A Penton Media Publication

OCTOBER 2011
$35.00

Trusts & Estates®

The Journal of Wealth Management for Estate-Planning Professionals—Since 1904

Golden Hues—John Houston's "Sunflowers and Checked Cloth" sold for 6,240 GBP (about $9,814) at Bonhams' "The Scottish Sale Edinburgh," held on Aug. 16 to 31, 2011, p. 4.

BRIEFING
9/ Tax Law Update • Family Businesses

FEATURES
16/ Where Do You Live?
Residency issues are more complex than you think
By Timothy P. Noonan

22/ Raising the Bar
New SEC disclosure requirements impact how trustees evaluate and choose financial advisers
By Julie Jason

29/ Lifetime Versus Testamentary Giving
Consider three non-tax implications
By Roger D. Silk

33/ Family Office Management of Private Foundation Funds
Properly structure compensation arrangements
By Eric L. Johnson & Ryan E. Thomas

SPECIAL REPORT
VALUATIONS
45/ High Frequency Trading Firms
How to figure out what they're worth
By Daniel R. Van Vleet

51/ Appraisal Issues Surrounding the Leveraged Reverse Freeze
Address these in the early stages of planning
By Alex W. Howard & Bradley A. Gates

57/ Section 2036 Estate Controversies of Tenants in Common Interests
Historical perspectives and modern defenses
By Dennis I. Leonard & Alison Merino

INSIDE: 2011 CHARITABLE GIVING SUPPLEMENT

By Timothy P. Noonan

Where Do You Live?

The answer to this question may not be so simple, as states raise revenue through increased audit enforcement of residency issues

State governments are, more than ever, struggling to meet budget deficits. But state legislators often find that raising taxes and cutting programs aren't the best ways to get re-elected. Instead, many states have found a new way to plug holes in the budget: increasing revenue through heightened audit enforcement. And what better way to increase revenue than to go after high-net-worth individuals (those "corporate jet owners," as our President likes to call them) who claim they don't even live in the state? Indeed, those folks don't even vote in state elections! So, increasingly, state governments are turning to their own state tax departments and empowering them to mine their database of high-net-worth individuals and look for residency targets.

Don't worry, it gets even better. Not only do taxpayers have to deal with aggressive tax departments and hungry tax auditors, but also taxpayers potentially have to deal with 51 different sets of rules. That's because each jurisdiction determines residency differently. What makes you a resident of New York might not necessarily also make you a nonresident of California and vice versa. Moreover, because jurisdictions have disparate tests for residency, it's quite possible for taxpayers to qualify as residents of multiple states in the same tax year, facing double—or possibly even triple—taxation on the same income. While this result may create a boom in business for tax practitioners, for everyone else it creates a terrible headache and incredible concern. To properly advise clients, it's important to know the rules in this context. Indeed, of all the different tax issues out there facing high-net-worth individuals and the tax professionals who represent them, residency really isn't all that complicated. Still, it's more complex than people think, and taxpayers and their advisors need to have a full understanding of the test (or tests) that apply in various jurisdictions.

Timothy P. Noonan is a partner at Hodgson Russ LLP in Buffalo, N.Y.

Residency Status

As noted, different jurisdictions have different rules for determining residency. But "residency," in and of itself, is the all-important concept. The taxing structure for residents is incredibly simple. Residents are taxable on one thing: everything. If you qualify as a resident of the state of New York, the state of New York has the authority to impose taxes on all of your income, regardless of its source. Nonresidents, on the other hand, are only taxed on income with a source in the state. Sure, as we'll see later, all states have some sort of mechanism to ensure that taxpayers get credit in their home state for taxes paid to other states on certain types of income. But often these credits are insufficient to relieve double taxation. This is especially true when a taxpayer potentially qualifies as a resident of two states. In that case, double taxation is all but unavoidable. And again, the problem is only heightened because, as we'll discuss later, jurisdictions have different rules for determining residency. But it's important to recognize that all issues in this context begin and end with the jurisdictions' definition of "resident."

