December 20, 2000

New York Issues:
Unincorporated Business Tax, Source of Income

By: Glenn Newman

Two recent New York decisions dealing with the taxation of individuals' earnings seem to strain to reach out and tax someone. The first deals with the application of the New York City Unincorporated Business Tax to income paid as wages to an actor. The second applies New York State's "source of income" rule to a telecommuter's out-of-state activities.

Employment as an Actor

The New York City unincorporated business tax ("UBT") is thought of as applying to partnerships, sole proprietorships and self-employed individuals such as independent contractors. Many tax professionals would answer questions about what is or is not subject to UBT by answering that wages, reported on a W-2 and for which social security and income taxes are withheld are not taxed under the UBT. Well, that is not entirely accurate as demonstrated to Robin T. Grossman.[1]

Mr. Grossman, better known to fans of "Another World" by his professional name "Robin Thomas", performed as an actor for several entities as well as under a contract to appear on that television series. Pursuant to the contract, the taxpayer was under the direction and control of the owners of the television series, Proctor and Gamble Productions, Inc. ("Principal") and the series manager, Benton & Bowles, Inc. ("Agent"). They set the time and place for performing; he was required to personally perform and could not provide a substitute; all of his actions were controlled by a script from which he could not deviate.

The taxpayer was paid on a per program basis, had two-weeks paid vacation and could take up to six weeks leave, subject to approval, to appear in motion pictures, Broadway plays or television specials. Consent was not needed for the taxpayer to participate in commercials, television shows, movies or plays that did not interfere with his role or conflict with the products of the Principal. The Agent paid for medical insurance, retirement fund, unemployment insurance and workers' compensation.

In addition to income earned from the television series, the taxpayer received residuals for work done in prior years. He also earned income from three other small theater entities (totaling $6,631.88 for work done in one year and $2,457.30 for the other).

The taxpayer filed income tax returns for the two periods in issue but did not file a UBT return. His federal income tax return included a Schedule C ("Profit or Loss from Business or Profession") in which he claimed the following deductions for expenses related to his services as an actor: advertising; commissions; depreciation; legal and professional fees; travel and entertainment; union dues; makeup expenses;

haircut expenses; photographs; training and instruction costs; business meals; health club fees; gifts; taxis, subway and bus fares; publications; insurance premiums; office expenses; rent and; utilities.

The taxpayer testified that he practiced lines, called his agent and his studio from his home office. He also advertised his availability in various theatrical publications making reference to his role on the television series.

In the proceedings below, the Administrative Law Judge determined that the taxpayer performed services for the television series as an employee and the City did not disagree. Rather, the City argued that UBT was due "because the acting services [the taxpayer] provided as an employee constituted part of a business regularly carried on by him." The City Tribunal agreed, quoting the UBT exemption provision that states, "performance of services by an individual as an employee or as an officer or director of a corporation, society, association or political entity, or as a fiduciary, shall not be deemed an unincorporated business, *unless such services constitute part of a business regularly carried on by such individual."*[2] (Emphasis supplied by Tribunal).

The UBT Rules provide that personal services rendered by an individual as an employee will ordinarily be deemed part of a business regularly carried on if such services are performed in furtherance of or for the direct benefit of other business, professional or occupational activities. The Rules specifically state that services as an employee will *not* be deemed to be performed in furtherance of or for the benefit of other businesses, if the individual does not maintain an office or employ assistants and his services as an employee are performed on a full-time basis for one employer or if those services are entirely independent of any other business, professional or occupational activity engaged in by the individual.[3]

The Tribunal concluded that under the facts present the taxpayer's "acting career was a regularly carried on business activity and the services he performed as an employee were in furtherance of, and directly benefitted, such business activity". It noted that the Schedule C treated his services with respect to the television series as part of his acting business, referenced it in his advertising and took business deductions relating to such service. The Tribunal upheld the City's position that "the issue is the nature of the employee's activities not the quantity."

The Tribunal also noted that the taxpayer claimed to have a home office and said that it was unpersuaded that the UBT Rules required a more formal office. Finally, the Tribunal explicitly stated that the existence of an office combined with all of the other factors leads to a finding that UBT is owed.

How Far Can This Extend?

