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JUST VISITING?

If you're not careful, an extended stay in a state can lead to residency status and a huge tax bill.

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When it comes to slamming the tax hammer on the wealthy, one area government officials are intently focusing on is state residency. Specifically, when is someone legally a resident of a state or other tax jurisdiction and subject to its taxes?

Inquiries into such matters usually start with a state residency audit, which can be as simple for a taxpayer as filling out a questionnaire or as complicated as answering repeated and onerous requests for information and documents.

The dollars at stake in a residency audit can be staggering. If a state successfully establishes that an individual is a resident, it will generally apply its tax rate to 100% of the individual's taxable income for the year, with credit given for taxes paid to other states only when the taxed income was derived in the other state. The taxes owed can be particularly high in states that have enacted so-called "millionaire" brackets that tax all income above specified thresholds at particularly high rates.

Residency Definitions

The term "resident" is not uniformly defined by all states. Most states assert the power to tax someone as a resident if he is domiciled in the state. "Domicile" is an ancient common law term that refers to an individual's true and permanent home—the place a person intends to return to after an absence. An individual may have multiple residences but can, by definition, have only one domicile.

In addition to the domicile standard, states have other criteria to establish residency. The main alternative criteria are as follows:

Presence in the state for something other than a temporary or transitory purpose.

In a number of states, including California and Illinois, presence in the state for a reason "other than a temporary or transitory purpose" causes one to become taxable as a resident. This definition is intended to cover individuals who are in the state for an indefinite period of time and have a "closer connection" to the state than to any other state during the tax year.

Presence in the state for a specified period of time.

Some states will tax an individual as a resident solely because of the individual's presence in the state for a specified period of time, say six months to a year. In some states, his presence during that time creates a presumption that the individual is a resident for that period.

Maintenance of a place of abode for a specified period of time.

Several juridictions, including the District of Columbia, Maryland and Virginia, tax individuals as residents if they merely maintain a home in the jurisdiction for a specified period of time—generally six months or more—during a taxable year. In such jurisdictions, an individual may be taxed as a resident even if he is not present in the state for most of the year.

Presence for a specified period of time accompanied by the maintenance of a permanent place of abode.

Massachusetts, New York, New York City and several other tax jurisdictions will tax an individual as a resident if he maintains a permanent place of abode in the jurisdiction and is present in the jurisdiction for over 183 days. The determination hinges on two audit issues: (1) determining when an abode is "permanent"; and (2) determining how many days the individual was present in the jurisdiction during the taxable year.

Dual residents and credits.

A “dual resident” situation is quite common—i.e., an individual may be a resident of one state since he’s domiciled there but may also be considered a resident of another state if he owns or rents property there or is present in the other state for over a certain number of days in a taxable year. Such a situation may result in double taxation at the state level. Most states offer a credit for taxes paid to other states, but the credits are often limited and often only apply to income derived from a particular state. Investment income is generally not considered derived from any particular state, so dual residents may be taxed on 100% of their annual investment income from more than one state and not be eligible for any credits.

Common Audit Issues Change of domicile.

The most frequently litigated state tax residency situation involves an individual who has historically been domiciled in a state that imposes an income tax and claims for the audit period that his residence has changed to a state that does not impose an income tax (such as Montana, New Hampshire, Nevada and Texas and especially Florida). Case law generally says that the party asserting the domicile change has the burden of proof. But proving a change in domicile can be difficult.

Many states require evidence showing that the original domicile has been abandoned. Simply purchasing property in a new state, registering to vote in the state and switching driver’s licenses is generally insufficient to prove a change in domicile.

It is usually necessary to switch the focus of one’s life to a new state—living with family members in the new state, partaking in the state’s cultural activities and becoming part of the community fabric—to prove a domicile change. Such a case can be made if the domicile switch is planned in advance and is carefully and meticulously executed. Without careful planning, showing a change in domicile can be quite challenging because people rarely cut all ties to their former domiciles. Such ties commonly give auditors the “bad facts” they need to resist a change in domicile declaration.

Day count issues.

In jurisdictions that base residency on the number of days spent in the state, determining how much time a person has spent in a state during an audit period can be a major issue. Problems arise when the audit years go far back and records need to be tracked down. Individuals need to account for their whereabouts each day of the tax years in question in those cases where just a few days make a huge difference.

In one case, Julian Robertson, the hedge fund manager who founded the now-defunct Tiger Management Corp., successfully fought off a claim that he owed New York City $27 million in back taxes from the 2000 tax year. The dispute centered around four days. At trial, Robertson used his appointments calendar and oral testimony to show that he was not in the city during the four days in question, and therefore did not meet the 183-day threshold that would have made him a city resident. The case demonstrates how crucial it can be to keep detailed records—including third-party documentation such as airline frequent flyer records and credit card receipts—that verify where an individual was on a particular day.

Temporary business presence.

It is common for an individual to travel to a jurisdiction for a temporary stay, perhaps for a work assignment or to start a new business venture. The law in some states says that a temporary presence is not enough to make someone a resident. But at what point does a temporary stay become permanent? The law on this fundamental issue is surprisingly unclear in many states. Note that just because an individual considers his presence in a jurisdiction to be temporary does not mean that law will recognize it as such. What is "temporary" and what is "permanent" in a particular jurisdiction will depend on case law, and the rules may be less than intuitive. Before assuming that a stay in a jurisdiction for business reasons is temporary for state tax purposes it would be prudent to consider how the courts in that jurisdiction have ruled on such matters.

Concluding Thoughts

State tax residency rules are complicated and confusing, and the rules often vary significantly from jurisdiction to jurisdiction. The best defense is to carefully consider the rules before expanding one's geographical footprint, such as by buying property or undertaking a business venture in a new jurisdiction. Residency audits are becoming increasingly common and familiarity with the rules for all relevant jurisdictions, along with careful planning, can ensure that the best set of facts are in place should a residency questionnaire ultimately be received.

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