New York

Let's start with the state that has been the leader in the residency charge—my home state of New York. With tax rates that can reach as high as 13 percent (combined New York State and New York City tax rates), it's no surprise that taxpayers attempt to seek safety in more tax friendly neighboring jurisdictions (for example, Connecticut, Pennsylvania or Vermont) or in zero-tax states like Florida. The question, of course, is whether these taxpayers really qualify as nonresidents of New York.

Under New York's rules, residency can be established through one of two tests. The first test is if you're domiciled in New York. If so, then you're taxable as a New York resident.[1] As we'll see below, many states use this same definition to define residency, so it's important to have a full understanding of the domicile test. Domicile refers to one's principal, primary and permanent home,[2] but its colloquial definition is simpler: "home is where the heart is." 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.'"[3] That should be easy enough for a tax auditor to figure out, right? This is, in fact, why domicile audits can be so difficult: the tests are incredibly subjective.

Over the years, to help auditors figure out where someone's "permanent" home was located, the New York State Department of Taxation and Finance developed a set of "factors" for use by auditors during residency audits. These factors are the focus of almost every residency audit that the Department conducts. The five factors are: home, active business involvement, time, near-and-dear items and family. When planning a move outside New York, taxpayers should be sure that most or all of these "factors" weigh in favor of their new home state. Of all these factors, we often find that the "time" factor is most instructive in a domicile case. If the taxpayer doesn't spend more time in her claimed "home" than in any other location, an auditor will have questions. In all of our clients' audits, we're looking to demonstrate that the taxpayer spends more time at home than anywhere else. This, however, isn't always determinative. Indeed, the test is as much focused on a change in patterns than on a simple quantification of days in and out of New York. Thus, for example, a taxpayer who goes from spending 300 days in New York to 150, and from 10 days in Florida to 145, may be able to establish a change in domicile given the change in pattern.

But, taxpayers who steer clear of the domicile test aren't out of the woods. That's because, like many states, New York has an alternative test for residency—the "statutory residency" test. Under this test, a person can be taxed as a New York resident if she maintains a permanent place of abode in New York and spends more than 183 full or partial days in New York during the year.[4] Over the past year, there have been several cases highlighting the problems and difficulties that can arise in these statutory residency cases. On the "days" issue, a recent case involving the noted hedge fund manager Julian Robertson highlights the high stakes poker that can go on. In *Matter of Robertson*,[5] the issue concerned the taxpayer's location in or out of New York City over the course of two days during a tax year. If the taxpayer was unable to prove his non-New York City location on either of those days, he would have been hit with a $26 million tax bill. Luckily for the taxpayer, the New York State Tax Appeals Tribunal (Tribunal) held that he presented adequate proof of his non-New York City location on the two days in question. This case, however, highlights how difficult and intrusive the day-count investigation can be. *Robertson* culminated in a trial lasting over four days, with incredibly detailed evidence, testimony and documentation focused on the taxpayer's whereabouts on a few days during the tax year.

The focus should be on where someone's permanent and primary home is located.

To help taxpayers defend against these types of audits, I'm in the process of developing a smart-phone application to allow a person to track her whereabouts in and out of New York using global positioning system technology.[6] That technology may reduce the burden in some of these audits, since the taxpayer in a statutory residency audit has the arduous task of proving each and every day spent outside of New York.

