Breaking Up Is Hard to Do: Nonresidents' Role in the New York Economy

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In this edition of Noonan's Notes, the authors discuss a finding by the New York City Comptroller's Office Budget Bureau that the number of high-income nonresidents reporting income has increased dramatically, then ponder the tax implications of this development.

Breaking up is hard to do. Or so the old Neil Sedaka song goes. And a new report from the New York City Comptroller's Office suggests that when it comes to the love affair between the city and the country's highest-income earners, the song rings true.

Although a number of recent articles and summaries[1] convincingly argue that New Yorkers and other residents in high-tax jurisdictions are fleeing their states at record paces, several others[2] argue that tax flight is nothing more than a myth created by *Atlas Shrugged*-waiving fiscal conservatives. But regardless of which side you take on the issue, the September 6 analysis by the city comptroller's Budget Bureau suggests that if New Yorkers are dumping the Empire State, it hasn't been a clean break.[3]

The comptroller's report argues that over the past decade, the share of the nation's highest-income earners who reported income in New York state has grown substantially, fueled in large part by a sharp increase in the number of high-earning nonresidents reporting income to the state. The report, according to the comptroller's office, is the first to empirically document "the expanding presence of high-income nonresidents in the New York economy." While the impact of this report remains to be seen, chances are New York may act more like a jaded ex-lover than a one-time suitor turned loyal friend.

The Report's Findings

The slew of facts and figures in the comptroller's report leave tax practitioners and taxpayers with two main takeaways. First, the comptroller sees a growing presence of high-income earners in New York state. Second, this growth has been largely driven by nonresident taxpayers.

Using data from state and federal income tax filings, the report concludes that in 2013 over 43 percent of all U.S. taxpayers who made $10 million or more reported at least some income to New York state.[4] This figure is up from just over 31 percent in 2001. The percentages are also up for taxpayers in the $1 million to $5 million range (from 20.6 percent of all taxpayers reporting income to the state in 2001 to 22.8 percent in 2013) and taxpayers in the $5 million to $10 million ranges (from 27.6 percent in 2001 to 33.1 percent in 2013).[5]

According to the report, a primary reason for this increase is the growing presence of high-income *nonresident* taxpayers earning income in the state and city. In 2014, for example, more than half of New York taxpayers who earned $720,000 or more in total income did not legally reside in New York state. At incomes above $10 million, nearly two-thirds of state taxpayers (residents and nonresidents) who earned that amount in 2014 filed as nonresidents. And

[1] *See, e.g.*, Jonathan Williams and Philip D. Schlosser, "No Magic Carpet Ride: Why State Tax Flight Is Not a Myth," *State Tax Notes*, Aug. 15, 2016, p. 565.

[2] *See, e.g.*, Stephanie Cumings, "Taxes Are Not Pushing Out the Rich, Report Finds," *State Tax Notes*, June 13, 2016, p. 838.

[3] New York City Comptroller's Office Budget Bureau, "The Increasing Concentration of High-Income Nonresidents in the New York Economy," *available at* http://comptroller.nyc.gov/wp-content/uploads/documents/Stringer_High_Income_Earners_Report.pdf.

(Footnote continued in next column.)

[4] *Id.*

[5] *Id.*

as a whole, nonresidents earned more than $90 billion in New York state income in 2014.[6]

Quick sidebar here, of interest to those of us who practice in the income tax and residency world. In a section titled "Determining Residency Status for New York State Income Taxes," the comptroller's report notes that in order for tax auditors to prove that an individual maintains a permanent place of abode in the state (one of the tests under New York's statutory residency analysis), the auditors must "prove that someone who owns or rents a housing unit in the state and spends 184 days or more in New York *also actually lives in the dwelling*" (emphasis added) (citing *Matter of John Gaied*, 22 N.Y.3d 592 (2014)). While we agree, we're hoping that the comptroller's office will share its conclusion with the New York State Department of Taxation and Finance, which has yet to adopt such a clear understanding of the New York State Court of Appeals' ruling in *Gaied*.[7]

Back to the report. In the press release announcing it, New York City Comptroller Scott M. Stringer argues that "the higher rate of New York taxpayers filing as nonresidents does not suggest that high-income earners are leaving the state."[8] Instead, the comptroller argues that the evidence implies the opposite. According to the comptroller, since 2002, the percentage of high-income New York state taxpayers with incomes above $1 million has consistently been below the rate for taxpayers earning less than $1 million. And in 2014, only about 1 percent of resident taxpayers with more than $1 million in annual income moved out of the state. Conversely, the comptroller argues that high-income nonresidents continue to flock to and earn income in the state. For example, the comptroller's report indicates that in 2013, more than one in four U.S. taxpayers with incomes of $10 million or more reported earning at least some income in New York state while maintaining a primary residence elsewhere — up from 16.8 percent of U.S. taxpayers in 2001.[9]

Another notable takeaway from the report is that although most nonresident taxpayers are local commuters, the average incomes for long-distance nonresidents are higher than those in the tri-state area. The average incomes reported by nonresident taxpayers from New Jersey, Pennsylvania, and Connecticut were $189,485, $225,921, and $432,196, respectively. Long-distance nonresident taxpayers from Texas, California, and Illinois, however, reported average incomes of roughly $1 million, whereas nonresident taxpayers from Wyoming reported average federal incomes of over $5 million.[10] In other words, it's not just northeast residents who can't make a clean break from New York.

