The Rich Are Different and So Are Their Tax Homes

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Working from a primary residence or a vacation home during the pandemic may have unintended tax consequences.

Almost two thousand years ago the Roman philosopher Gaius Plinius Secundus, better known as Pliny the Elder, was first credited with the phrase "home is where the heart is." At its core, this translates to the place where a person feels most emotionally attached and connected, typically associated with the home where one's family resides. During the pandemic, families have had to shelter in place. For some, the prolonged togetherness and forced family interactions can best be described as a never-ending dysfunctional Thanksgiving dinner. Others have enjoyed hunkering down with their family members and still others fall somewhere in between. These experiences, whether generally positive or negative, have been exacerbated by the fact that parents and adult children must now also work from home and, given the lack of a vaccine, this trend may continue for quite some time. The current circumstance favors those who can perform rather seamlessly via the use of technology rather than through face-to-face interactions and these individuals tend strongly towards the wealthiest members of our society.

It is difficult at this point to predict how these societal changes will impact the employment dynamic long term and whether they will become permanent. For example, Facebook recently announced that it will begin allowing new hires who are senior engineers to permanently work remotely and then allow current employees to apply for permis-

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sion to work indefinitely from home if they have positive performance reviews. This historic policy change followed similar decisions at Twitter and the payments company Square. Within a decade, Facebook expects that as many as half of the company's more than 45,000 employees will work from home.

The work from home or Zoom economy may ultimately affect more than just tech companies and their employees. The early adopters may ultimately give rise to and migrate into being the accepted business practice in other industries and professions including financial services, law, medicine, engineering, architecture, and others. State and local boundaries may become far less significant and professional licensing rules may be forced to adjust to this changed workplace dynamic. Given that more have worked and will continue to work from home, there are important federal, state, and city tax implications. While there is this quaint notion of home being a place where one's heart and family are located, this is not the view of the Internal Revenue Service or many state and city taxing authorities.

A full discussion of state and local tax residency and domicile is beyond the scope of this article, although it is important to note that states and municipalities have their own rules governing the authority to tax that are limited only by state and U.S. Constitutions. Some states, like New York, apply a dual test empowering the state to tax persons who either meet a statutory days test or a domicile test. N.Y. Tax Law § 605(b). To illustrate, a taxpayer who maintains a permanent place of abode and is not considered a domiciliary of New York becomes a statutory resident on the 184th day spent in New York. At this point, the taxpayer is required to file a resident tax return and pay tax in New York on his or her worldwide income. The same basic rules apply for determining whether the taxpayer is also a tax resident of New York City.

A taxpayer's domicile is the place that an individual considers his or her "permanent place of abode" or "true, fixed, permanent home," i.e. the principal establishment to which he or she intends to return whenever absent. The following information is considered by the state of New York (and other states as well) in determining a taxpayer's domicile: (i) the use and maintenance of the home in the state compared to another home outside of the state (comparable size of the properties; functionality of the properties and nature of use, i.e. seasonal usage versus year-round usage; and comparable use of the property, i.e. more time spent in one versus the other); (ii) patterns of employment and business activities in the state; (iii) time spent in the state as compared to elsewhere; (iv) location of items with sentimental value including family heirlooms, works of art, and other valuable collections (so called "items near and dear" and this is sometimes also called the Teddy Bear Test); (v) family connection, particularly the location of a taxpayer's spouse and children. These and other factors are considered by the taxing authority to determine a domiciliary for taxing purposes.

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Colorado is a state with many second homeowners from Texas and Florida and has a similar dual tax residency test. A person is considered a Colorado resident for income tax purposes if Colorado is the person's state of domicile or the person qualifies as a "statutory" resident. When evaluating whether a taxpayer is domiciled in Colorado, the state will consider, among other factors, voter registration, vehicle registration, driver's license, school registration, property ownership, and residence of spouse and children. A taxpayer is considered a "statutory" resident of Colorado if he or she maintains a permanent place of abode in Colorado and spends, in the aggregate, more than six months of the tax year in Colorado. *See* Colorado Department of Revenue Regulation 39-22-103(8)(A).

Complicating matters is that both Florida and Texas, states with no state individual income tax and therefore highly desirable as locations for one's tax residency, have no general rules for establishing residency. Rather, residency is program specific. So, for example, to take advantage of Florida's favorable homestead property exemption rules, where the property owner may be eligible to receive a reduction in the property's taxable value by as much as $50,000 and an annual assessment cap, the taxpayer must meet certain requirements including completing a form containing sufficient information to enable the property appraiser to determine that the taxpayer's permanent residence is in Florida. Fla. Stat. § 196.121.