Permanency Requirement

Two other recent cases highlight some problematic issues in the statutory residency area; specifically regarding whether a person's dwelling constitutes a

"permanent place of abode" in New York. In *Matter of Gaied*,[7] the Tribunal ruled that an apartment maintained by the taxpayer for his elderly parents was a "permanent place of abode," even though the taxpayer had no living quarters of his own in the apartment and didn't use it as his own residence.[8] The other case generating publicity is *Matter of Barker*.[9] In that case, the taxpayer, John Barker, lived in Connecticut but worked in New York City, commuting to work each day from his Connecticut home. He didn't maintain any New York living quarters near his office or home. However, he and his wife owned a small cottage in the Hamptons (the eastern part of Long Island, N.Y.), several hours from their home and John's workplace, where they spent about 10 to 12 nights a year. Applying the statutory residency rules in a mechanical fashion, the Tribunal held in January 2011 that the taxpayers could be taxed, as statutory residents of New York, on all income from all sources, because John spent more than 183 days in New York and "maintained a permanent place of abode" in New York. The case is still under review, but the Tribunal's ruling made headlines in *The New York Times, The Wall Street Journal* and several other notable publications.[10] Reviews of the decision have been critical.[11] The ruling has surprised many tax practitioners and upset many real estate professionals, who fear that rulings like this will discourage nonresidents from purchasing second homes in New York. The New York state legislature has also proposed legislation to reverse the ruling in the case, even while it's still under appeal.

California and Illinois

Many states follow an approach similar to New York's, with residency defined based either on domicile or some combination of days in the state and an abode in the state. But other states—like California and Illinois—have a different structure. Under both states' personal income tax laws, a "resident" individual is defined as someone: (1) who's in the state for other than a temporary or transitory purpose during the tax year; or (2) who's domiciled in the state but absent from the state for a temporary or transitory purpose during the tax year.[12]

So both states focus on this "temporary or transitory" test. And under both states' rules, an individual is in the state for a temporary or transitory purpose if she's simply passing through the state on the way to another state, or is there for a brief rest or vacation, to complete a particular transaction or to perform a particular contract. If, however, the individual is in the state to improve her health and a relatively long or indefinite recuperation period is required; or she's in the state for business purposes that will require a long or indefinite period to accomplish; or she's employed in a position in the state that will last permanently or indefinitely, her presence won't be defined as temporary or transitory.[13]

All this is pretty confusing, but California has issued a publication that helps define the test more simply.[14] In this publication, the Franchise Tax Board indicates that "the underlying theory of residency is that you're a resident of the place where you have the closest connections." California lists a number of ties that should be used as a comparison in trying to determine where someone has her closest connections. It considers factors such as:

- amount of time spent in California versus time spent elsewhere;
- location of spouse and children;
- location of principal residence;
- state that issued driver's license;
- state of voter registration;
- state where professional licenses are maintained;
- location of banks;
- location of medical professionals and health care providers as well as accountants and attorneys;
- location of social ties; and
- permanence of work assignment in the state.

Illinois provides a similar list of factors.[15]

To the casual observer, the California/Illinois tests appear drastically different from the New York test. And in some respects, they are. Neither California nor Illinois have the concept of "statutory residency," in which residency is based on an alternative test looking to days/abodes. But in reality, the temporary/transitory purpose test looks a lot like the domicile test, focusing on where someone has their closest connections. To that extent, the focus should be on where someone's permanent and primary home is located. We can call that a "domicile" test. We can call it a "closest connection" test. Or we can call it a "temporary/transitory" purpose test. But the focus is the same: to figure out where the taxpayer really lives.

Other State Residency Tests

Many states/jurisdictions follow the New York structure,

basing resident taxation on one of two alternative tests: domicile or statutory residency. They include: Alabama, Arkansas, Colorado, Connecticut, Delaware, Georgia, Indiana, Kansas, Kentucky, Louisiana, Maryland, Massachusetts, Minnesota, Missouri, Nebraska, North Dakota, Oklahoma, Pennsylvania, Rhode Island, Utah, Vermont, Virginia, West Virginia and Washington, D.C. There are some variations among different jurisdictions. For instance, some jurisdictions have a higher threshold of days (Oklahoma requires seven months as opposed to six months or 183 days). But each idea is the same. They will look to domicile as the primary test, but they also will look to "days" in the alternative.

