The Nuts and Bolts of New York's Resident Credit

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In this edition of Noonan's Notes, the authors discuss New York's resident tax credit provision, advising that while it appears straightforward, there are a lot of nuances and special situations to consider when addressing a resident tax credit issue, especially in the context of a state tax audit.

We often cover the trials and tribulations of nonresident taxpayers facing residency and income allocation audits, which are a significant focus of the New York Department of Taxation and Finance's audit activity. But we've also recently seen a focus on audits of New York residents as well — usually on the complex issues surrounding resident tax credits.

A common refrain in the state income tax residency world is that "residents are taxed on only one thing: *every* thing." As much as we like this statement, which captures the impact of a state-level residency determination, it can be too simplistic. A taxpayer's state of residency will generally offer some tax credit against the tax it imposes on its residents for taxes that they pay to other states. In New York, residents are entitled to a credit against their New York personal income tax for taxes they paid to other states on income properly sourced to those states.

But like most state tax issues, it's a lot more complicated than that. This piece outlines many issues with resident credits that we see in New York income tax audits.

I. Introduction to the Credit

Before getting into the nuances of New York's resident tax credit provision, we need to lay the groundwork. New York taxes its residents on worldwide income regardless of source. However, residents are allowed a credit for taxes paid to other states. Under Tax Law section 620(a), a New York resident taxpayer is entitled to a credit for taxes paid to another state (or a locality within that state, the District of Columbia, or a province of Canada) on income that is both derived from that state and taxed by New York.

A resident taxpayer must prove three things to receive a resident tax credit: (1) that the income was subject to tax by another state or locality, (2) that the income was "derived from" the other state, and (3) that the income was subject to tax under article 22 of the New York Tax Law.[1] Generally speaking, the first and third requirements are fairly straightforward. However, in determining whether income was derived from the other state for purposes of its resident tax credit, New York uses the definition of New York-source income in Tax Law section 631.[2] In other words, New York will determine whether the income at issue was derived from the other state by applying *its own* income-sourcing rules — not those of the other state. As a result, New York limits its resident tax credit to those same items of income that would be taxable to a nonresident of New York (that is, wages, business income, income from real property, etc.). More on this in the next section.

There are other limitations on New York's resident tax credit.[3] First, the credit cannot be larger than the taxes payable to the other tax jurisdiction. Also, the amount of the resident tax credit cannot reduce the New York tax payable to an amount less than would have been due if the income subject to taxation by the other state was excluded from the taxpayer's New York income. In other words, the resident tax credit is not refundable.

II. Special Situations

So that gives us the basics of how the credit mechanism works. Now comes the fun part.

A. Audits of Resident Taxpayers

New York's nonresident audit program focuses on nonresidents, but as noted, we've seen an increase in audits of New York residents — specifically to focus on the propriety

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[1] *Matter of Jane A. Mallinckrodt,* DTA No. 807553 (Tax Appeals Tribunal 1992); 20 NYCRR 120.1.

[2] *See* 20 NYCCR 120.4(d).

[3] *See* 20 NYCCR 120.2.

of the resident tax credits they claim for taxes paid to other states. More specifically, the tax department focuses on whether New York residents have properly sourced the income on which they have paid tax to another state and for which they have claimed the resident tax credit in New York. And in a lot of those audits, as the tax department likely has experienced, taxpayers have been overstating resident tax credits because of limitations inherent in New York's rules.

The most obvious example involves a taxpayer who lives in New York but works in a neighboring state such as Connecticut. Under Connecticut's rules, a nonresident taxpayer is required to pay personal income tax on his Connecticut-source income, including the wages he receives for his Connecticut work. In most cases, that means that the taxpayer's in-state employer will withhold Connecticut tax on 100 percent of his wages. As a result, the taxpayer will often report and pay tax to Connecticut on 100 percent of his wages when filing his state nonresident income tax return. The eventual New York audit of that resident taxpayer will ask whether Connecticut tax was properly paid on 100 percent of the taxpayer's wage income. And if, for example, the employee traveled 25 percent of the time for work outside Connecticut, then technically he should have only paid Connecticut tax on 75 percent of his Connecticut wages. In this situation, New York will only allow a resident tax credit for 75 percent of the tax paid by that taxpayer to Connecticut.

That doesn't mean that income automatically gets double-taxed. Indeed, if the taxpayer spent 25 percent of her time working outside Connecticut, then she should have only paid tax on 75 percent of her Connecticut wages as well. But that kind of adjustment would require the employee to amend her Connecticut return, and ideally the statute of limitations for that amendment is still open. Even then, it's not a wash, because New York would impose interest on the underpayment, while Connecticut would likely pay zero interest on the potential refund. Plus, there are statute of limitations issues here, as we will outline later.

B. Dual Residency Situations

Everything we discussed in the introduction applies equally to taxpayers residing in New York and another state. Dual residency situations arise most often in New York nonresident audits when a taxpayer domiciled in another state is found to be a statutory resident of New York. Dual residents are taxed on worldwide income in two states, but claim their relevant resident tax credits in both. When a dual resident claims a resident tax credit from New York for taxes paid to a nonresident state, the general rules are the same as those discussed earlier.

