New York Issues New Nonresident Audit Guidelines

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The New York State Department of Taxation and Finance has issued its long-awaited update of the Nonresident Audit Guidelines, last revised in 1997. Even though the guidelines do not carry any legal weight, they are supposed to accurately reflect the current status of New York's laws of residency and provide a strong indication of audit's position on the various issues that arise in a residency audit. In that sense, a new edition of the audit guidelines is important in determining how New York's residency rules have changed over the past decade. Moreover, given the recent and rapid expansion of New York's residency audit program, the guidelines offer a glimpse into the department's new audit techniques and approaches. Indeed, a tax practitioner with any experience in New York has undoubtedly run into residency issues. It is one of the most active tax practice areas out there in state and local tax circles. So practitioners should take note of the important changes to these guidelines.

The overview below highlights what we believe are the most significant changes to the audit guidelines in the new 2009 edition. Many of these changes simply reflect changes to the laws or regulations and updates in case law — some of which have already been covered in previous installments of Noonan's Notes — but it is useful to review these changes in one place. Note that the 2009 Nonresident Audit Guidelines cover only residency audits. For a revised version of the rules on nonresident allocation, we will have to wait a little longer. The allocation guidelines, in place since 1997, have not been updated.

Domicile

New York's law of domicile has remained fairly consistent over the years. So it's unsurprising that there are fewer changes to this area of audit than to statutory residency. Nevertheless, there are some notable changes in the guidelines.

Family Factor

The most significant change was to elevate the "family factor" to one of the primary factors to examine during an audit. Previously, the audit guidelines stated that auditors should focus on the four primary factors (the home, business involvement, time, and "near and dear"); family ties should be looked at only if the four primary factors were inconclusive. The new guidelines now refer to the "five primary factors," including family connections.[1] Because of the intrusive nature of examining the family factor, auditors had been instructed to wait to examine this factor until they have determined whether the other primary factors were conclusive. The new guidelines, however, direct auditors to wait only until they evaluate the initial residency questionnaire before requesting information on the individual's family connections.[2] Although the location of the individual's spouse or partner and minor children will generally be the focus of the audit, the new guidelines do not rule out that the relationship with grandchildren or aging parents would be an appropriate avenue of inquiry for an audit. Auditors are advised to consult with

[1]State of New York — Department of Taxation and Finance, Income Franchise Bureau, "2009 Nonresident Audit Guidelines," Mar. 31, 2009, at 13.

[2]*Id.* at 32.

their team leader or field audit management before initiating a wider inquiry.[3]

Additional Changes to Domicile

There are several other small but notable changes to the guideline's discussion of domicile. The new guidelines expand the discussion of intent as the key to determining an individual's domicile.[4] To "determine what was in a taxpayer's mind," the auditor is directed to follow the lead of the courts by looking to the actions and deeds, rather than the words, of the taxpayer.

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Also, the 2009 guidelines say that in some situations, based on the taxpayer's "lifestyle," factors other than the five primary factors could be a more "appropriate" focus for auditors. Perhaps recognizing the potential for subjectivity and abuse if auditors were allowed to disregard the standard primary factors, the auditor is instructed to first discuss the use of other factors with the team leader or field audit management "before informing the taxpayer."[5] The new guidelines, like the previous, also caution auditors that the tax law prohibits the use of charitable contributions in determining an individual's domicile.[6] In the new guidelines, however, auditors are reminded to be sure that the taxpayer's presence in New York is solely for charitable purposes before disregarding the day in the analysis of the time factor. And, of course, charitable days still count as New York days for statutory residency purposes.

For the home factor, the new guidelines instruct auditors to keep in mind the geographic area of the residences when evaluating the size of a particular home. Although a 3,000-square-foot apartment in New York City might pale in comparison with a palatial Florida home, it is spacious by Manhattan standards.[7] And the new guidelines have expanded the discussion of the time factor, noting that although an analysis of where the individual spends his time must be weighed with the other primary factors, "the location where an individual spends his time is often an important consideration in ascertaining his intentions with regard to domicile."[8] The guidelines mention the importance of both the amount of time spent in New York compared with other locations as well as how the individual divides his time between New York and the claimed domicile in the context of his lifestyle. In other words, while an audit might focus on where a New York City commuter spends his weekends, this inquiry might be less instructive for a Florida retiree with a home in New York.

Statutory Residency

Permanent Place of Abode

The new guidelines highlight several important changes to the definition of a permanent place of abode (PPA). As to be expected, the guidelines recognize the recent change in New York's regulations that eliminates the "temporary stay" exception for a PPA.[9] A taxpayer with a New York apartment can no longer claim to be a nonresident on the basis that he is in New York for a temporary stay to accomplish a particular purpose.[10] And even for years before 2008 when the temporary stay rules still apply, the examples in the new guidelines make clear that the audit division will take a hard line on those cases. For example, in situation 3 — described as an out-of-state attorney coming to the New York office to handle a class action suit expected to last for three years — the guidelines note that the temporary stay rule would apply only if the attorney worked on the class action suit and *no other legal matters* (hardly a likely scenario).