Potential contradictions can arise for a taxpayer who's either very cheap or simply not paying attention.

A number of other states, however, follow the California/Illinois rule, with the focus on a temporary/transitory purpose. Those states include: Arizona, Hawaii, Montana and Wisconsin. And still other states have different tests. In Mississippi, residency is based solely on domicile. The same goes for South Carolina. Ohio has an unusual rule focused on the number of "contact periods" a taxpayer has in the state. And Iowa's "statutory residency" test doesn't even have a "days" requirement: An individual is taxed as a resident of Iowa if she's domiciled in the state or if she merely maintains a permanent place of abode in the state.

The above list isn't meant to create confusion, although, admittedly, it probably does. Instead, it's designed to make a point. While there are 51 different jurisdictions out there with 51 different sets of taxing rules, it's actually possible to boil down different residency tests into a couple of different components. From there, of course, we have to deal with the vagaries of individual income tax auditors applying ridiculously subjective domicile tests. There, in fact, is where we find most of the "fun" of these audits. Whatever the case, and wherever the state, taxpayers and their advisors can do themselves a great service by focusing on where the taxpayer truly maintains her permanent and primary home and establishing enough background facts to document that position.

The Residency "Formalities"

For the most part, you'll notice that states don't generally base their residency tests on items like voter registration and driver's licenses. Under New York's rules, these are referred to as "other" factors. Other states, including California and Illinois, list these as evidence of a taxpayer's "connections" in a state. But beware of these factors. Too many times, we see taxpayers relying almost exclusively on items like driver's licenses and voter registrations to document and substantiate their change of residency to another state. While it's necessary for taxpayers to take these steps, they generally aren't determinative in establishing residency. Or at least that's the case if you ask a residency auditor. The auditor's view is that "anyone can change his driver's license." Or "anyone can register to vote." However, taxpayers who change residency to another state and fail to change their driver's license face a troubling double standard—auditors will hold it against the taxpayer and say "Ah-hah, he clearly couldn't have changed residency to Florida because he didn't get a Florida driver's license!" Such is the nature of the beast in the residency audit. Whatever the case, beware of reliance on these domicile formalities. You need to advise your clients to take these formal steps, but you also need to advise them that these steps aren't sufficient to document their change of residency.

Along the same lines, be careful of potential contradictions that can arise for a taxpayer who's either very cheap or simply not paying attention. For instance, we've had clients claiming a change of residency outside New York who nonetheless have applied for New York resident fishing or hunting licenses ... to save $10 on their registration fee! We've also had taxpayers claiming the New York State School Tax Relief Program (STAR) exemption in a year after they've changed their residency—which is a problem because the STAR exemption is only available to residents. Or, we've had taxpayers taking the federal capital gains tax exclusion for sales of primary residences for a home located in the state that hasn't been their primary residence for many years. So be careful of these contradictions. Try to identify any

registrations or exemptions that a taxpayer might have based on some sort of residency exclusion. Make sure everything gets switched.

State Tax Credits

Some taxpayers or practitioners brush aside dual residency concerns because they're under the impression that double taxation is constitutionally prohibited or that states have credit mechanisms in place to restrict double taxation. This is a mistake. In fact, double taxation in the residency area is, unfortunately, all too common.

How does this happen? The main problem is created by the state's tax credit mechanisms. Despite what many believe, states won't provide a credit for any and all taxes imposed by other jurisdictions. First, the credit is generally limited to residents of a state. So if a taxpayer is a resident of the state, the taxpayer could qualify to receive a credit for taxes paid to other states. But here's where the issue gets even trickier: Many states limit the extent of that credit.