However, dual residents must often compute a credit for taxes paid to their other state of residency. Because dual residents of New York and another state often pay tax to their other state of residency on income for which a resident tax credit would not normally be allowed (that is, interest and dividends), New York requires that dual residents claiming the credit for tax paid to another state prorate the tax paid (that is, the number reported on line 24 of the IT-112-R) according to the following formula:

other state income subject to the resident credit /
(total income taxable by the other state x
total tax due to the other state)

Most importantly, when determining the "total tax due to the other state" for purposes of the dual resident tax credit formula, taxpayers should use the total tax due to the other state of residency before any credit previously claimed in that state for taxes paid to New York. This distinction is often missed by tax department auditors.

Consider a situation we see frequently: a taxpayer who files as a domiciliary of Connecticut, works in both Connecticut and New York, and is audited by New York and determined to be statutory resident of the Empire State. Because that taxpayer works in New York, he will have claimed a resident tax credit on his Connecticut resident tax return for tax paid to New York. As a result, the total tax he actually paid to Connecticut will likely be substantially lower than the tax due to Connecticut before the relevant credit claimed for taxes paid to New York. After determining that the taxpayer was a statutory resident of New York, the New York auditor must compute the applicable resident tax credits. If the auditor used the total tax actually paid to Connecticut, rather than the tax due to Connecticut before the application of the resident tax credit for taxes paid to New York, the taxpayer's New York resident tax credit for tax paid to Connecticut may be improperly limited. In short, this is something that practitioners should keep an eye out for when a dual residency situation arises.

C. Mixing and Matching of Sourcing Rules

As outlined above, one difficulty with the resident credit rule is that the state doesn't rely on the amount of tax paid by the taxpayer to the other jurisdiction when computing the credit. Instead, New York will only provide a credit for taxes paid to another state on income sourced to another state, but also with the caveat that when determining the source of the income, New York applies its own sourcing rules, not the other state's.

There are two examples worth considering. First, in one advisory opinion, a New York resident taxpayer paid taxes to New Jersey on slot machine winnings from a New Jersey casino. While that income is subject to tax under New Jersey's rules, New York would not tax a nonresident on slot machine winnings from a New York casino unless the taxpayer was engaged in the business of gambling. Thus, the New York resident in the advisory opinion was not entitled to a credit for the taxes he paid to New Jersey on his New Jersey slot machine winnings, despite the fact that New Jersey's rules required him to source that income to New Jersey.[4]

[4]*See* TSB-A-02(4)I.

Another example: Many other states do not employ a "convenience of the employee" test for determining workday location like New York does. Under New York's rules, days an employee works at his Connecticut vacation home are considered New York workdays if the employee's assigned or primary work location is at an established office or other bona fide place of business of the employer in New York.[5] However, Connecticut's rules require that employee to count the days worked at his Connecticut vacation home as Connecticut workdays, even though his assigned or primary work location was in New York. So a New York resident in this situation may be required to pay tax to Connecticut based on the number of days he physically worked at his Connecticut vacation home, without any offsetting credit in New York. Obviously, those are harsh results, but ones that arise as a result of different states' sourcing rules.

Interestingly, though, New York's nonresident audit guidelines point out one important exception to the general principle that New York's sourcing rules must be applied when determining whether income was derived from the other state. That exception generally arises in the context of taxes paid to other states on flow-through income, such as income from a partnership or S corporation.[6] In that situation, New York has pointed out that its regulation regarding the derivation of income "addresses only the *type* of income for which a resident would generally be allowed the credit and not necessarily *how* the income is calculated in the other state." (Emphasis in original.) Thus, in the example above, New York would not provide a resident credit for taxes paid on gambling winnings in the other state, because New York would not tax that type of income against its own nonresidents. But if the mismatch arises simply because of how New York would tax the income differs from the other state, then the rules get friendlier.

For instance, a New York resident taxpayer may pay tax to New Jersey on income that flowed through to him from a New Jersey partnership. Let's assume for this example that New Jersey would use single-sales-factor apportionment, resulting in the taxpayer paying $10,000 in tax to New Jersey under that formula. The partnership income was clearly derived from sources within New Jersey under New York's rules, because New York also requires nonresident taxpayers to apportion this type of flow-through income. However, New York would require a nonresident taxpayer to apportion income that flowed through to him from a partnership either based on the partnership's books and records or on a three-factor apportionment formula. And if, for example, we applied New York's three-factor formula to this hypothetical taxpayer to determine how much of this income was properly sourced to New Jersey, New York's rules may suggest that only $5,000 in tax should have been paid to New Jersey.

