

Show Me Where the Money Goes! Taxing Income of High Earners

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In this article, White and Tsoflias examine state and local tax consequences for the income of high earners who have relocated their work environments in response to the COVID-19 pandemic.

By now, we all know that 2020's unexpected office closures and stay-at-home orders, resulting from the global COVID-19 pandemic, have increased the frequency of telecommuting across the United States. Many employees have traded corporate offices for at-home setups. But unforeseen changes have affected not just the average employee — professional athletes, entertainers, and other high earners have also been affected. Training camps have been replaced by Zoom meetings, and television shows have been filmed from home. This article reviews some of the tax questions raised by this phenomenon, specifically: What are the state and local tax consequences for the income of high earners who have relocated their work environments in light of the pandemic?

The Basics

We begin with a quick recap of basic state income tax principles, using New York as an example. New York imposes income tax on New York resident, part-year New York resident, and nonresident individuals.¹ Residents generally are taxed on their worldwide income² and receive a credit for taxes paid to other states for income sourced to those states.³

Conversely, nonresidents are generally taxed only on the portion of income “derived from or connected with New York sources.”⁴ Income derived from New York sources includes those items attributable to “a business, trade, profession or occupation carried on in th[e] state.”⁵ In some instances, New York-source income may include signing bonuses, retention bonuses, severance payments, and other lump sum payments.⁶ The relevant analysis considers whether the payment is for the execution of a contract, or for another intangible right, or if it is paid based on the performance of a service.⁷ For example, regarding severance payments, the outcome turns on

¹ N.Y. Tax Law section 601(a)-(c), (e).

² New York residents are taxed on their federal adjusted gross income subject to state-specific modifications and deductions. N.Y. Tax Law section 612.

³ N.Y. Tax Law section 620(a).

⁴ N.Y. Tax Law sections 601(e), 631(a).

⁵ N.Y. Tax Law section 631(b)(B).

⁶ See N.Y. Comp. Codes R. & Regs. tit. 20, section 132.1(a) (New York AGI of a nonresident individual); see, e.g., N.Y. Comp. Codes R. & Regs. tit. 20, section 132.22(b)(4)(ii)(b) (including signing bonuses paid to professional athletes as New York-source income if the bonuses were paid for the performance of services in the state).

⁷ See, e.g., N.Y. Comp. Codes R. & Regs. tit. 20, section 132.22(b)(4)(ii)(b).

whether the severance payment was made for services previously rendered or for the recipient's right to future employment.⁸ If the severance payment is to compensate the employee-recipient for services previously performed in New York, the receipts constitute New York-source income.⁹ However, if the nonresident employee-recipient had entered into an employment contract with his employer and the termination pay was made in exchange for the employee's right to future employment, the income would not be sourced to New York.¹⁰

Nonresident employees who perform services both within and outside New York must include in their New York-source income the proportion of their compensation attributable to the services performed in New York. This allocation is generally measured by computing a ratio of total working days in New York over total working days both in and outside New York.¹¹ When allocating the income of professional athletes, New York uses a duty day formula, whereby it includes all days during which the athlete must report to work (as compared with the athlete's game days).¹²

In determining whether earnings for work performed outside the state should be sourced to New York, the state uses the "convenience of the employer" doctrine.¹³ Under the test, working days spent outside New York must include only those days worked for the necessity of the nonresident's employer (rather than for the convenience of the employee).¹⁴ In most cases, necessity includes only those instances when (1) the employee telecommutes to be close to a specialized facility, or (2) the employer and employee have taken significant action to treat the employee's home office as a bona fide office of the business. In response to the COVID-19 crisis, the state recently issued a statement asserting that "if you are a nonresident whose primary office is in

New York State, your days telecommuting during the pandemic are considered days worked in the state unless your employer has established a bona fide employer office at your telecommuting location."¹⁵

Stars — They're Just Like Us!

The rise of remote work — particularly given the environment shaped by the global pandemic — raises questions about the proper sourcing of lump sum payments to highly paid, nonresident employees, athletes, and entertainers. Consider this issue, and the potential impact on taxation, in the context of the following professions.

