Noonan's Notes on Tax Practice
State Tax Notes, Dec. 22, 2008, p. 793
50 State Tax Notes 793 (Dec. 22, 2008)

The Nuts and Bolts of a New York Residency Audit

by Timothy P. Noonan and Mark S. Klein

Without question, the New York State Department of Taxation and Finance has the most advanced residency audit program in the nation. We would hazard to guess that the department, whether out of necessity -- because so many taxpayers in the New York region have, at least allegedly, questionable residency issues -- or sheer force of will, does more auditing of taxpayers on residency issues than does any other state, and perhaps more than all states combined. So, like it or not, that is an area with which practitioners have to be conversant. And given that this column is generally devoted to tax practice issues (with a focus on New York), We thought it a good time for a nuts-and-bolts discussion about what a residency audit is all about.

Of course, the focus here will be on New York's rules and procedures, but the department generally follows the outlines of the 1996 North Eastern State Tax Officials Association cooperative agreement regarding domicile, statutory residence, and allocation, in which 13 states pledged to focus on the same primary factors for considering a person's domicile status. So the analysis in this article will likely be helpful in addressing other states' residency audits as well.

What Is a Residency Audit?

A residency audit is designed to determine whether the taxpayer correctly filed his New York state personal income tax return as a nonresident or part-year resident. Because New York residents are subject to tax on their worldwide income while nonresidents are subject to tax only on that portion of their income attributable to (sourced to) New York, the difference in tax liability can be significant, particularly if the taxpayer has substantial investment income. And if there is a possibility that the taxpayer was also a New York City resident, the difference in potential tax can be even more significant because city residents also pay tax on their worldwide income, while city nonresidents pay no tax to the city, even if they work there.

In addition to questions about residency, generally the residency audit will also examine the amount of income the taxpayer allocated to New York and whether it was calculated correctly. That, however, is the subject of another article. We'll just focus on the residency question here.

In a residency audit, the auditor will first attempt to establish whether the taxpayer is domiciled in New York. That is the first way residence is determined under New York law.[1] The other residency test is based on "statutory residency," and generally all residency audits focus on questions of statutory residency too. We'll discuss both issues in this article.

The Domicile Test

A domicile audit usually is concerned with change: Did the taxpayer move into or out of New York during the audit period? And we practitioners are often looking to tie that change to a change in lifestyle or some life-changing event, like a marriage, retirement, new job, and so forth. There are no specific regulations or tests one can apply for determining domicile. Despite what many taxpayers and practitioners believe, it really is not focused on where the taxpayer is registered to vote, maintains a driver's license, or registers his cars. It is a much more substantive inquiry, and involves, you might say, a bit of fuzzy math. The domicile test is based on long-standing common-law principles of domicile that are often difficult to apply. The general standard is that "the test of intent with respect to a purported new domicile [depends on] 'whether the place of habitation is the permanent home of a person, with the range of sentiment, feeling and permanent association with it.'"[2]

An often overlooked aspect of domicile cases involves the "leave and land" concept. To change his domicile, a person not only has to "leave" his old home, but also has to "land" in a new one. As stated recently by the Tax Appeals Tribunal in *Knight*:

> If a domiciliary of New York terminated his residence in New York with the intention of never returning and spent the following several years traveling among the capitals of Europe, residing for a few months in each, and finally returned to the United States to make a home in Florida, he would remain a domiciliary of New York until his new home in Florida was established.[3]

And although a taxpayer's existing domicile continues until a new one is acquired, the law does not require ownership of a home at the new location. A taxpayer can move, live with family or friends, or rent a new home in the new location and still not be considered to have changed domicile.[4]

Obviously, because domicile has to do with feelings and intentions, it can be somewhat difficult to quantify. As an example of how sophisticated the department has become on these residency issues, years ago it developed detailed audit guidelines to assist auditors (and, in some cases, practitioners) in working through the issues that come up during a residency audit. Under the guidelines, the auditor is instructed to analyze the taxpayer's lifestyle, using four factors to determine where the domicile is located. A fifth factor may be used if the other four are inconclusive. Obviously, therefore, in developing a residency case the practitioner has to focus on those four (or five) factors and how they come into play in the taxpayer's life circumstances.

