waivers needed for partnership, since the return is information only

Other Issues for Partners/LLC Members

- Taxation of Corporate Owners
  - Corporate owners generally take into account the partnership tax attributes on an *aggregate* basis
  - Thus, the Department treats items of income, gain, loss and deduction and tax attributes as being passed through to corporate owners pro rata

Other Issues for Partners/LLC Members

- Corporate Partners
  - Corporations that are partners in a partnership doing business in New York are subject to tax under the Article 9-A rules
- 2015 Law
  - Economic nexus (more than $1MM in NY receipts) determined by combining corporate partner's NY receipts and partnership's NY receipts (NOT corporate partner's share interest of receipts!)
  - Corporate partner with NY nexus required to get apportionment info from partnership (see new K-1 form)

Other Issues for Partners/LLC Members

- Taxation of SMLLCs
  - Generally are disregarded for income tax purposes; Treated as sole proprietorship
  - New legislation: Tax Law § 43
    - SMLLC must also be disregarded for purposes of determining whether the taxpayer that includes the SMLLC satisfies the requirements to be eligible for tax credits
    - If the taxpayer is the sole member of multiple LLCs, the sole member and all LLCs are treated as a single entity.

Offshore Deferred Compensation Under IRC §457A

- IRC §457A requires service providers who deferred compensation into an offshore fund prior to 2009 to recognize that income before the end of 2017
- Frequently used in hedge fund structure where service provider is a flow-through entity
- Deferred fees are ordinary income
- No clear guidance from NYS as to how to apportion those fees
- TSB-M-10(9)I suggests that NYS might use BAP from year earned but is there a statutory basis for this approach?

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New York City Issues

- NYC taxes flow-through entities at the entity level
- Currently 3 separate regimes
    - New Corporation Business Tax for C corporations (like new Article 9-A)
    - Old General Corporation Tax for <u>federal</u> S corporations (like old Article 9-A)
    - Unincorporated Business Tax for partnerships/LLCs
- Three-factor formula completely phased out by 2018. Receipts only going forward