Nonresident Income Reporting Rules in New York

As noted, the comptroller's report indicates that nonresident taxpayers earned more than $90 billion in New York state in 2014. Although this represents only a fraction (11 percent) of the total income earned by those taxpayers everywhere, it is still a huge figure — suggesting that many taxpayers are cognizant of the state's nonresident income allocation rules.

As we've reported,[11] New York state residents are taxable on everything. Nonresidents, however, can be taxed only on income derived from or connected to New York sources.[12] Generally, under Tax Law section 631, the New York-source income of a nonresident individual includes all items of income, gain, loss, and deduction entering into the taxpayer's federal adjusted gross income that are attributable to the ownership of any interest in real or tangible personal property located in New York or a business, trade, profession, or occupation carried on in New York. According to the comptroller's report, the total income from these categories earned by nonresidents in 2014 was over $90 billion.

The report also estimates that of this $90 billion, nonresidents earned about $68 billion in New York City in 2014.[13] While nonresidents earning income in New York City pay a host of taxes — including sales tax, property taxes, certain business taxes, and New York state personal income tax on income earned in the state — they are not required to pay city personal income tax, which is imposed only on residents. Thus, the city may be hinting at what it is currently leaving on the table by not taxing nonresidents earning income in the city.

After the Breakup

According to the comptroller's report, "the growing concentration of New York-sourced income in the hands of people who do not call New York home raises numerous questions about tax policy, transparency, and the long-term impact on the local economy and the character of the community."[14] And in his press release, Stringer notes that "as the center of global finance and other high-paying industries, New York City has long attracted many of the nation's high-income earners."[15] But according to the

[6] *Id.*

[7] *See, e.g.*, Timothy P. Noonan, "New York Tax Department's Response to *Gaied* Misses the Mark," *State Tax Notes*, July 21, 2014, p. 145.

[8] New York City Comptroller Scott M. Stringer, press release, "Comptroller Stringer Analysis Finds High-Income Non-New Yorkers Earning a Larger Slice of New York's Pie," September 6, 2016, *available at* http://comptroller.nyc.gov/newsroom/comptroller-stringer-analysis-finds-high-income-non-new-yorkers-earning-a-larger-slice-of-new-yorks-pie/.

[9] *Supra* note 2.

[10] *Supra* note 2.

[11] *See* Noonan, "The Ins and Outs of New York Nonresident Allocation Issues," *State Tax Notes*, Feb. 8, 2010, p. 439.

[12] N.Y. Tax Law section 631.

[13] *Supra* note 2.

[14] *Supra* note 2.

[15] *Supra* note 8.

comptroller, "since 2001, the number of high-income individuals who benefit from the New York economy, but live elsewhere, has grown dramatically, [and] the changing nature of our economy demands that we begin to think about how to ensure everyone who pays taxes in the Empire State is treated fairly."[16]

So what will all this new thinking lead to? And what are the takeaways for us tax practitioners?

First, many tax department auditors may ask if all of these taxpayers are really nonresidents. We certainly know from practice that the mere fact that a taxpayer claims nonresident status in New York state and New York City does not actually mean that he qualifies as a nonresident. Do many of these nonresidents still maintain their domicile in the city? Or could it be that some of these nonresidents have an apartment in the city and are not aware of the statutory residency test? The bottom line is that if there are so many high-income nonresidents deriving income from New York, you can bet that the department will be checking to ensure that they actually qualify as nonresidents.

Beyond that, are there even more nonresidents who did not make this report? If 40 percent of all taxpayers in the country who make $10 million or more reported at least some New York source income to New York state, doesn't that probably mean there is a percentage of high-income taxpayers who also had New York income but failed to report it? The math, and common sense, would suggest that there probably is a void there. And how does that void get closed? More audits, of course. This could include not only personal income tax audits, but we could also see the tax department focused on employer withholding, and specifically on high-income nonresident employees who travel into New York occasionally for work.

[16] *Supra* note 8.

What about transparency? The report mentions analyzing whether greater transparency and disclosure are needed to understand who owns properties or businesses in the state and city. But some measures have already been taken in this regard. Form NYC-RPT, New York City's Real Property Transfer Tax Return form, has historically required taxpayers to list information about the "grantor" and the "grantee" in given real estate transactions, including names, addresses, and Social Security numbers. When it came to limited liability companies, only single-member LLCs previously needed to disclose any identifying information on the form, and only the identity of the sole member was required. But effective May 18, 2015, both Form NYC-RPT and the corresponding online Automated City Register Information System now include both single-member and multiple-member LLCs as types of grantors and grantees required to submit identifying information. It's our understanding that these enhanced forms have been and will be used to assist with residency audits and other New York City and state tax matters. Expect possibly to see more efforts encouraging this type of disclosure.

Finally, and what might seem most obvious from this report, is whether there may again be a push for a nonresident income tax in New York City. As noted, nonresidents of New York state pay personal income taxes on income derived from New York sources. But nonresident taxpayers of New York City pay no city tax on their income. The city tax is basically an all-or-nothing proposition. If you are a city resident, you pay taxes on all of your income, regardless of its source. If you are a nonresident of the city, you pay zero city tax. With this report concluding that there is such a concentration of high-income taxpayers in New York City and questioning how to ensure everyone is treated fairly, one wonders whether the simplest fix would be to create a tax on city nonresidents. For city residents, such as those in the Reilly household, this could be welcome news. For the Noonans, however, not so much. ■