- A late-night television host receives a bonus on execution of her contract with the television network on which she appears. The payment is made for the performance of future services. The show was scheduled to be filmed in New York City, but because of the pandemic, it is being filmed from the host's out-of-state residence. The television host is a nonresident New York individual. New York income tax was withheld from the payment at the time it was made. However, a refund opportunity likely exists due to the ultimate performance of the service outside New York. Because the service on which the payment was contingent was not performed in New York, New York tax should not be due on the payment.
- A professional football player is a New York nonresident playing for the Buffalo Bills. On signing his player contract, the athlete received a signing bonus expressly paid in exchange for performing future services for the team.¹⁶ At the time of payment, the team withheld tax on the bonus payment based on the New York duty day formula. As a result of the pandemic, the player appeared at training camp virtually in videoconference sessions with his team

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

¹¹ N.Y. Comp. Codes R. & Regs. tit. 20, section 132.18(a).

¹² N.Y. Comp. Codes R. & Regs. tit. 20, section 132.22(a)(1), (b)(3).

¹³ N.Y. Comp. Codes R. & Regs. tit. 20, section 132.18(a).

¹⁴ *Id.*

¹⁵ 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 Oct. 19, 2020).

¹⁶ Whether signing bonuses paid to athletes are sourced income is an interesting question that is up for debate. However, for purposes of this example, we assume that the signing bonuses are sourced income (that is, paid for services rendered).

from his home outside New York. Several practices and games are also rescheduled because of COVID-19. Withholding at the time of payment will likely not accurately reflect the true income tax liability due. Virtual attendance at training camps will result in a decrease to New York duty days. Unforeseen changes to schedules will also affect not only the number of New York duty days, but the total number of duty days used to allocate the player's signing bonus. Adjustments to this formula could result in a significant refund of taxes paid.

- A highly paid employee — a Connecticut resident who commutes daily to his New York office — is terminated in 2021. At the time of termination, he receives a severance payment, computed based on services previously performed. As a result of the stay-at-home orders issued in 2020 and office closures, the employee was required by his employer to work remotely. There is an opportunity to assert that the allocation of the employee's severance payment may be computed by treating 2020 work-from-home days as non-New York days. Under the state's detailed guidance governing the convenience of the employer doctrine, an employee may qualify to escape New York taxation during work-from-home days predicated by office closures. However, even if the multifactor test is not met, an opportunity to reduce New York taxes still exists. While the state's convenience of the employer doctrine is a department policy, its authority is derived from a regulation that states that "any allowance claimed for days worked outside New York State must be based upon the performance of services which of necessity, as distinguished from convenience, obligate the employee to out-of-state duties in the service of his employer."¹⁷ A strong argument can be made that, regardless of the state's policy guidance, the impact of COVID-19 led to the *necessity* for employees to work outside their New York-based offices.

Takeaway

The current environment has highlighted issues with the sourcing of income earned by individuals across the United States. To protect themselves from exposure, it is likely that payers have taken — and will continue to take — conservative positions on withholding tax obligations at the time payments are made. To make matters worse, unlike with salary withholding (which is often done in recurring paychecks), payers of lump sum payments often make withholding tax determinations *before* services are actually being performed. For those payments made before the onset of COVID-19, the withholding determination could not have taken into account the unforeseen changes to where the services would ultimately be performed.

Finally, as states grapple with these issues, we anticipate that they may take — and, indeed, already have taken — aggressive positions to preserve income tax revenues. And the risk of double taxation increases when states disagree about the location to which income should be sourced, because, typically, the state of residence will not allow a credit for tax paid to another state on income sourced to the state of residence under its own sourcing rules. More than ever, it is imperative for payees to independently evaluate, when their personal income tax returns are filed, the tax implications of the sourcing of any payments for services performed. ■

¹⁷ N.Y. Comp. Codes R. & Regs. tit. 20, section 132.18(a).