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A New Trump Card for New York Residency Audits?

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In this article, the authors discuss a statutory residency case recently decided in New York. The authors note that the administrative law judge's ruling in *Matter of Sobotka* sharply contrasts New York State Department of Taxation and Finance policy, but caution readers to remember that ALJ decisions are not binding and to prepare for audits accordingly.

When the U.S. Supreme Court issued its decision in *Comptroller v. Wynne* earlier this year, numerous practitioners and commentators thought that the decision might signal the death of New York's so-called statutory residency provision (and other similar state taxing schemes that potentially resulted in double taxation). The jury's still out on that one, of course, so for now, statutory residency is still a big issue in New York.[1]

But you may not have noticed another interesting development that had a more direct effect on statutory residency issues. On August 20 an administrative law judge in New York's Division of Tax Appeals issued an order in *Matter of David and Karen Sobotka*.[2] Admittedly, an ALJ's order is slightly (read: considerably) less exciting than a U.S. Supreme Court decision in the state individual income tax area. But Judge Dennis Galliher's order in *Matter of Sobotka* may be no less important in shaping the way we think about New York's statutory residency rule. In *Sobotka*, Galliher held that a taxpayer claiming part-year domicile-based resident status may also be a statutory resident for the other part of that tax year, but only if he maintained a permanent place of abode (PPA) and was present in New York on at least 183 days *during the non-domiciliary part of the tax year* at issue. In other words, the taxpayer must meet both prongs of the statutory residency test for the nonresident part of the tax year.

That ruling stands in stark contrast to New York State Department of Taxation and Finance policy in this area. In the most recent version of its Nonresident Audit Guidelines, the department states that "the statutory residence test is applied to a taxable year during which a taxpayer has changed domicile from or to New York . . . [and] if the taxpayer is determined to be a statutory resident, he will be taxed for the entire year even though his domicile may have changed during the year."[3] In other words, the tax department asserts that the conclusion that a taxpayer qualifies as a statutory resident of New York "trumps" the issue of domicile. But in *Sobotka*, the New York ALJ says not so fast.

In this article, we will summarize the underlying facts in *Sobotka* and the rationale laid out in the judge's order, explain how the "new" rule works, and discuss the potential importance of this decision and what's coming next in this area.

The Facts

The taxpayer was a longtime domiciliary of Texas. In late 2007, he began commuting from Texas to New York City in connection with his employment. In mid-2008 the taxpayer's employer offered him a new position that necessitated a permanent move from Texas to New York City. So in August 2008, the taxpayer and his family moved, claiming a change of domicile on the date of the move. The taxpayers then filed a part-year resident return in New York, claiming to be residents of New York City from August to December 2008.

End of story, right? Not exactly.

As it turns out, the taxpayer's employer had rented temporary, furnished living quarters (essentially a hotel substitute) for him to use during his trips to New York City between October 2007 and August 2008. On audit, the department determined that the taxpayer's relationship with those living quarters constituted the maintenance of a

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[1] And we wrote about it at http://bit.ly/1LIJRaT and http://bit.ly/1NlXj3V.

[2] *Matter of Sobotka*, No. 826286 (N.Y. Div. Tax App. 2015). The authors represented the taxpayers in this matter.

[3] Nonresident Audit Guidelines, at 64 (June 2014).

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PPA under New York's rules.[4] And when his period of use of those living quarters was combined with the lease of the apartment he and his family moved into in August, the department determined that he maintained a PPA in New York City for the entire 2008 tax year.

Further, because it was undisputed that the taxpayer spent more than 183 days in New York City during the entirety of the 2008 tax year, the department concluded that even though he moved to New York City in August, he was taxable as a statutory resident for the *entire* 2008 tax year.

In other words, the tax department ruled that the statutory residency test trumped the domicile change, and therefore the taxpayer was a full-year resident in 2008.

The Ruling — What Does It Mean?

After the department issued its assessment, the taxpayers filed a petition for administrative hearing with the Division of Tax Appeals. Shortly thereafter, though, they filed a motion for summary determination on the facts laid out above. The legal question posed was whether, given the language of Tax Law section 605(b)(1)(B), a taxpayer could be taxed as a statutory resident of New York in the same year he or she changed domicile into or out of New York.