But there are a number of other significant changes to this section of the guidelines that are worth noting. The 2009 guidelines state that a residence that is maintained by the taxpayer but exclusively used by another does not constitute a PPA for the taxpayer.[11] Citing *Matter of Panico*,[12] in which the taxpayers paid the mortgage and phone bills for a Long Island residence where their daughter and grandchild lived, the department says that so long as the taxpayer *never* uses the residence and it is used by another, it should not be considered the taxpayer's PPA. Along the same lines, the 2009 guidelines include a detailed discussion of the *Matter of Stein*,[13] in which a New York City apartment

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[3] *Id.* at 33.
[4] *Id.* at 9-10.
[5] *Id.* at 40.
[6] *Id.* at 41; N.Y. Tax Law section 605(c).
[7] Guidelines at 18.
[8] *Id.* at 25.
[9] *Id.* at 58.
[10] 20 NYCRR 105.20(e). *See also* TSB-M-09(2)I; Timothy P. Noonan and Jack Trachtenberg, "An End to the Temporary Stay Test in New York?" *State Tax Notes*, Nov. 10, 2008, p. 383, *Doc 2008-22979*, or *2008 STT 219-3*; Noonan, "Temporary Stays in New York: A New Set of Rules in Residency Audits," *State Tax Notes*, Feb. 21, 2005, p. 551, *Doc 2005-2554*, or *2005 STT 34-17*; and Noonan, "New York Practice Issue — More Developments in the Temporary Stay Area," *State Tax Notes*, July 30, 2007, p. 313, *Doc 2007-16738*, or *2007 STT 147-5*.
[11] Guidelines at 47-49.
[12] ALJ (Aug. 17, 1990).
[13] ALJ (Sept. 07, 1995).

owned by the taxpayer and clearly suitable for the taxpayer's use nonetheless did not constitute a PPA because the taxpayer never established any living arrangement with the apartment, and his relationship to the apartment vis-à-vis the spirit of statutory residency was nonexistent. That discussion is significant, as is the DOR's recognition in this section of the guidelines that the presence of a property interest in an apartment does not guarantee that it will be a PPA for the taxpayer "if it can be shown that the residence was not used by the taxpayer."[14] That certainly hasn't been the position of auditors in many of the audits we have handled in recent years.

The new guidelines add a section to discuss the habitability of a residence when it is undergoing renovations, an issue that often arises in statutory residency cases.[15] The guidelines instruct auditors to differentiate between major renovations, in which a residence lacks adequate plumbing or sleeping quarters and therefore does not constitute a habitable residence, and minor repairs, which merely create inconveniences for a taxpayer. How renovations that lie somewhere in between those two categories should be treated appears to remain within the auditor's discretion. For example, whether a complete kitchen renovation would render a residence uninhabitable is unclear from these new guidelines.

The new guidelines retain the section on whether corporate apartments constitute a PPA but add a reference to *Knight*,[16] one of the most important tribunal cases recently decided in favor of the taxpayers. The guidelines note that the tribunal enumerated four factors as significant in determining whether a corporate apartment constitutes a PPA:

- whether the taxpayer shares in expenses;
- whether the taxpayer maintains clothing or personal effects in the apartment;
- whether there is a dedicated room for the taxpayer's own use with free and continuous access; and
- whether it is used for daily attendance in connection with employment.[17]

Finally, in yet another clarification of the definition of a PPA, the new guidelines say that when the ownership of a PPA has been transferred to an entity controlled by the taxpayers, the residence still represents a PPA for the taxpayers.[18] Citing to *Matter of Esikoff*,[19] the guidelines state that so long as the taxpayers continue to use the residence, transfer of ownership to a trust or limited liability company will not change the fact that the residence is the taxpayer's PPA.

Substantial Part of the Year

The audit division continues the policy of defining the term "substantial" for purposes of 20 NYCRR 105.20(a)(2) as 11 months of the year. However, noting the potential for abuse of that rule, the guidelines instruct auditors to apply the 11-month rule in the year that a taxpayer either acquires or disposes of a residence.[20] In other words, when a taxpayer rents out a residence for six or eight weeks during the summer, the residence would still constitute a PPA for the taxpayer, even though technically he doesn't maintain it for 11 months of the year. In support of the position that the 11-month rule constitutes a general rather than absolute rule, the guidelines cite to a nonprecedential advisory opinion and an administrative law judge decision.[21] But a tax appeals tribunal case not mentioned in this section of the guidelines contains a more forceful statement about the validity of the 11-month test as more of an absolute rule.[22]

A Day Spent in New York

The new guidelines reiterate audit division policy on what to treat as a day in New York. The guidelines note that even though the regulations treat "any part of a calendar day" as a New York day, and thus one second over the state line could therefore constitute a day, "no audit is ever expected to be based on such a minimal amount of time spent in New York."[23] Note, however, that it does not say that an audit *cannot* be based on such a minimal amount of time. And the guidelines cite to *Matter of Klingenstein*[24] for the position that even brief amounts of time spent in New York for shopping or dining will count as a day in New York for statutory residency purposes.