New York is a perfect example. In New York, residents are permitted to take a credit for "any income tax imposed for the taxable year by another state . . . upon income both derived therefrom and subject to tax under [New York law]."[16] So, New York will provide a credit for taxes paid to other states only to the extent the income is sourced to that state under New York's sourcing rules. Thus, if a New York resident pays tax to Wisconsin because the taxpayer worked half the year in Wisconsin, then New York will provide a credit for the Wisconsin tax because, under New York's rules, the tax was properly payable to Wisconsin because the taxpayer was working there. But, for instance, if the taxpayer ended up qualifying as a Wisconsin resident and was taxed on all his income—including income from interest, dividends and capital gains—then New York wouldn't give a credit for the Wisconsin tax on the taxpayer's "intangible" income (the interest, dividends and capital gains). Again, it's a sourcing issue. In the example, the Wisconsin tax on the taxpayer's wage income was properly sourced to Wisconsin because the taxpayer worked there. New York has the same rule, so it will provide a credit. But the interest, dividend and capable gains income didn't have a source in Wisconsin; the only reason Wisconsin taxed it was because the taxpayer qualified as a Wisconsin resident. Under that scenario, New York wouldn't provide a credit.

Most jurisdictions follow the same rules as New York — they'll only give credit for taxes paid to other states if the tax was on income sourced to that state. Some states, like New Jersey, have more reasonable and relaxed rules. New Jersey will provide a credit for taxes paid to other states so long as the income is taxed both in New Jersey and in the other state. But New Jersey is the exception. As a result, double taxation is a real possibility.

High-net-worth individuals and their advisors need to be careful. Again, jurisdictions are hungry for revenue. They like going after people who don't vote. And with residency rules so subjective and confusing, difficult audits are unavoidable. Regardless of the jurisdiction we're dealing with, all we can do is prepare: learn the rules, take the necessary steps and save every piece of paper. TE

Endnotes

1. N.Y. Tax Law Section 605(b)(1); 20 N.Y.C.R.R. Section 105.20.
2. 20 N.Y.C.R.R. Section 105.20(d).
3. *Matter of Bodfish v. Gallman*, 50 A.D.2d 457 (1976) (quoting *Matter of Bourne*, 181 Misc. 238, 246, *aff'd*, 267 App. Div. 876, *aff'd*, 293 N.Y. 785 (1943).
4. N.Y. Tax Law Section 605(b).
5. *Matter of Robertson*, N.Y.S. Tax Appeals Tribunal (Sept. 23, 2010).
6. Cara Buckley, "In City Often? Tax Man Asks Some for Tally," *The New York Times* (Feb. 24, 2011).
7. *Matter of Gaied*, N.Y.S. Tax Appeals Tribunal (July 24, 2010).
8. Timothy P. Noonan and Joshua K. Lawrence, "The *Gaied* Case: A Potential Game-Changer in The Statutory Residency Area," *The Trusted Professional* (June 2011), at p. 1.
9. *Matter of Barker*, N.Y.S. Tax Appeals Tribunal (Jan. 14, 2011).
10. Craig Karmin, "State Tax Probe Expands," *The Wall Street Journal*, March 8, 2011; Craig Karmin, "Second Homes May Be Costly At Tax Time," *The Wall Street Journal* (Feb. 17, 2011); Craig Karmin, "Out of State Owners Could Face Tax Bill," *The Wall Street Journal* (Feb. 11, 2011).
11. *See* Peter L. Faber, "New York's Statutory Residence Rule Should be Repealed," *State Tax Today* (April 4, 2011); *see also* Joseph Lipari and Debra Silverman Herman, "Recent New York Residency Cases Reveal Difficulties," *New York Law Journal* (March 11, 2011).
12. *See* ILCS Chapter 35, Section 5-1501(a)(20); *see also* Cal. Rev. & Tax Code Section 17014.
13. *See* California FTB Informal Publication 1031 (Dec. 1, 2009) and Ill. Admin. Code 86 Section 100.3020.
14. *See* California FTB Informal Publication, *ibid.*
15. *See* Ill. Admin. Code, *supra* note 13.
16. N.Y. Tax Law Section 620.