The significance of this case is less in the specific facts of business deductions being claimed to reduce what was ostensibly income from employment but, rather, that if employment is "in furtherance of" an outside business activity, it too will be subject to UBT. For example, an attorney employed by a law firm or corporate or government office who has an outside legal practice (and, it is hoped) files a UBT return with respect to the outside practice, might find that the wages are also includible in UBT income. Similarly, a journalist working at a newspaper, magazine or TV or radio station who writes freelance articles could find the reporting to be in furtherance of the freelance business activity. What about a physician on staff at a university or hospital who also gets fees for consulting work, providing expert testimony or giving lectures? Or a university professor who also writes and lectures? How about a professional athlete

earning millions in wages who also has endorsement and appearance fees; is that employment in furtherance of directly benefitting the business activity? Could it be argued that the employment of an elected official who also receives income from speeches or books on political matters is "in furtherance" of his business activity?

One way of ameliorating the issue of double taxation (i.e., the UBT is imposed, at a rate of 4% of net income in addition to the New York City resident income tax, currently at the rate of 3.91%), would be to increase the credit against the NYC resident income tax for UBT paid. Right now there is a credit against the City's income tax for 65% (sliding down to 15%) of UBT paid. If there was full credit, it would be of no real significance whether someone paid the UBT or the resident income tax, but at least they wouldn't pay twice.

Telecommuting

Telecommuting is fast becoming a way of life for employees and employers. Increasingly, employees can set up remote locations from which they perform part of their work for New York-based employers. One might think that the work these employees perform from their employer-sponsored home offices would be sourced, for income allocation purposes, to the state in which the services are actually performed. New York State, however, has rather odd wage allocation rules which make it very likely that telecommuters will find their income from such out-of-state activities treated as taxable New York source income.

Under New York law, nonresident individuals are taxable on their taxable income derived from New York sources. In the case of a nonresident employee working partly in New York and partly outside the state, the tax statute provides that the items of income derived from New York sources are determined "by allocation and apportionment under [the tax department's] regulations."[4] Although the regulations provide that the portion f an employee's wages derived in New York is determined by comparing the number of working days in New York to the total number of working days, the definition of a day worked outside New York is quite troublesome.

Specifically, the regulations provide that "any allowance claimed for days worked outside New York State must be based on 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."[5] This means that if an employee chooses to work at home in New Jersey on any given day because it is convenient for the employee, that day will *not* be considered a non-New York day.

This standard, while referred to by the state as "convenience of the employer" really is the "necessity of the employer"—can be very difficult to satisfy. This rule has generated a good deal of controversy over the years. The most recent matter is an Administrative Law Judge determination which illustrates that even though a nonresident employee may actually be working outside the state, his earnings may nevertheless be taxable as New York source income.[6]

Professor Zelinsky (taxpayer) is a Professor of Law at a law school located in New York City. For the 28 weeks of the school year, his duties involved meeting with students and teaching classes three days a week, and working in his home in Connecticut two days a week preparing examinations, conducting research and writing. During the weeks that school was not in session, the taxpayer worked exclusively in Connecticut.

On his New York nonresident income tax returns, the taxpayer apportioned his income from his employment between New York and Connecticut based upon the days worked in each State. The New York tax department disregarded the apportionment and taxed 100% of the income from the taxpayer's employment.

The taxpayer argued that New York's convenience of the employer test is unconstitutional as applied to him, in that Connecticut treats the days worked in that State as Connecticut source income and allows no credit for taxes paid to New York when he was physically present and working in Connecticut. Therefore, the taxpayer argued, there is multiple taxation and a violation of the U.S. Constitution's requirement that income be fairly apportioned and not be an undue burden on commerce, and that the income earned while working in Connecticut was not sufficiently connected to New York.

That taxpayer pointed out that when originally put in place, the "convenience of the employer" test was needed to prevent taxpayers from surrounding states achieving an undue incentive for claiming to work at home (at the time neither New Jersey nor Connecticut had broad-based personal income taxes). He noted that once the other states adopted income taxes, the incentive was no longer there.

The Administrative Law Judge disagreed and found that the convenience of the employer test and its application in this case was valid. First, the ALJ noted that a nonresident employed by a New York employer is not subject to the convenience of the employer test "when he works outside of New York, performs no work within New York, and has no office or place of business in New York (i.e., where suitable facilities to carry out his employment duties are not maintained for or available to him in New York). In these circumstances the so-called "place of performance doctrine applies."

Upholding the convenience of the employer test, the ALJ cited several court decisions upholding the rule including *Matter of Phillips,*[7] involving an employee of Lehman Brothers, Inc., who worked out of a home office in Pennsylvania. In that case, Lehman provided computers, fax machines, information systems, and 25 phone lines for Mr. Phillips' home office. His office was listed in the local phone book as "Shearson Institutional Capital Funding;" and his desk on the Lehman trading floor in New York City was inadequate, due to security limitations, to serve the full needs of his job. Lehman itself explained that the nature of Mr. Phillips' work required that he maintain unconventional hours monitoring overseas markets and making trades, working at times when the New York office was closed, and Mr. Phillips testified that, on days when the markets were volatile, he had to work out of the home office to avoid being "out-of-pocket" during his commute.