When considering permanent residency, the Florida property appraiser's office may consider any of the following relevant factors contained in Fla. Stat. § 196.015:

- a formal declaration of domicile by the applicant recorded in the public records of the county in which the exemption is being sought;
- evidence of the location where the applicant's dependent children are registered for school;
- the place of employment of the applicant;
- the previous permanent residency by the applicant in a state other than Florida or in another country and the date non-Florida residency was terminated;
- proof of voter registration in the state with the voter information card address of the applicant matching the address of the physical location where the exemption is being sought;
- a valid Florida driver's license or a valid Florida identification card and evidence of relinquishment of driver's licenses from any other states;
- issuance of a Florida license tag on any motor vehicle owned by the applicant;

- the address as listed on federal income tax returns filed by the applicant;
- the location where the applicant's bank statements and checking accounts are registered; and
- proof of payment for utilities at the property for which permanent residency is being claimed.

Texas has a similar $25,000 homestead exemption for school taxes if the home is the taxpayer's "principal residence." Tex. Tax Code Ann. § 11.13(b). To qualify, a home must meet the definition of a residence homestead: The home's owner must be an individual (as opposed to a corporation or other entity) and use the home as his or her principal residence on January 1 of the tax year. Establishing a taxpayer's home as a homestead, eligible for the property tax exemption in either Texas or Florida, is important evidence when a taxpayer is attempting to demonstrate that he or she is not a domiciliary of another, presumably higher tax, jurisdiction. Applying for the homestead exemption in Texas or Florida, which requires taxpayers to establish that their home is their principal residence, shows an intent to make Texas or Florida their tax home. But what happens when the presumptive Texas or Florida resident is forced to shelter in place in a higher tax state for a prolonged period? For example, Aspen and Vail are currently full of Texans and Floridians living and working from their second homes. Likewise, some Manhattanites are doing the same thing, but from their second homes in the South Beach, Ft. Lauderdale, or Palm Beach areas. These prolonged habitations can result in unexpected state and local tax consequences.

In the case of second homeowners living and working in Colorado, these taxpayers may find themselves subject to Colorado tax. Conversely, it is difficult but not impossible that the New Yorkers may avoid New York State and City taxation because they are "stuck" in their homes in Florida with no current intention of returning to New York. Depending on the specific facts, shelter in place orders may have shifted the domicile for some of these taxpayers. Most states have not issued guidance on whether they will count the days in quarantine toward state residency tests. As a general rule, visitors to a state are generally allowed to stay there if they get sick and not be subjected to state taxation, but it is unclear how they will be treated if they are stuck in the state under a shelter-in-place order. The IRS has issued some guidance on this in an analogous situation involving nonresident aliens who are stuck in the United States during the pandemic. In Rev. Proc. 2020-20, issued on April 21, 2020, the IRS stated that days in the United States will not count if a visitor is unable to leave the country. The exclusion extends for 60 days, starting on or after February 1, 2020. The U.K., Singapore, and Australia have enacted similar rules for individuals trapped in those places because of the pandemic.

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Unless a tax treaty applies, an individual who is not a U.S. citizen or lawful permanent resident (i.e., a green card holder) is treated as a U.S. tax resident during a taxable year and thus subject to U.S. federal income tax on worldwide income if such individual is physically present in the U.S. for 183 days or more. Under these same rules, a foreign individual may also be treated as a U.S. tax resident if the sum of (i) the number of days of physical presence in the U.S. in the current calendar year, (ii) one-third the number of days of physical presence in the U.S. in the first preceding calendar year, and (iii) one-sixth the number of days of physical presence in the U.S. in the second preceding calendar year, equals or exceeds 183 days. Section 7701(b)(3). Under this weighted average test, a person will generally not be classified as a U.S. tax resident unless he or she spends more than 121 days per calendar year in the United States. However, under a medical exception, days of U.S. presence are ignored if the nonresident "was unable to leave the United States because of a medical condition that arose while such individual was present in the United States." The Treasury Regulations require a nonresident to establish: (i) whether he or she would have remained in the U.S. anyway if the medical problem had not occurred; and (ii) whether the medical condition arose before he or she arrived in the U.S. Section 7701(b)(3)(D)(ii) and Reg. 301.7701(b)-3(c). If either of these conditions apply, prior to Rev. Proc 2020-20, nonresidents who exceeded their days of physical presence in the U.S. as a result of the COVID-19 travel restrictions would have been U.S. tax residents.