The Five Domicile Factors

Home

The home factor reviews the use and maintenance of the New York residence as compared with the nature and use patterns of the non-New York residence. In other words, does the taxpayer behave as though the non-New York residence is her "home"? That is particularly crucial when a New York residence is acquired by a taxpayer whose domicile is in another state or a residence in New York is retained after a move to another state. So questions about timing, and which residence was owned or occupied first, are often important. But other questions often arise. Is one residence owned but the other a rental? What is the value and size of each residence? What actions did the taxpayer take to remove herself from the old community? Has she established roots in the new community? Where does the family spend holidays and special occasions? Those are the questions practitioners have to ask -- because we know the auditor will.

Active Business Involvement

This factor considers the pattern of employment and the compensation derived from that employment. It will also examine the taxpayer's active business involvement other than employment. Ongoing participation in decision-making and frequent communication with a business, even after official retirement, can be viewed as the most significant evidence of one's domicile.[5] For that factor, we would be looking to determine where the taxpayer actually worked on a day-to-day basis as well as the location of his primary office. If the taxpayer is a partner or shareholder in a New York business, the level of participation in the day-to-day management of the business can be looked at as well. Often, of course, the taxpayer is retired, so this is a nonfactor in some cases.

Time

Time is often the most important factor in a domicile case. Generally, an individual is going to spend the majority of time at his "home." So the residency audit is naturally focused on that question. There are a few important aspects of this factor to mention.

First, often we see taxpayers focus on the statutory residency test detailed below, and do everything they can to make sure they spend less than six months in New York. That's great, and it's obviously important, but a taxpayer who spends 182 days in New York might still have a residency problem under the domicile test.

Second, as indicated, one thing auditors are looking for is where the taxpayer spends the majority of time. If the taxpayer does not spend more time in her claimed "home" than in any other location, the auditor will have questions. That, however, is not always determinative. Indeed, the test is as much focused on a change in patterns more than a simple quantification of days in and out of New York. For instance, as clearly stated in the audit guidelines, "the auditor should focus on the overall living pattern of the taxpayer, asking whether the patterns present strong evidence that the new location has become the taxpayer's domicile."[6] Thus, for example, a taxpayer who goes from spending 300 days in New York to 150, and from 10 days in Florida to 145, certainly may be able to establish a change in domicile given the change in pattern.

Moreover, this factor sometimes takes on less importance for non-New York state or city commuters. As stated by the New York Tax Appeals Tribunal in a recent case, regular presence and significant time in New York City, without further proof of a New York domicile, is not at all inconsistent with a suburban commuter who comes into New York just for "work or play."[7]

Finally, to state it bluntly, this factor can also be a real pain in the neck. Proof of day-to-day location in some form or another is generally required for every single day in the audit period. That is obviously a time-consuming process, and --

like the statutory residency test that will be described below -- will require an examination of diaries or appointment books, expense reports, credit cards, phone bills, frequent flier statements, passport, and other similar documents.

Near and Dear

This factor is often the most unusual, and one that can be specific to the particular taxpayer. The auditor will investigate the location of those items that are of value to the taxpayer, whether because they are of significant value or just items of sentimental value. Insurance riders are also often used by auditors to attempt to verify the location of treasured items. They are "those personal items which enhance the quality of lifestyle."[8] We like to call this the "teddy bear" test, looking for the things it just wouldn't be "home" without.

Family

This factor is supposed to be considered only if the auditor is unable to reach a conclusion using the other four factors. In practice, however, we find that it can be incorporated into consideration of the other factors. The family factor applies only to the spouse and minor children, although occasionally the location of other family members (siblings, parents, and so forth) may be determinative in a person's choice to change domiciles. When we find that to be the case, we bring it to the auditor's attention.

Notice that, up to this point, none of the domicile factors look to things like voter registration, driver's licenses, and so forth. Those are the so-called other factors (so called in the department's audit guidelines), and include:

- the address at which bank statements, bills, and other family and business correspondence are received;
- the physical location of safe-deposit boxes;
- the location of auto, boat, and airplane registrations and of the taxpayer's driver's or operator's license;
- voter registration;
- possession of a New York City parking tax exemption;
- telephone services and activity at each residence; and
- the domicile declaration in legal documents such as a will.[9]

And although it is important that taxpayers who change their residence actually do those things, generally those aren't the types of things that are determinative in a residency audit. We like to think of those factors as defensive in nature: We like to have them to back up our residency position, but they won't be enough to carry the day.