Yet all of this was not enough. While Lehman's letter stated that Mr. Phillips' "presence in our office is not feasible or practical," the Tax Appeals Tribunal found that the employer's "letter does not explicitly state that petitioner's presence in New York was not feasible or practical for his employer."

The Tribunal held that Mr. Phillips had to treat the days worked in his Pennsylvania home office as New York days and was upheld on appeal. The Appellate Division was "not persuaded that Lehman's offices would not be reasonably adapted to serve petitioner's needs." As a result, the compensation received by Mr. Phillips for services performed in his home office was allocated to New York.

Along similar lines, in *Matter of Friedman,*[8] the State Tax Tribunal found that New York can tax amounts earned for doing nothing in Florida. Mrs. Friedman was paid $50,000 annually by her husband's company,

but the facts showed that she performed no actual services for the company. Since no services were actually performed, the Tribunal allocated the $50,000 on a pro rata basis over the days in the year. Three-quarters of those days were spent by Mrs. Friedman in Florida. She could not demonstrate that her employer required her to be in Florida while doing nothing, however, and as a result the days she spent in Florida were treated as New York work days. New York was therefore entitled to tax the full $50,000, on the basis she was in Florida for her convenience, not her employer's necessity.

Practical Impact of These Cases

These recent decisions, which are consistent with a Department Advisory Opinion issued in 1996 to a Citibank telecommuter (Annito[9]), may seem surprising in result. Nevertheless, they clearly describe the current state of New York law, and highlight issues that have become increasingly common as the economy shifts from physical linkage to electronic. Employees who consider themselves based in remote sites outside New York bear a difficult burden of satisfying the State that the location of their work is dictated by the employer's requirement, and that they could not have performed these same services at the employer's New York office.

Even when the employer requires the employee to work out of his home, as Citibank did in Annito, the State will still maintain that the employee cannot allocate unless the nature of the out-of-state services is such that they cannot be performed at the employer's New York office. The result of this difficult standard can be a New York tax on income the employee earned while working out-of-state. And if an employee resides in a state with location-based sourcing rules (as Connecticut did in *Zelinsky*), the employee may have to pay income tax to his or her home state as well, with no offsetting credit for the New York tax paid. This double taxation can occur where different state sourcing rules lead both New York and the home state to claim to be the source of the employee's earnings. As the ALJ in *Zelinsky* said, "because Connecticut does not, under its physical presence sourcing rules, recognize the income in question as New York source income, and instead taxes the same as Connecticut source income without credit for taxes paid to New York, does not serve to invalidate the regulation in issue."

Concern for Employers Too

While troubling for nonresident employees, there are reasons employers should be concerned about New York's sourcing rules as well. Employers may need to review their withholding policies, and consider the extent to which wages paid to nonresident employees may be taxable in New York. The payroll factor utilized in employers' business allocation formulas also could be implicated by the New York income tax sourcing of an out-of-stater's work.

Employers not otherwise present in an employee's home state also should be concerned that if an employee is treated as working in that state to satisfy the employer's necessity, that may cause the employer to be treated as doing business, and taxable, in that state. Corporate policy may encourage or even require telecommuting, but employers generally do not control where their employees live. If the state in which an employee chooses to set up a laptop treats the telecommuter as establishing a place of business for the employer, that employer's state (and local) tax burdens may quickly mushroom.

---

1 *Matter of Robin T. Grossman,* (NYC Tax Appeals Tribunal, decided July 24, 2000).
2 Currently found at NYC Administrative Code Search7RH11-502(b).
3 19 RCNY 28-02(e)(4).

[4] Tax Law Search7RHSearch7RH601(e), 631(c).
[5] 20 NYCRR 132.18(a).
[6] *Matter of Edward A. and Doris Zelinsky*, NYS Division of Tax Appeals (November 2, 2000).
[7] *Matter of Phillips*,(NYS Tax Tribunal, decided April 15, 1999); aff'd *Phillips v. New York State Department of Taxation & Finance*, 267 AD2d 927, 700 NYS 2d 566 (December 30, 1999).
[8] *Matter of Friedman*,(NYS Division of Tax Appeals ALJ determination, March 2, 2000).
[9] Mark F. Annito, TSB-A-96(10)I (December 27, 1996).