RESIDENCY AUDITS

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State taxing authorities devote significant resources to conducting residency audits and their aggressive use as a means of generating additional revenue will continue for the foreseeable future since individuals who are residents of the State are subject to that State's tax on their worldwide income and nonresidents are taxed on only certain categories of income sourced to the State. The stakes can be high here – leading to large income, or estate tax assessments.

The issue of residency for State tax purposes has long been a contentious issue and has caused much litigation. The audits (characterized by some tax practitioners as "tax colonoscopies") and resulting cases frequently delve into matters of an extremely personal nature and serve to highlight just how intrusive residency audits can be.

Residency audits typically encompass three main areas, domicile, statutory residency and income allocation.

States (ex. New York and New Jersey) define residents by two alternative tests. An individual is a resident if either (1) the individual is domiciled in the State – the domicile test – or (2) although not domiciled in the State the individual maintains a permanent place of abode in the State and spends all or part of more than 183 days in the State - the statutory residency test.

Domicile

A taxpayer's existing domicile continues until a new one is acquired. Domicile is established by physical presence coupled with an intent to establish a permanent home. As to the domicile test, the Courts in deciding whether a taxpayer has proven a change in domicile have focused on facts indicating that the taxpayer has established a home in the claimed domicile (time spent in location, location of items near and dear), as well as the location where the taxpayer's business activities are centered; the location of the taxpayers family ties, the location of social and community ties; and formal declaration of domicile – for example, driver's licenses, voting records, citizenship, etc.

Statutory Residency

As to the statutory residency test, a day count analysis supporting the individual's out of state presence by documentary evidence is critical to winning since a taxpayer must prove that he was present in the State for fewer than 184 days. Any part of a day spent in a State is a day in that State for statutory residency purposes. Credible testimony and a diary or other contemporaneous documentation can establish a taxpayer's location or pattern of travel.

Regarding permanent place of abode issues in second home type statutory resident situations, it is important to note that a recent New York Court of Appeals case – Matter of Gaied – held that just owning a house is not enough, the State has to present some evidence that it is being used as a residence by the taxpayer, not as an abode for others. Thus, properties held as investments, or for use by a child in college, or other relatives will not cause a statutory resident conclusion.

Residency audits are fact intensive and the devil is in the details – often times placing difficult evidentiary burdens of proof on individuals. It cannot be emphasized enough that planning and documentation (diaries, appointment books, expense reports, credit cards, E-Z Pass statements, e-mail and phone bills, frequent flier statements, passports, etc.) are crucial to successfully defending residency audit issues relating to change of domicile and establishing an individual's whereabouts throughout the year for statutory residency purposes.

Income Allocation

As part of residency audits, auditors also focus on income allocation, especially when a nonresident individual works for an in-State based employer.

In general, resident individuals are responsible for reporting and paying their State's income tax on income from all sources regardless of where the income is generated. A nonresident individual generally allocates income and reports to a State only that income actually generated in that State. In addition, a nonresident individual generally reports to on State income from intangibles that are attributable to a business, trade or profession carried on in that State.

If a nonresident individual performs services partly within and without a State, an allocation of income is permitted. For employees and officers, the allocation is generally the proportion of total compensation for services rendered which the total number of days worked in the State bears to the total number of days worked both within and without the State. When a nonresident individual works for an employer based in that State harsh "convenience of employer" tests in certain jurisdictions (ex. New York) treat work done outside the State by a nonresident individual at a home office as work done in the State unless the employer's necessity requires the work to be done outside the State.

Lastly, for clients considering relocation or establishing domicile in another State, the following list of non-inclusive factors should be considered:

- Records should be kept (for example, flight tickets, credit card and money card receipts, E-Z Pass statements, hard line phone bills) showing exactly how much time spent in and out of old state

- Locate doctors, dentists and other health care professionals who provide regular treatments in new state.

- Locate pets in new state.

- Change cell phone plan to new state area code.

- Obtain a driver's license in new state and relinquish old state's driver's license.

- Acquire license plates and register car in new state and relinquish old state license plates – same applies to boats and operator licenses.

- Register to vote in new state and vote there.

- File a nonresident, rather than a resident old state Income Tax Return if there is source income from old state.

- File federal income tax returns with the corresponding IRS Service Center for new state using the taxpayer's new state's address.

- Transfer safe deposit box contents to a safe deposit box in new state.

- Open new state bank and investment accounts.

- Change credit cards to new state address and make certain that charges are not made in old state during periods that you maintain you were in new state.

- Execute new wills, powers of attorney, health care proxies and living wills in which you recite that new state is your state of domicile.

- Declare new state as your residence when renewing a passport, and all other documents such as W-2s, 1099s and K-1s.

- File a declaration of domicile in new state, if applicable.

- File for a homestead exemption in new state, if applicable.

- Establish memberships in new state clubs, houses of worship, social and other organizations. Resign, or change membership status in old state organizations from resident to nonresident membership.

- Where feasible, have family gatherings and social activities in new state.

- Transfer works of art, expensive furniture and heirlooms to new state.

- Consider acquiring cemetery plots in new state.

- List new state as the primary residence on all homeowner's insurance policies.

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