The Statutory Residency Test

A taxpayer can also be a resident if he or she qualifies as a statutory resident under section 605(b)(1)(B) of the New York Tax Law. A statutory resident is one who "is not domiciled in this state but maintains a permanent place of abode in New York state and spends in the aggregate more than one hundred and eighty-three days of the taxable year in this state."[10] Those are two entirely separate requirements: a statutory resident must both maintain a permanent place of abode in New York *and* spend more than 183 days in New York.

The first requirement -- maintenance of a permanent place of abode -- has a few different parts. First, the place of abode must be "a dwelling place." That means that it must be suitable for human habitation throughout the year. A rustic hunting camp lacking running water and heat, for example, would not qualify. Nor would a dwelling that is suitable and used only for vacation purposes by the taxpayer.[11]

Also, the place of abode must be "maintained." Ownership of the dwelling, for those purposes, is irrelevant. The tax tribunal defines maintenance this way: "One maintains a place of abode by doing whatever is necessary to continue one's living arrangements in a particular dwelling place. This would include making contributions to the household, in money or otherwise."[12] So if someone other than the taxpayer pays all of the expenses for a New York residence, the taxpayer is still considered to be maintaining it if it is used exclusively by the taxpayer or if the taxpayer has free and unlimited access to it. But if a company maintains a corporate apartment that is used by many people, or if an apartment is maintained for something other than as a residence for the taxpayer or his or her family, that apartment would not be considered the permanent place of abode of any one person. The taxpayer under audit would, however, have to prove that the apartment was regularly used by more than one person, usually by providing logs or other proof that arrangements must be made in advance for the apartment's use.

Finally, the place of abode must be maintained for substantially all of the year. The law contains the "substantially all of the year" test, and the department has historically interpreted that as a period of time that exceeds 11 months.[13] This issue often arises when an executive is transferred to New York on a part-time basis. Provided the executive maintains his domicile elsewhere, he won't be a resident of New York for the part-year periods of time at the front or back end of his stay in New York. Alternatively, some taxpayers rent out their place for a short period of time during a particular tax year, or their apartment is unavailable because of construction or other issues. Under the so-called 11-month rule, those taxpayers probably would not meet the statutory residency test either.[14]

The second requirement for statutory residence -- spending more than an aggregate of 183 days of the tax year in the state (and in New York City, if city residence is an issue) -- is often the most difficult and frustrating aspect of a residency audit. To begin with, the 183-day test does not apply to full days only. "Days" for this purpose are *parts* of days -- and any part of a day is equal to a full day in New York.[15] So, for example, if the taxpayer wakes up in his New York apartment on Saturday morning, drives to Atlantic City for the weekend and returns to New York after dinner Sunday evening, he still has two days in New York (he woke up in New York on Saturday and went to sleep in New York on Sunday). Also, the burden of proof is on the taxpayer, and unidentified or undocumented days are counted as New York days. Thus, if there's no proof of where the taxpayer was on a particular day, can you guess how the auditor will treat that day?

The guidelines do instruct auditors to be reasonable. If the taxpayer has established that he was in Florida on Tuesday and Thursday, for example, the auditor should concede that the taxpayer was in Florida on Wednesday, absent any evidence to the contrary. Similarly, the auditor is instructed to think about the kinds of documents the taxpayer would be generating when she is at home on weekends and holidays. Most people don't generate a lot of documentation when they are at home working in the garden or spending time with their families. Thus, undocumented weekend days and holidays are usually assumed to be at home (that is, at the non-New York domicile). However, if the auditor sees lots of evidence that a taxpayer is in New York on weekends, the taxpayer may lose the benefit of the assumption of weekends at home.

The documentation required here is much the same as for the time factor of domicile: appointment books or calendars, expense reports, credit card statements, frequent flier statements, passports, telephone bills, and so forth. This test is, however, much more difficult because it is concerned with parts of days rather than patterns of behavior. So practitioners are often required to investigate every possible source for documentation of your whereabouts. Sounds like fun, no?

Other Nuts-and-Bolts Issues

Timing

Residency audits tend to be slow processes. The accumulation and analysis of the documents can take months, if not years, and discussion and negotiation can drag on as well. So sit tight. These things don't get resolved in a matter of weeks. Of course, many audits are resolved for less than 100 percent of the tax that might otherwise be due. But a practitioner's ability to negotiate a resolution will depend in large part on the quality of the documentation available.

