Could the Tax Cuts and Jobs Act Mean More State Income Tax Audits?

By Michael Sardar

The Tax Cuts and Jobs Act (TCJA), signed into law on December 22, 2018, delivered sweeping changes to the federal tax code. These changes brought with them ambiguity and uncertainty, which will likely lead to federal tax audits and disputes on how such provisions should be applied and interpreted. One of the TCJA's changes, however, is expected to trigger state tax collateral consequences that may lead to an increase in state and local income tax audits and disputes, specifically audits by states and localities to determine if a taxpayer is a resident and thus subject to tax on all income. These are often called residency audits.

The TCJA's State and Local Tax Limitations

One of the TCJA's signature changes was the introduction of a cap on the deduction at the federal level of state and local taxes (SALT). Under prior law, individual taxpayers who itemized their federal income tax deductions could generally deduct, without limitation, all of their state and local income taxes, as well as property taxes. For many taxpayers residing in high-tax states such as California and New York, this SALT deduction was often one of the largest itemized deductions. Under the new TCJA rules, the SALT deduction is limited to $10,000 ($5,000 for married taxpayers filing separately). For high-income taxpayers, this limitation will significantly reduce an otherwise large and valuable deduction.

The conventional wisdom is that high-income taxpayers in high-tax states, such as New York, who can no longer deduct the full amount of their state tax obligations will increasingly try to relocate to low- or no-tax states, such as Florida, which imposes no personal income tax. Before taxpayers attempt to make such a move, however, they and their advisors need to fully consider the tax residency rules that apply. Taxpayers should also be aware of how such moves are scrutinized during the seemingly inevitable residency audit that follows a high-income taxpayer's move to a low- or no-tax state.

State Tax Residency

For the majority of states and localities that impose an income tax, the tax is generally applicable to *all* income earned by resident taxpayers. For example, a New York City resident will be subject to New York State and New York City income tax on all of his income, even if the income at issue does not derive from New York sources. Because the taxpayer is a resident, his worldwide income is subject to tax by New York State and City (subject to credits for taxes paid to other states). On the other hand, individuals who are not residents of New York are generally taxed only on their New York–source income. Thus, whether an individual is a resident of a particular state will ultimately determine whether that state can tax the individual on all of his income, or just some of it.

Staying with the example of New York State, whose residency rules are similar to many other states, a taxpayer is deemed to be a resident for tax purposes if she is domiciled in New York *or* qualifies as a statutory resident. Falling into either category subjects an individual to full income taxation by New York. Taxpayers seeking to avoid resident status by moving to another state will need to make sure that they are no longer domiciled in the state they are leaving *and* that they are not otherwise deemed to be statutory residents upon exiting the state. Doing this effectively is often harder than it appears and the subject of hotly contested residency audits.

Domicile

A taxpayer's domicile is generally the place where the taxpayer intends to have his true permanent home and the "principal place to which he intends to return whenever absent." A taxpayer's domicile is essentially determined by the taxpayer's intentions and is therefore ultimately a subjective determination. Once a taxpayer has established a domicile, that place continues to be the taxpayer's domicile until the taxpayer abandons it and moves to a new location "with the bona fide intention" to make the new location his permanent home (i.e., the place to which he will return whenever absent).

For most taxpayers looking to leave high-tax states, the state they are leaving is likely their current domicile. These taxpayers,

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therefore, need to establish that they have abandoned their New York domicile and have established a new domicile in a different state. Because domicile is a subjective inquiry that requires determining a taxpayer's intent and what is inside a taxpayer's mind, the determination of domicile is both difficult and prone to disagreement. In order to determine what a taxpayer's true intentions are, states and taxpayers will look at the taxpayer's conduct and actions in order to determine the taxpayer's intent. The difficulty of determining whether a change in domicile has occurred is especially noteworthy because the taxpayer is the one required to prove the change. In New York, for example, a taxpayer claiming a change of domicile to Florida would be required to prove such change by "clear and convincing" evidence, a legal standard that is above and beyond the "preponderance of the evidence" standard that is often applicable in civil litigation.

Knowing how states reach domicile determinations can help taxpayers and their advisors plan accordingly. A taxpayer looking to change her domicile will need to make sure that her actions clearly and adequately convey and demonstrate her intentions. New York uses five primary factors to gauge whether a taxpayer's stated intention to change domicile matches up with what the state believes to be her true intentions:

- The size, value, and nature of use of the taxpayer's former New York residence compared to the size, value, and nature of use of the residence in the new state of domicile
- The taxpayer's employment and business connections in both states
- The amount of time spent in both states
- The physical location of items that have significant sentimental value to the taxpayer
- The taxpayer's close family ties in both states.

No one factor is determinative; rather, all of the factors are weighed individually and collectively.

A taxpayer who truly intends to relocate his domicile will want to make sure that the above factors will weigh decisively in favor of such a change. Selling one's home in the prior place of domicile and purchasing a home in the new location is advisable. A taxpayer who wishes to maintain a home in New York should consider renting or buying a smaller residence that will, when objectively compared to the new home, demonstrate that the New York residence is secondary in nature. Continued employment and business connections in New York will also weigh against a change in domicile. Taxpayers changing domicile should also be mindful of the time spent in the new location as compared to the old. Continuing to spend significant amounts of time in the former state of domicile may not square with a real change.

In addition to these factors, states will often look at many other factors that can speak to the taxpayer's true intentions. As one might imagine, an audit to determine a taxpayer's domicile can be quite intrusive and will require the presentation of information regarding very personal aspects of the taxpayer's life, movements, and family, areas that are usually not central to other types of tax audits. A high-earning taxpayer who leaves a state like New York in search of sunshine (and lower taxes) in Florida should expect a residency audit; the question is often a matter of when, not if. During such an audit, taxpayers can expect to have their personal diaries and calendars inspected, their toll-tag records analyzed, their cell phone records reviewed, and their New York pied-à-terres walked through, among other equally intrusive methods of examination.

Statutory Residency

Even if a taxpayer can overcome the change of domicile hurdle, she is not off the hook unless she can also establish that she is not a statutory resident of the state she is leaving behind. In New York, an individual is a "statutory resident" and thus taxed on worldwide income if she 1) maintains a permanent place of abode in New York and 2) spends more than 183 days in New York during the tax year. If a state auditor cannot overcome the taxpayer's demonstration of a change of domicile, the auditor will try to establish that the taxpayer is a statutory resident. For purposes of this test, a permanent place of abode is any dwelling available to the taxpayer in a residential capacity for substantially all of the tax year. A pied-à-terre certainly qualifies as a permanent place of abode, while corporate apartments may also qualify depending on the circumstances.

For purposes of meeting the 183-day threshold, spending even one minute in New York counts as a full day. A New York day will count as such even if the taxpayer does not visit his New York residence during that day. States and taxpayers now use increasingly sophisticated tools to determine a taxpayer's day count; these can include mobile phone location data, credit and debit card usage, and even apps that track and monitor physical location. Because statutory residency is measured on a year-by-year basis, taxpayers who are statutory residents of a state are often subject to repeat audits to determine their status for each tax year.

Proceed with Caution

While the examples in this article use New York State residency rules, many other states use similar rules and concepts in determining residency status. Thus, taxpayers looking to leave a high-tax state should seriously consider whether they can do so in a manner that will satisfy the former state of residence that they are really gone. These individuals need to be certain that they document their movements, take clear actions that demonstrate the desired move, and sever ties to the old state while establishing new formal and informal connections in the new state. ❑

Michael Sardar, JD, *is a tax controversy attorney at Kostelanetz & Fink LLP, New York, N.Y.*

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