Rev. Proc. 2020-20 specifically provides relief for nonresidents who, but for COVID-19-related emergency travel disruptions, would not have been in the United States long enough to meet the days test during 2020. Under the revenue procedure, a nonresident can exclude up to 60 consecutive calendar days of U.S. presence that are presumed to arise from travel disruptions caused by COVID-19. The COVID-19 travel restrictions will thus be considered a medical condition that prevented the nonresident from leaving the U.S. on each day during the 60-day period and will not be treated as a pre-existing medical condition. Furthermore, the guidance clarifies that there is a presumption that a person intended to leave the U.S. but was unable to do so as a result of the COVID-19 pandemic. Nonresidents may choose any date from February 1, 2020, to April 1, 2020, to begin counting the 60 days of exclusion. Hopefully, the states will follow suit and provide guidance in this area.

Separate from the issue of physical presence is the issue of where services are performed and which states get to tax the income earned as a result of these services. Sourcing rules generally dictate that income is sourced based on where the service or employment is performed based on a days method of allocation.

If a nonresident of New York regularly commutes from his home in New Jersey or Palm Beach, for example, to a job in Manhattan, then New York State will subject the income earned during the days performing services in New York to taxation. The same rule applies if the taxpayer worked from his home for his own convenience. But if the taxpayer is now working from home because of a shelter in place order and is no longer commuting to New York, then New York would presumably no longer have a claim on such income as the failure to commute was not for the convenience of the employee.

New Jersey, in a Telecommuter COVID-19 Employer and Employee FAQ, recently stated that during the temporary period of the COVID-19 pandemic, wage income will continue to be sourced as determined by the employer in accordance with the employer's jurisdiction and it will therefore not impose a tax on the income of people who usually work in another state but are now working from home in New Jersey because of the pandemic. New York has not issued guidance on whether it will continue to tax the income of taxpayers who are resident in another state and who regularly commute to New York but cannot do so because of shelter in place orders.

Until now this article has focused on matters relating to state and local taxation, but the pandemic may also impact the location of a taxpayer's tax home for federal income tax purposes. The identification of a taxpayer's "tax home" is critical to the determination of whether travel expense deductions are allowed because the IRS only permits a deduction for traveling expenses when a taxpayer is "away from home." The IRS has long held the belief that a "tax home" is the place at which the taxpayer conducts his or her "trade or business" and not a personal residence which would be a layperson's common meaning of the word "home." However, the IRS does acknowledge that the location of a taxpayer's "tax home" must be determined on the facts of each unique case. There are also circumstances where a taxpayer has no identifiable place of business to be considered a "tax home" but does maintain a regular place of abode, which could be regarded as being the "tax home" for that taxpayer.

Section 162(a)(2) provides a deduction for all ordinary and necessary expenses paid or incurred as "traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business…." Some guidance is provided in Reg. 1.162-2 but the regulation does not clarify or even address the definition of a "tax home." Rather, guidance has been provided through case law and revenue rulings. Authorities fall into two distinct camps: (i) Those that find that a taxpayer's "tax home" is the location of the taxpayer's "principal place of business" and (ii) Those that find that a taxpayer's "tax home" is his "permanent place of abode." In many cases, a taxpayer's "principal place of business" and "permanent place of abode" are one and the same. In those instances, the determination of the "tax home" is simple; however, the determination of "tax home" becomes much more complex when taxpayers, courts, and the IRS deal with divergent places of business and abode, multiple places of business, multiple businesses, and multiple abodes.

The COVID-19 pandemic has only amplified these existing complexities. When taxpayers work from their primary home or from a second home because of a stay-at-home order or for their own long-term safety, health, and welfare, do these homes become their new principal places of business? Have their homes become secondary business locations or temporary business locations? Under the IRS view, travel expenses paid or incurred with respect to a location that is the taxpayer's principal place of business are generally not deductible, while travel expenses paid or incurred with respect to secondary and temporary (as opposed to an assignment of indefinite duration) business locations are fully deductible. Deductible travel expenses while away from home include, but are not limited to, the costs of:

1. Travel by airplane, train, bus, or car to the business destination.
2. Fares for taxis or other types of transportation from the airport or train station.
3. Shipping of baggage.
4. Using your car or a rental car for business while at the business destination.
5. Lodging and non-entertainment-related meals.
6. Dry cleaning and laundry.
7. Business calls while on the business trip. (This includes business communications via the internet, fax machine, or other communication devices.)
8. Tips paid for services related to any of the above expenses.
9. Other similar ordinary and necessary expenses related to the business travel. (These expenses might include transportation to and from a business meal, public stenographer's fees, computer rental fees, and operating and maintaining a house trailer.)

See IRS Topic No. 511 Business Travel Expenses and IRS Publication 463 (2019), Travel, Entertainment, Gift, and Car Expenses.