So is only $5,000 of the $10,000 in tax paid to New Jersey creditable under New York resident tax credit provisions? No. New York's audit guidelines indicate that regardless of what apportionment method the other state uses, a New York resident must be allowed a resident tax credit for the actual taxes paid to New Jersey in this situation and that a New York auditor should not attempt to "recompute the partnership income taxable by the other state using New York's rules." Again, the distinction here is that both New York and New Jersey tax this type of income. So since they both tax it, New York won't nitpick and further limit the resident credit based on how the respective states tax the income.

D. Resident Credit on Intangibles

This situation — our favorite issue — arises when a taxpayer is deemed to be a resident of both New York and another state based on alternative resident classifications. We usually see the situation arise when someone is taxed as a domiciliary of another state but is deemed to be a statutory resident of New York. Here, the New York statutory resident would receive credit for taxes paid to other states, even to his home state, on income that is properly sourced to those states. However, for non-source income — like interest, dividends, capital gains, and other intangible income — New York's position is that it is not required to provide its residents with a credit for taxes paid to other states on this intangible income. That position was upheld in the 1998 *Tamagni* case, in which a New Jersey domiciliary taxpayer who also qualified as a New York statutory resident challenged New York's failure to provide a resident credit for taxes paid to New Jersey on constitutional grounds.[7]

That's still the rule. However, we actually are relitigating that very issue in light of the U.S. Supreme Court's *Wynne* ruling.[8] The analysis of the constitutional issues by the Court in *Wynne* calls New York's position on this issue into serious question. Stay tuned for further details!

E. Statute of Limitations Issues

Because resident credit issues involve technical questions in two states, taxpayers and practitioners also need to pay special attention to statute of limitations issues.

Under the most common scenario, a taxpayer is under audit by New York, which determines that she did not properly allocate her income to New York and owes additional tax. While it's unfortunate that New York nonresidents have to pay additional tax to New York, they should be able to return to their home state and claim a credit for those

[5] *See* TSB-M-06(5)I.

[6] New York's Nonresident Audit Guidelines (June 2014), at 76-77.

[7] *Matter of Tamagni v. Tax Appeals Tribunal of New York State*, 91 N.Y.2d 530 (N.Y. 1998).

[8] *Comptroller of the Treasury of Maryland v. Wynne*, 135 S. Ct. 1787 (2015).

additional taxes, potentially subject to the same credit limitations. But make sure not to request those resident tax credits too late. In many states, the statute of limitations for filing an amended return is three or four years, which is not extended even if the change is brought on by another state's audit.

There are exceptions, however. In Connecticut, even if the normal three-year statute of limitations has expired, resident taxpayers may amend their Connecticut resident returns to increase their resident tax credit as a result of additional tax paid to another state via an audit — if they file within 90 days of the close of the other state's audit.[9] New Jersey has a similar taxpayer-friendly rule, and it does not even put a 90-day limit on the amended return. Under New Jersey's rules, there is no statute of limitations for taxpayers in that scenario.[10]

But be careful. Those statute of limitations rules only apply for a taxpayer who wants to change the amount of the resident tax credit originally reported. Thus, if the taxpayer wants to make some other change, such as switching residency status, that must be done within the normal statutes of limitations. Also, both Connecticut and New Jersey only allow resident taxpayers to amend the resident tax credit outside the normal statute of limitations if they claimed a resident tax credit for taxes paid to the other state on their originally filed tax returns. Thus, if a Connecticut resident taxpayer claimed no resident credit for taxes paid to New York on her initial return, the Department of Revenue Services would hold that the special 90-day relief provision would not apply if she later had to pay tax to New York as a result of a New York audit. Whether the language of these statutes support this kind of strict interpretation is another matter!

[9]Conn. Gen. Stat. Ann. section 12-704(b)(2).
[10]N.J. Stat. section 54A:4-1(e).

Finally, statute of limitations issues can also arise in resident tax credit audits by New York's tax department. For instance, a New York resident taxpayer commutes to New Jersey for work. As we suggested might happen in special situation A above, the employer withholds New Jersey tax on 100 percent of the wage income. Consequently, the taxpayer files a nonresident return in New Jersey allocating 100 percent of his wage income to that state. On his New York resident return, he claims a resident tax credit for the taxes paid to New Jersey on his wage income. Lo and behold, New York opens a resident tax credit audit and determines that the taxpayer only spent 50 percent of his workdays in New Jersey, and therefore should have only allocated 50 percent of his wage income there.

As a result, New York decreases the resident tax credit claimed by 50 percent. But the taxpayer can just amend his New Jersey nonresident return to reduce the New Jersey allocation by 50 percent, right? Maybe. Even though New Jersey keeps its statute of limitations open for resident taxpayers to amend their resident tax credits based on the results of other state audits, the same is not true for nonresident taxpayers. In this situation, the nonresident taxpayer would need to amend his New Jersey tax return within the normal statute of limitations.

III. Conclusion

Although New York's resident tax credit provision sounds fairly straightforward, there are a lot of nuances and special situations to consider when addressing a resident tax credit issue, especially in the context of a state tax audit. Though this article does not cover every situation you may encounter with resident tax credits, it should give you a good idea of the most common issues in this area and how to address them. ■