Working from Home

State Income Tax Complications

By Mark S. Klein, Joseph N. Endres, and Tyler J. Gately

The coronavirus (COVID-19) pandemic triggered an exodus of workers from their comfortable offices to the safety of their homes and other remote locations. For some, this displacement is temporary and will end when the pandemic subsides; for others, the ability to work remotely represents a paradigm shift that may be felt for many years to come. This article explores some of the state income tax issues created by the relocation of workers.

Residency-Domicile

One common issue involves residency and the "leave and land" rule used by most states to establish a change of domicile. Under this rule, a taxpayer must both "leave" her old place of residence and "land" in her new home. A temporary departure, no matter how long, will not qualify. The landing has to represent a permanent (or at least indefinite) move. If a taxpayer returns to her original home after the pandemic, an auditor will surely use "20/20 hindsight" to suggest that the original departure was temporary. The consequences of this rule can be quite significant, because a domiciliary of a state can be subject to tax on worldwide income, regardless of where the taxpayer has been spending time.

Case Study 1. A husband and wife, New York City residents, departed for their home in the Hamptons in March 2020. Their children continued their New York City–based schooling through remote learning and the parents have no plans to return to their New York City apartment until sometime in 2022, once things return to "normal." It is clear that this couple, who have not been in New York City since March 2020, will continue to be subject to New York City taxes on their worldwide income. Although they clearly left New York City, they did not "stick the landing" (i.e., relocate permanently) in the Hamptons due to their intent to return. Many taxpayers are surprised to learn of this result.

Case Study 2. Kathy is a New York domiciliary who moved to Florida to stay with her parents during the pandemic. She planned to move back to her apartment in New York City after the pandemic subsided, but she enjoyed life in Florida and decided to make it her permanent home. She terminated her New York City lease and acquired her own abode in Florida.

As noted in Case Study 1, Kathy would continue to be a domiciliary of New York City until she decides to make her move to Florida permanent. Although Kathy ultimately changed her domicile, tax practitioners are required to identify and report the exact date that residency changed. Under the law, Kathy's domicile changed once she decided to remain in Florida permanently. But Kathy must demonstrate by "clear and convincing evidence" that she intended this change of residence. Because no one can read her mind, auditors will look at objective evidence to see if and when it reflects her stated intention. Auditors will want to know when Kathy terminated her New York City lease, when she packed her belongings and moved them to her new home, and the date she acquired her own place in Florida. Contrary to common belief, most auditors are unimpressed by taxpayers who merely change their driver's license and voter registration to a new state.

The burden to prove a change of domicile is on the taxpayer; the stronger the evidence, the easier it will be to succeed in an audit.

Statutory Residence

In addition to taxing domiciliaries, most states also have a rule that allows them to tax nonresidents on their worldwide income if a they maintain living quarters within the state and are physically present in that state for more than 183 days. In New York, this rule also trumps domicile.

01-02-2022News&Views.indd 10 2/16/22 12:01 PM

Case Study 3. In October 2021, Stephen decided to sell his investment in Bitcoin. He and his spouse (and the family dog) moved to Texas, enrolled their kids in a Texas school and did not return to their New York City apartment until the summer of 2022, for a two-month vacation, before returning to Texas for the next school year. On December 1, 2021, Steven sold his Bitcoin for a large profit.

Stephen and his family undoubtedly changed their domicile to Texas in October 2021. Although the Bitcoin sale did not occur until December, Stephen will most likely still owe tax to New York State and New York City on the entire gain. This is because, during the 2021 calendar year, he was probably in New York more than 183 days while maintaining living quarters there for the entire year. Even though Stephen changed his domicile to Texas, his residency, for New York tax purposes, was still in New York, at least for 2021. And because he continues to maintain the New York City apartment, he will be taxed as a New York State/City resident for any year that he spends more than 183 days in New York State/City.

Case Study 4. Jessica and her spouse left New York for their Connecticut beach house in March 2020, with no plans to return to New York until 2023. Once again, the couple will be taxed by New York for their entire stay in Connecticut since they did not "stick the landing" (i.e., relocate indefinitely to Connecticut). But like New York, Connecticut also has a rule that imposes tax on nonresidents who spend more than 183 days in the state while maintaining living quarters there. Here, because Jessica and her husband were domiciled in New York, the Empire State will tax them on their worldwide income. Unfortunately for these taxpayers, Jessica and her husband are also considered statutory residents of Connecticut, taxable by Connecticut on their worldwide income. And although Connecticut and New York will each provide a credit for taxes paid on income earned in the other state, all of their intangible income (interest, dividends, capital gains on stock sales) is subject to tax in both states, with no credit available for taxes paid to either state.

Interestingly, Connecticut is well aware of the fact that many New Yorkers spent too much time in the state during 2020 and has targeted property owners in Connecticut who did not file Connecticut resident returns in 2020. Many of these taxpayers are receiving a letter from the Connecticut Department of Revenue Services that includes a reminder of how Connecticut applies its 183-day rule. Connecticut also recommends that taxpayers who spent too much time in the state consider filing resident returns under Connecticut's recent amnesty program, which was available until January 31, 2022.

