ROCHESTER BUSINESS JOURNAL
RBJ
VOLUME 31, NUMBER 17 WWW.RBJDAILY.COM JULY 24, 2015

Stage is set for possible challenge to N.Y. investment income laws

TAXING MATTERS
Josh Gewolb

Paying state tax once is bad enough, but certain unlucky taxpayers pay state tax twice on investment income, as a result of a New York state law that denies credits for taxes paid to other states in some cases.

A recent Supreme Court decision, however, casts doubt on the law's constitutionality and may force New York to reconsider its policy.

New York imposes tax on the worldwide income of its residents, but only on the New York state income of non-residents.

A New Jersey resident who commutes to New York City, for example, would only pay New York tax on wages, not on investment income. New Jersey would tax the commuter's worldwide income, including the wage income, but offer a credit for the New York tax paid. Overall, given the credit, the commuter would only pay state tax once—the sensible result—and would pay New York tax only on his earnings here.

Under current law, however, if the New Jersey commuter buys a pied-a-terre in Manhattan, he would end up paying both New York and New Jersey tax on his investment income. In this situation, New York denies a credit for the taxes paid to New Jersey—a result New York's highest court has said is constitutional.

The problem has its roots in basic principles of the New York individual income tax. There are two classes of people treated as New York residents: domiciliaries and statutory residents.

People are New York domiciliaries if New York is their permanent home: the place they plan to return whenever they are absent. Under state tax law, a taxpayer can only have one domicile. For most of us, determining where our permanent home is easy; however, it can be difficult for snowbirds and jet setters. The New Jersey commuter in our example is a New Jersey domiciliary.

Additionally, New York imposes state tax on statutory residents, defined as individuals that have a home in New York and are here for more than 183 days per year. The theory is that these people are taking sufficient advantage of New York's resources that even if their permanent home is elsewhere, they should be paying New York tax on their worldwide income.

Most commuters are not statutory residents because they don't have a "permanent place of abode" in New York. However, even an apartment used occasionally qualifies, so when the New Jersey commuter in our example acquires the pied-a-terre, he becomes a New York resident for tax purposes and pays tax on his worldwide income. This is the result even if he only stays at the apartment occasionally, as long as he is in New York at any point during the day for 183 or more days per year.

New Jersey, however, also imposes tax on worldwide income. For income that is tied to a particular place—employment income in New York or rental real estate income in New Jersey—the two states give reciprocal credits.

However, for income from intangibles—stocks, mutual funds, bonds, etc.—New York refuses to grant the credit. Hence the commuter's investment income from intangibles taxed twice: once in New York and once in New Jersey, for a total combined maximum state tax rate of almost 18 percent.

In a 1998 case, the New York Court of Appeals reviewed the exact pattern of the New Jersey commuter, and determined that New York's refusal to provide a credit for the New Jersey income taxes was constitutional. In doing so, it relied on Supreme Court ruling focused on another topic where the justices noted that the purpose of the constitution was not to shield residents "from their own state taxes."

In the recently decided case of *Comptroller v. Wynne*, the Supreme Court addressed the issue head on, and changed its mind: In a five-to-four decision, the court concluded that Maryland's county income tax was unconstitutional.

The county personal income tax applied to both Maryland residents and non-residents. The problem was that Maryland residents do not earn credit against the county tax when they pay personal income taxes to other jurisdictions.

In the May 18, 2015, decision, written by Justice Samuel Alito, the Supreme Court held that this violates the constitution.

In reviewing the law, the court relied on a constitutional test that requires it to assume that all 50 states have the same tax scheme, and then assess whether that scheme would create an incentive for taxpayers to opt for intrastate rather than interstate economic activity.

The court held that interstate commerce is burdened when individuals are subjected to a risk of double taxation, and that Maryland's tax was therefore unconstitutional.

Based on the decision in *Wynne*, the constitutionality of other state and local tax structures, such as New York's, will likely be challenged. New York's refusal to credit out of state commerce may be found impermissible.

Taxpayers potentially affected by the decision should consult with their tax advisors about filing protective refund claims for past years, and about reporting positions for future years. While New York has not changed its laws to reflect the new holding, they are subject to the higher authority of the constitution, under which the existing laws may no longer pass muster.

Josh Gewolb is a tax attorney at Harter Secrest & Emery LLP.