In his order, Galliher actually answered that question in the affirmative, concluding that a taxpayer can in fact qualify as both a statutory resident and domiciliary of New York during the same tax year (that is, the two are not mutually exclusive), just not at the same time. But taking a plain language reading of the statutory residency statute, Galliher concluded that to be taxed as a statutory resident, a taxpayer must meet each of the three relevant criteria:

1. the taxpayer must be a non-domiciliary of New York for at least part of the tax year at issue;

2. the taxpayer must maintain a PPA in New York; and

3. the taxpayer must be present in New York for more than 183 days during the non-domiciliary part of the tax year at issue.

In other words, as Galliher explained in his opinion, a taxpayer can only be a statutory resident of New York during any non-domiciliary period if he meets both the abode and day-count tests during the relevant non-domiciliary period. Therefore, when the relevant non-domiciliary period at issue covers only part of a tax year, the taxpayer must exceed the 183-day limit during the non-domiciliary part of that tax year in order to be taxed as a statutory resident of New York. Therefore, under that reading of the rule, the nonresident part of the tax year must contain 183 days in order for that to be a possibility.

As mentioned above, that is a complete reversal of the department's prior policy in that area. However, as the ALJ's decision outlines, this is a result that flows directly from the plain language of the law and is fully supported by the statute's legislative history, which showed that the underlying intent of the part-year residency provision was to enable equitable taxation based on a person's actual connections with New York.[5]

The department disagreed, arguing that the tax appeals tribunal had previously concluded that all days during a relevant tax year must be considered in determining whether a taxpayer met the requirement of statutory residency, even if the taxpayer had changed his domicile during the tax year at issue. But the ALJ's order also addressed those cases. Noting that the division cited cases in which taxpayers were found to be statutory residents of New York even though the division's claims of full-year domiciliary status had failed,[6] Galliher concluded that the cases cited addressed only *potential* statutory residency status on a full-year basis. As a result, those cases did not create any binding precedent regarding the issue of determining statutory residency status for part of a tax year.

That rationale didn't come out of nowhere. In fact, as the taxpayer had pointed out in its motion, another judge had addressed a very similar issue in Minnesota under an almost identical statutory scheme. In *Marks v. Commissioner of Revenue*,[7] former Minnesota taxpayers had changed their domicile from Florida back to Minnesota during the 2007 tax year and filed as part-year residents. After an audit, the commissioner of revenue sought to tax them as full-year residents under Minnesota's "statutory residency" provision. After its review, the Minnesota Tax Court concluded that the state's statutory residency test contained three requirements, one of them being that the taxpayer is domiciled outside the state. As Galliher said in his order, of critical importance in *Marks* was that the taxpayers had not been physically present in Minnesota for more than 183 days during the part of the 2007 tax year before they became Minnesota domiciliaries. As a result, the Minnesota Tax Court concluded that they simply couldn't be statutory residents for the non-domiciliary part of the tax year, because only days spent in the

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[4]Note that because of the temporary nature of the taxpayer's accommodations in the first half of 2008, the taxpayer did not agree with the department's position that the living quarters constituted a permanent place of abode for him under the statute.

[5]Note that New York's early definition of residency made taxpayers full-year residents if they spent more than six months of the tax year in New York. The State Legislature decided that result was "too drastic" and passed a law providing for part-year resident status. At the same time, it passed the statutory residency provision to cast a net to catch taxpayers who were, for all intents and purposes, domiciled in New York but claimed nonresident status.

[6]*See, e.g.*, *Matter of Hero* (Tax Appeals Tribunal, Sept. 11, 2013); *Matter of Kornblum* (Tax Appeals Tribunal, Jan. 16, 1992 (confirmed 194 AD2d 882 (1993))); *Matter of Veeder* (Tax Appeals Tribunal, Jan. 16, 1992); *Matter of Edward L. Smith v. State Tax Comm'n*, 68 Ad2d 993 (1979).

[7]*Marks v. Commissioner of Revenue*, No. 8463-R (Minn. Tax. Ct. 2014).

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state during the non-domiciliary period count toward the physical presence test for statutory resident status.

Applying the Rule — How Does It Work?