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New York Desk Audit Initiative

With so many New Yorkers leaving the state during the pandemic, there has been an increased focus by the New York State Department of Taxation and Finance on taxpayers who changed their residency status in 2020, or who reported less New York–sourced income in 2020 than in 2019. This has turned into a major new desk audit initiative where over 100,000 taxpayers have received an inquiry letter asking for more information about their residency status and income allocation during the 2020 tax year.

Typically, a taxpayer will receive a letter, either a Form DTF-948 or DTF948O, "Request for Information." The questions seem innocuous enough, but most preparers believe that taxpayers' responses will be used to identify strong candidates for a follow-up and detailed field audit. In other words, this new initiative seems to be an initial attempt by the state to triage the large number of taxpayers who have either claimed to have left the state or are reporting significantly less New York–sourced income.

Taxpayers and their representatives need to be very careful how they respond to these seemingly innocent inquiries because, as they say in movies, "anything you say can and will be used against you." And, as we all know, you can't "un-ring" a bell.

New York's Convenience Rule

Even if taxpayers have changed their tax residence, there is still an issue of how much income earned by nonresident taxpayers is taxable by New York State. A previous article by the authors discussed some of the tax implications of COVID-19 telecommuters ("Tax Implications of COVID-19 Telecommuting and Beyond," https://bit.ly/3mXWnMk) but New York's "convenience of the employer rule" existed well before the pandemic, and

01-02-2022News&Views.indd 11 2/16/22 12:01 PM

will continue to impact nonresidents going forward. Under this doctrine, the sourcing of employment compensation earned by a New York–based employee depends on why the employee worked out of state. If the employee was working remotely for her own convenience, then the compensation defaults to her New York employer's location; however, if she was working remotely by necessity, the income will be sourced to the employee's physical location. For employees working remotely as a result of the pandemic, the question is: what is considered "necessity"?

At the beginning of the pandemic, only essential workers were permitted to work on-site in a New York employer's office. The remaining nonessential workforce was prohibited from entering their offices. In spite of this, New York State has taken the position that employees who worked from home during this period are subject to the convenience rule and that the income defaults to the employer's location. So, if an employee of a New York–based business lived in Connecticut and historically commuted to New York before the pandemic, the governmental prohibition from entering the New York office during the pandemic is still subject to the convenience rule in the eyes of the New York taxing authorities. Quite frankly, it is hard to understand how an employee's work from home was not based on necessity when it was illegal for them to enter their New York offices. This issue will most certainly be played out in the courts.

It is important to recognize that there is an exception to the convenience rule that applies to nonresidents who did not work a single day in New York State during a calendar year. Pursuant to *Hayes v. State Tax Commissioner* [401 N.Y.S.2d 876 (3d Dep't 1978)], "a non-resident 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." Consequently, when a nonresident performs no services in New York, the convenience rule does not apply. [There are other planning opportunities to avoid New York's convenience rules as well; for example, see TSB-M-06(5)I.]

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Case Study 5. Before the pandemic, Aaron lived and worked in New York City. In early 2020, he moved out of his New York City apartment, terminated his lease, and began working remotely from his mountain home in Colorado. By April 2020, he had taken sufficient steps to change his domicile to Colorado. His New York office remained open during the pandemic, but most employees worked remotely in different states across the country. Aaron has not worked in New York since 2020, and his employer is fine with this arrangement.

In this case, New York will take the position that the convenience rule applies to all of the work performed by Aaron in 2020, even though he left New York and never returned. This assumes that Aaron had no business purpose for working from Colorado that would transform the situation from one of convenience to one of necessity. Regardless of the convenience/necessity dichotomy, however, the convenience rule should not apply to any work performed in 2021, because Aaron did not work in New York for even a single day.

The most difficult aspect of this example is that although New York State will continue to tax Aaron throughout 2020, the state of Colorado believes it has every right to tax him whenever he is physically working in Colorado. Like many states, Colorado does not respect New York's convenience rule and believes it has every right to tax its residents on income earned from services performed in the state while not allowing a resident credit if another state seeks to tax that income. This leads to a very difficult situation, where an employee of a New York business could potentially be subject to double taxation on income earned in another state.

A Mass Exodus?

According to the U.S. Census Bureau, New York lost more than 319,000 residents (1.6% of its population) between June 2020 and July 2021 (https://bit.ly/3t4B1j0). This was a greater loss than any state in the nation. This mass exodus has created a myriad of residency-related questions and issues. Tax preparers need to be aware of the state income tax consequences for the common circumstances highlighted above. Because the state tax world is continually changing, tax professionals will also want to be on the lookout for any changes to the taxing authorities' response to these unusual times. ■

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01-02-2022News&Views.indd 12 2/16/22 12:02 PM