Interest and Penalty

In most circumstances statutory interest will be added to any tax liability determined as a result of the audit. It cannot be reduced or negotiated. Interest rates change quarterly but have been generally in the 6 percent to 7 percent range. As for penalties, New York law provides for the imposition of penalties for failure to file, failure to pay, substantial understatement of income, and negligence. During the negotiation process, it's obviously advisable to pursue the abatement of those penalties as a condition for settlement of the case.

Federal Tax Issues

A New York residency audit generally does not affect the federal return for the year under audit. However, any New York tax paid as a result of an audit may be deductible on the taxpayers' federal return for the current year, if the taxpayer itemizes deductions and is not subject to alternative minimum tax. To alleviate potential AMT issues, we are often able to structure an agreement under which the taxpayer pays part of the tax in the current year and part of the tax in the next year. That often makes more of the New York tax usable as an itemized deduction.

Home State Issues

In many cases, taxpayers are advised to file protective refund claims with their home state to keep its statute of limitations open until the New York audit is concluded. Why? In some cases, the additional New York tax paid may be used to claim a credit from the taxpayer's home state for the taxes paid to New York. That is not a dollar-for-dollar calculation, and will be limited to the amount of tax actually paid to that state on the New York income as well as that state's rules regarding allocation of income and other items. But it often softens the blow.

What About Next Year?

Domicile, once determined, remains the same until the taxpayer takes some action to change it. So if domicile is the only issue in an audit, and the auditor agrees that the taxpayer is not domiciled in New York, there should be no later audit unless the taxpayer relocates to New York or takes some other action that might be construed as relocating.

But statutory residency stands alone. It can be examined every year. As a practical matter, though, our experience has been that a taxpayer who has proven she did not spend 183 days in New York during the audit period will probably not be audited again for several years. However, a taxpayer who was unable to prove that she did not spend 183 days in New York during the current audit period probably won't have the same luck.

Conclusion

Is this everything you need to know about residency audits? Of course not. We'd need a whole book for that.[16] But this article should give you a flavor of the types of issues that will undoubtedly come up in every residency audit. The department's efforts in that area continue to expand, so it's important for you and your clients to be aware of them.

* * * * *

Noonan's Notes on Tax Practice is a column by Timothy P. Noonan, a partner with Hodgson Russ LLP, Buffalo, N.Y. This column was cowritten by Mark S. Klein, also a partner with Hodgson Russ LLP, Buffalo.

FOOTNOTES

[1] Tax Law 605(b).
[2] *Matter of Bodfish v. Gallman*, 50 A.D. 2d 457, 378 N.Y.S. 2d 138 (1976) (*quoting Matter of Bourne*, 181 Misc. 238, 246, *aff'd,* 267 App. Div. 876, *aff'd,* 293 NY 785 (1943)).
[3] *Matter of Knight*, Tax Appeals Tribunal, Nov. 9, 2006.
[4] *See Matter of Jeter*, administrative law judge, Nov. 8, 2007.
[5] *See Matter of Kartiganer*, 599 N.Y.S. 2d 312 (3rd Dept. 1993).
[6] Audit Guidelines at para. 1001.4(E)(1)(c).
[7] *Knight*, *supra* note 3.
[8] Audit Guidelines at para. 1001.4(E)(1)(d).
[9] *Id.* at paragraph 1001.4(E)(3).
[10] *Id.*
[11] 20 NYCRR section 105.20(e).
[12] *Matter of Evans*, Tax Appeals Tribunal, June 18, 1992.
[13] *See, e.g., Matter of Tweed*, Tax Appeals Tribunal, May 23, 1996; *Matter of Hofler*, NYS Tax Comm'n, May 15, 1981. The department also referred to the existence of the 11-month rule in the Regulatory Impact Statement issued in connection with the recent proposal to eliminate the temporary stay exclusion from 20 NYCRR section 105.20(e) (discussed in "An End to the Temporary Stay Test in New York," *State Tax Notes*, Nov. 10, 2008, p. 383, *Doc 2008-22979* [**PDF**], or *2008 STT 219-3*).
[14] TSB-A-04(4)I (July 6, 2004).
[15] 20 NYCRR section 105.20(e).
[16] Incidentally, we've written a book on this issue, too! Klein is one of the authors, along with Paul R. Comeau, of *New York Residency and Allocation Audit Handbook,* 4th Ed. (CCH, Inc. 2002).