We get it, there's a lot to follow here. But in practice, it is pretty straightforward. Here are a couple of examples to illustrate the application of the rule:

- Andrew was previously domiciled in North Carolina, but frequently worked in New York and rented an apartment in New York to use during his stays. During the middle of 2014, Andrew received a promotion at work that required him to be in New York full time. So on July 15, 2014, Andrew bought a home in New York and moved his family into the state. Andrew maintained a PPA and spent more than 183 days in New York during the entirety of the 2014 tax year. However, between January 1 and July 15, 2014, Andrew spent less than 184 days in New York.
- Tim was a longtime domiciliary of New York who retired in early 2014. On March 1, 2014, Tim moved to Florida but kept his place in New York so he'd have a place to visit. Tim did end up spending portions of the summer and fall months in New York while completing some renovations to his Florida residence. Still, Tim did not spend more than 183 days in New York between March 1 and December 31. However, because he spent the entire first two months of 2014 in New York, he did end up spending more than 183 days in New York over the entire year.

The above examples represent factual situations that arise frequently in audits of taxpayers conducted by New York. Under its interpretation of the statutory residency rule, the department would conclude that both Andrew and Tim were full-year statutory residents of New York, despite their changes of domicile. In other words, they'd conclude that statutory residency trumped domicile.

But under the rule announced in *Sobotka*, Andrew cannot be taxed as a statutory resident, because he did not spend more than 183 days in New York between January 1 and July 15, 2014. And the same would go for Tim, because he didn't spend more than 183 days in New York between March 1 and December 31, the period of time he qualified as a non-domiciliary of New York.

Easy, right?

Why Is That Important?

As every New York tax practitioner knows, there are two ways that an individual can be taxed as a resident of New York. The first is domicile. The second is statutory residency. The statutory residency test was almost always recited as a two-part test: (1) maintenance of a PPA and (2) physical presence in New York for more than 183 days. But read the statute (Tax Law section 605(b)(1)(B)) again. The tax law defines resident individual as one who is either domiciled in New York or one who is *not domiciled in New York* but maintains a PPA and spends more than 183 days in the state. In other words, an explicit requirement of qualifying as a statutory resident of New York is that the taxpayer not be domiciled in New York.

Many taxpayers who move into or out of New York during the middle of a tax year also maintain a PPA in New York for substantially all of that tax year. In the past, the tax department's position was that such a taxpayer, one who was only a domiciliary of New York for part of the tax year, could still be taxed as a full-year resident if he met the *two* objective criteria of a statutory resident (that is, maintained a PPA for almost the whole year and spent more than 183 days in New York) for the entire year.[8]

But per the *Sobotka* holding, a taxpayer who moves into or out of New York during a tax year could be taxed as a statutory resident only if he spent more than 183 days during the non-domiciliary part of the tax year at issue. In a footnote in his order, Galliher mentioned the potential for eliminating the possibility of statutory residency taxation by properly planning a change of domicile. For instance, a taxpayer (like Andrew above) could claim a change of domicile into or out of New York at some point during the year so that there are fewer than 184 days in the nondomicilary part of the tax year.[9] Rather than address that unintended "planning opportunity," Galliher concluded that "the remedy, if any, rests within the purview of the Legislature."

What's Next?

Of course, ALJ decisions are not binding, so the department will have to decide how it wishes to handle the judge's order in *Sobotka*. As it has with other ALJ decisions, it could acquiesce to the holding and apply it to existing cases.[10]

But don't hold your breath for that one! Based on what we've heard, it's more likely that the department will stand by its prior position. So taxpayers who find themselves in that situation in an audit should be prepared for an audit determination that is potentially inconsistent with the *Sobotka* ruling. Along the same lines, however, any taxpayer who has recently paid tax to New York as a full-year statutory resident (whether via a filed tax return or as the result of a Consent to Field Audit Adjustment) in a tax year during which there was a change of domicile should consider filing a refund claim (if still timely) if the facts warrant.

At a minimum, though, the ruling in *of Sobotka* gives taxpayers a new card to play in change of domicile cases in which the department concludes that "statutory residency trumps domicile." ✰

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[8]Indeed, the tax department's Nonresident Audit Guidelines contain an entire section about taxpayers who find themselves in this factual scenario.

[9]Of course, it is always within the tax department's discretion to fully audit a claimed change of domicile date.

[10]*See, e.g.*, the department's response to the 2003 ALJ decision in *Matter of Falberg*: The division issued TSB-M-05(2)I to announce its agreement with the ruling and new policy.

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