The guidelines also expand the discussion of time spent in New York for medical treatment.[25] Confinement to any type of medical institution does not count for statutory residency, whereas outpatient care and time spent visiting a hospitalized spouse in New York will count as days spent in the state. The guidelines note that this is a "sensitive" issue for taxpayers and should be "handled accordingly" by the auditor.

[14]Guidelines at 48.
[15]*Id.* at 49-50.
[16]Tax Appeals Tribunal (Nov. 09, 2006).
[17]Guidelines at 50-51.
[18]*Id.* at 51.
[19]ALJ (June 10, 1999).
[20]Guidelines at 52.
[21]Marcus and Kliegman, TSB-A-04(4)I; *Matter of Brodman and Grimm*, ALJ (Nov. 07, 2002).
[22]*Matter of Tweed*, Tax Appeals Tribunal (May 23, 1996).
[23]Guidelines at 55.
[24]ALJ (Aug. 06, 1998).
[25]Guidelines at 57.

Audit Techniques

Several changes to the audit techniques described in the guidelines highlight the department's increasingly assertive approach to residency audits. Unsurprisingly, auditors are urged to make effective use of the Internet and other computer-based sources, such as Lexis, to research the taxpayer and the connections with New York, particularly for business activities in New York.

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Perhaps most troublesome, the guidelines urge auditors to increase their "personal observations" of taxpayers and residences.[26] Those observations include interviews of the doorman and postal carrier, visits to residences in and out of New York, as well as taking pictures of the residences. Also, citing to the tribunal's decision in *Matter of Avildsen*[27] regarding the credibility of personal testimony *in a trial*, the guidelines suggest a personal interview with taxpayers whenever possible. They note, however, that an interview might not always be possible "since representatives may bar access to the taxpayer."[28] Funny, but isn't that why the department allows attorneys and accountants to represent taxpayers on audit and also has a specific form (the power of attorney form) for that purpose? Representatives aren't running an audit to "bar access to the taxpayer." Instead, they do what every other lawyer does in any type of legal dispute: They *represent their client*! It's troubling to think that the department views that in a negative light.

The guidelines go on to cite *Avildsen* for the proposition that auditors have the power of subpoena available to them "as a last resort" when taxpayers are not forthcoming in providing information.[29] Further, the new guidelines state that there are situations when auditors should use the subpoena power "to depose a taxpayer to allow the auditor to assess his credibility." The guidelines note that before issuing a subpoena to depose the taxpayer, the audit staff must contact field audit management for guidance. These changes would suggest a more adversarial and intrusive approach to audits. Despite the words of caution to use these techniques as a last resort, there likely will be significant differences among auditors as to when they have reached that point. We can only hope that more stringent internal guidelines will be imposed on auditors on the use of this substantial and intrusive power.

One final change to note involves the 120-day rule, whereby the guidelines recommend that a nonresident audit for a particular tax year should not be started if there are fewer than 120 days until the expiration of the statute of limitations.[30] The new guidelines limit this rule more explicitly to new audits. In other words, when an audit is ongoing and the auditor "is merely updating the audit period," the 120-day rule would not apply, although taxpayers should have sufficient notice that the audit period is being extended. This change may prove to increase the incentives for auditors to tack on additional audit years close to the expiration of the statute of limitations, with a request that the taxpayer sign a waiver to extend the statute. Taxpayers in this situation are caught between a rock and a hard place, often having little choice but to sign the waiver to prevent the case from being closed and the taxpayer being labeled as uncooperative. But the law still makes it clear that an assessment must have a rational basis for the "presumption of correctness" to attach.[31] If an auditor waits until the last minute to open an audit (whether a new audit or additional audit years) and is forced to assess to avoid the expiration of the statute of limitations, this would certainly raise rational basis concerns and justify cancellation of an assessment.[32]

Conclusion

Although we welcome the updated and revised audit guidelines, we are wary of some of the changes that signal a more aggressive approach by New York in residency audits. Those audits already deeply intrude — perhaps unavoidably so — into a taxpayer's personal life, forcing taxpayers to reveal information about their marital situation, financial patterns, daily habits, and lifestyle. The promotion of the family factor for domicile, expanded subpoena powers, and fewer restrictions on opening new audit years may only increase the already adversarial nature of the audit. ✰

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[26]*Id.* at 71.
[27]Tax Appeals Tribunal (May 19, 1994).
[28]Guidelines at 73.
[29]*Id.* at 73-74.
[30]*Id.* at 68.
[31]*See Matter of O'Reilly*, Tax Appeals Tribunal, May 17, 2004; *Matter of Bernstein*, Tax Appeals Tribunal, Dec. 24, 1992.
[32]*See Brown v. State Tax Comm'n*, 304 N.Y. 651 (1952).