On the other hand, if the taxpayer's home or second home has become the taxpayer's principal place of business, then he or she may deduct certain direct and prorated home office expenses subject to the strict requirements of Section 280A(c)(1). To be deductible, these home office expenses must be allocable to a portion of a "dwelling unit" (what most people would consider to be a separate room within the home used as an office) which is exclusively used (meaning the room must be used for business purposes only and not as, for example, a guest room or play room) on a regular basis as (i) the principal place of business for any trade or business of the taxpayer; (ii) as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his or her trade or business (it is unclear whether video calls qualify for this purpose); or (iii) in the case of a separate structure which is not attached to the dwelling unit, in connection with the taxpayer's trade or business.

In the case of an employee as opposed to a self-employed individual, this favorable treatment will apply only if the

exclusive use is for the convenience of the employer, and a "principal place of business" includes a place of business which is used by the taxpayer for the administrative or management activities of any trade or business if there is no other fixed location of such trade or business where the taxpayer may conduct substantial administrative or management activities. In the context of the current pandemic and generally instituted employer requirement that employees must work from home, these IRS prerequisites should be satisfied. Once all the requirements are satisfied, a taxpayer must then allocate the expenses of operating the home between personal and business use. Home operating expenses that are direct expenses, such as for painting or repairs only in the area used for business, are fully deductible, whereas indirect expenses for keeping up and running the entire home are only deductible based on the percentage of the home used for business. These expenses include insurance, mortgage interest, utilities, real estate taxes, and depreciation. *See* Publication 587 (2018), Business Use of Your Home.

Adding further complexity to these issues is the fact that several jurisdictions, including the Fifth and Second Circuits, do not follow the IRS definition of tax home and the U.S. Supreme Court has never affirmed the IRS position of a tax home as being a taxpayer's principle place of business. In fact, the Supreme Court has reviewed the issue of "tax home" on several occasions, but the Court has consistently refused to commit to a definition of "tax home." Instead, the Court has made its rulings—on the deductibility of travel expenses—relying on different theories.

In *Flowers*, 326 U.S. 465 (1946), rev'g 148 F.2d 163 (CA-5, 1945), rev'g TCM 1944-263, the Supreme Court did not reject the deductibility of travel expenses by holding that the taxpayer's "tax home" was the principal place of business. Rather, the Court created a three-prong test to determine the deductibility of travel expenses and held that the taxpayer failed one of the prongs. Under *Flowers*, the three factors to consider are that (1) the expense must be reasonable and necessary, (2) the expense must be incurred while away from home, and (3) the expense must be incurred in pursuit of business. The Court held that because the taxpayer's employer gained nothing from the taxpayer's decision to reside in a different city from his place of business, the expenses incurred were irrelevant to carrying on a trade or business and, therefore, the so called "pursuit of business" prong of the three-part test was lacking and the deductions denied. Though courts are split on the determination of "tax home," travel expenses have been denied under both views.

The identification of a taxpayer's "tax home" is critical to the determination of whether travel expense deductions are allowed because the IRS only permits a deduction for traveling expenses when a taxpayer is "away from home."

Travel expenses incurred because of a taxpayer's personal choice of where to reside have been deemed nondeductible because (1) they are incurred while at or traveling to the taxpayer's principal business headquarters which is his or her tax home (under the IRS view) or (2) there is no direct connection between the expenditure and the carrying on of the trade or business of the taxpayer and the expenditure was thus not necessary or appropriate to the development and pursuit of the business (under the *Flowers* test). Under a *Flowers* analysis, the fact that the taxpayer must work from a primary or secondary home during the COVID-19 pandemic to benefit the employer would seem to satisfy the third prong of the test making these expenses deductible. Courts have also held that a taxpayer choosing to live in a particular location for personal reasons, and not because of the exigencies of his or her trade or business, does not make the travel to a business location deductible. *See Tucker*, 55 TC 783 (1971) (taxpayer chose to live in Knoxville, Tennessee with his family and commute to teaching jobs in Georgia and then North Carolina).

However, during a pandemic working from either a primary or secondary home is a matter of business exigency and is required by the employer; it's not done for personal reasons. A contrary view adverse to taxpayers in this context, because it would make the residences of the taxpayers their principal rather than secondary or temporary place of business, can be found in Rev. Rul. 71-247, 1971-1 C.B. 54, which establishes the principle that a tax home may be the place of residence for a taxpayer who has no other principal place of employment (does not work in an office outside of the home) and has actual duties that will be performed at home. The ruling supports a residence as a tax home, even if the individual travels to several temporary offices or assignments, so long as the employee is required to return to the employee's abode in between assignments.

In sum, while in a colloquial sense a home may be where the heart is, for tax purposes the specific facts and technical rules must be studied and analyzed. The failure to do this may result in unintended adverse tax consequences or lost tax deductions.