Minimizing the Risks of a New York State Residency audit After COVID

By: Karen Tenenbaum, Esq., LLM. (Tax), CPA
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COVID-19 caused millions of people to make a change in where and how they were living. To get away from crowds, they left cities in favor of the suburbs. Others sheltered in place free of the obligation to travel to an office. In many cases, this did not affect their taxes. However, where taxpayers lived and worked in different states, an opportunity arose to revisit their taxes. With the first income tax filing for 2020 behind us (except for those on extension), the question is: How many taxpayers took advantage of the chance to change their residency or recalculate how much time they spent working in New York to save money on taxes? Some of these taxpayers are likely to face audits. Ideally, before that happens, tax professionals should ensure they have all pertinent information from clients so tax returns can be justified. Further, clients should be warned about actions that could undo their changes after filing.

New York's Two Residency Tests
New York has two tests for residency: the **Domicile Test** and the **Statutory Residency Test**. (Note that New York City has its own distinct income tax that applies to city residents.) If taxpayers meet either of these, then they must pay taxes on all their worldwide income, regardless of where it is sourced. Nonresidents pay tax only on income earned in New York, such as wages or rental income earned in the state.
Domicile Test
Domicile is defined as the place the taxpayer considers their permanent home. The domicile test considers various factors to determine where the taxpayer's true home lies. The five primary factors are home, business involvement, time, family connections, and items near and dear.

The home factor involves a comparative analysis of the use, maintenance, value, and size of each home. It also looks at whether the taxpayer has severed roots in the old community while establishing connections in the new community.

The business Involvement factor looks at the taxpayer's active participation in the daily management of a business. The location of the taxpayer's primary office or the degree to which the taxpayer

remains involved in the day-to-day operations of a New York business could be evidence of the place the taxpayer considers his or her domicile.

The time factor considers the amount of time the taxpayer spends in New York State as against the amount of time spent in the new domicile. New York often focuses on whether there has been a significant shift in time between New York and the new domicile, or in the taxpayer's pattern of life when compared to years prior. Producing this evidence can be onerous. It may require reviewing personal calendars, flight records, credit card statements, and cell phone records.

The family connections factor examines the taxpayer's family structure in order to help determine where he or she is domiciled. Historically, where the taxpayer's school-aged children were attending school was dispositive. However, as schools went to remote learning, children may still be associated with the old domicile's school district even if the children were physically located elsewhere.

Items near and dear, also referred to as "the teddy bear test," examines where the taxpayer keeps sentimental and valuable possessions. Moving items to the new domicile may be indicative of the taxpayer's intention to change domicile. Similarly, leaving possessions in the old residence can be construed as having the intention to remain in, or return to, the old domicile.

Several less significant factors could are considered. These include obtaining a driver's license, registering to vote, registering one's vehicles and making a domicile declaration at the new domicile.

Note that the burden of proof is on the party asserting a change in domicile, generally, that is the taxpayer.

Statutory Residency Test

An individual who is not domiciled in New York can still be a resident under the Statutory Residency Test. It applies when a taxpayer maintains a *permanent place of abode* in New York for substantially all of the year and spends more than 183 days in the state. It should be noted that statutory residency is only important for income tax purposes, while domicile is relevant to both income and estate taxes.

COVID-19 Problems

As noted previously, many taxpayers changed where they were living or how much time they spent in New York because of COVID. If they decide to claim they are no longer New York residents, auditors are likely to examine some of the following issues to ascertain residency:

- **How much time was spent in the state?** Many switched homes perhaps more than once based on the severity of COVID-19 in the respective areas, which could cause problems under both the domicile and statutory residency tests.
- **Has the family established ties in their new community?** COVID may have made that difficult initially, but as restrictions are eased, auditors will want to see that the taxpayer is taking appropriate steps to develop connections to the new location.
- **Were the taxpayer's children moved to a new school district?** Remote learning allowed children to remain in their original district. However, as in-person instruction resumes, auditors will look at the actions taken by parents.
- **Did the taxpayer become more involved in out-of-state business interests?** As businesses struggled, a part-owner may have taken a more active role in a business located outside the state in which he or she resides, which could impact residency.
- **Did the taxpayer work from home out of convenience or necessity?** Where a taxpayer lives and works in different states, he or she may be subject to taxation in more than one state. However, various rules affect when someone is considered to have worked "in-state," such as whether it was for convenience or necessity. In New York, if the taxpayer is a nonresident and his or her primary business office is located in New York, telecommuting days are still considered days worked in New

York unless the taxpayer's employer has established a bona fide employer office at the taxpayer's telecommuting location.

Also note that although the taxpayer may be entitled to a tax credit on earned income, there is no tax credit on intangible income such as interest and dividends. State rules vary so it is important for clients to speak with a tax professional regarding telecommuting issues.

These and other actions may be problematic for many taxpayers if they are audited.

Minimizing the Risks of a Residency Audit
The first step for tax professionals is to confirm that the client properly completed the tax return and can justify a change in domicile, challenge statutory residency or substantiate a bona fide office as appropriate. Any documentation the client has in support of their position should be preserved.

Even if the client has sufficient evidence, the risks are not over. Auditors may not appear for months or years. They will be examining the taxpayer's actions with the benefit of hindsight to determine whether a move was simply temporary to get through the COVID-19 crisis. In that case, the taxpayer will be judged as a state resident retroactively and get hit with a commensurate tax bill.

Clients must be advised to continue to demonstrate their intent to change domicile. This is particularly important as COVID may have made it more difficult to show the existence of certain factors (e.g., changing a child's school, buying a new home, obtaining a driver's license). However, as life gets back to normal, clients must follow through and show that they have taken steps to establish a new domicile.

Where statutory residency is a risk, clients must carefully track their time in New York to avoid going over 183 days. This may be an issue, particularly as people start to travel again and families reconnect for longer visits.

Conclusion
New York State aggressively enforces its residency laws generating substantial revenue from audits. As a result, tax professionals should discuss these issues with clients so they take steps to dispute, mitigate or prepare for a potential tax bill.

***Karen Tenenbaum, Esq., LLM (Tax)**, CPA is founder and managing partner of Tenenbaum Law, P.C. (www.litaxattorney.com), a tax law firm in Melville, N.Y., which focuses its practice on the resolution of IRS and New York State tax controversies. Karen can be reached at ktenenbaum@litaxattorney.com and at 631-465-5000.*