Leaving on a Jet Plane? Not without a Residency Audit.

June 8, 2021

Changes in the Administration, high state tax rates, and COVID-19 have all increased the spotlight on where taxpayers wish to call home. For some, a potential move means relocation to Puerto Rico, where certain tax incentives are in place to increase business and drive a new island economy. For others, it means a move out of the highest state tax jurisdictions in the country, like New York and California, to states without a personal income tax such as Texas and Florida.

But before bags are packed and a taxpayer is ready to go, very careful consideration needs to be given to what it means to change domicile and residency. The exodus from high federal and state tax jurisdictions means significant shifts in revenue collection. With potential revenue loss, the IRS and state authorities are working hard to ensure any moves are legitimate in fact and substance. The result? Taxpayers should expect any residency transition to be audited at the federal and state level.

IRS Campaign

To appropriately qualify for the tax benefits derived under Puerto Rico Act 22 (now Act 60), including a 4% corporate tax rate and a potential 0% tax rate on capital gains, dividends, interest and royalties, a taxpayer must first be a bona fide resident (BFR) which is accomplished through the satisfaction of three tests:

1. Physical Presence, which measures how many days are spent in Puerto Rico or outside the U.S.;
2. Tax Home, which tests where the closet economic connection—usually a job or business—lies; and
3. Closer Connections, which is where the closest personal connections are located—close family, treasured belongings, voting, etc.

Earlier this year, the IRS identified benefits derived under Act 22 as subject to a new campaign. As part of its campaign effort, the Service will address noncompliance through a variety of measures that will include examinations, general outreach, and soft letters. Within an exam, contemporaneous detailed records will be essential to document and support BFR status.

It is critically important for taxpayers claiming benefits under Act 22 to expect an inquiry from the IRS. Simply put, the population of taxpayers relevant to this campaign is small and the IRS has a variety of data points at its disposal to help identify taxpayers claiming Act 22 benefits. These include, but are not limited to, tax returns filed and information sharing agreements with Hacienda.

State Audits

As we have seen over the past year, many high profile taxpayers have publicly declared their intent to move from New York and California to other states for a whole host of reasons, including favorable tax regimes and improvement in quality of life opportunities. While Austin and Miami become new hubs, New York City and Los Angeles are left with less money and more incentives to audit a residency change closely.

The overlap in the residency audit process between federal and state is what some would call a perfect marriage—in that a taxpayer preparing for an IRS audit should prepare in much the same way for a corresponding state exam. Not to be left out, taxpayers moving domestically from a high tax state to a low (or no) personal income tax state should do so with the understanding that a residency audit is not a remote possibility—it's better classified as a foregone conclusion. Without question, the times we live in with reduced state coffers and limited technical staff mean state revenue departments with significant big collection goals.

Taxpayers seeking to change state residency will generally need to consider two tests: domicile and statutory residency. The test for domicile asks the question of intent, i.e. where does the taxpayer intend to live on a regular and permanent basis and where have they made their life. Intent is often difficult to prove, which can make a domicile determination challenging for an unprepared taxpayer to defend. The most important factor to establish intent is true substance—a taxpayer that establishes a real connection and life in their new residence will fare much better on audit than those seeking to be present only in the most minimalist of ways. Factors that help reflect intent include time, location of family, items near and dear such as valuables, vehicle registration, real property ownership, and social connections.

For taxpayers familiar with the Puerto Rico BFR physical presence test noted above, state statutory residency is similar—it is driven by having more than 183 days of presence in a state with a permanent place of abode. Audits will often involve the state revenue agent presenting evidence that can be unexpected: publicly available information (news reports of presence), cell phone records, expense receipts, car rentals/ride share, and EZ pass tolls. All of which work to establish presence in the state.

Next Steps

With the IRS campaign focused on taxpayers that seek benefits under Act 22 and the exodus of high net worth taxpayers from states like New York and California, residency audits are to be expected and planned for with a keen understanding of the applicable laws and audit initiatives across federal and state jurisdictions.

Please contact Caplin & Drysdale if you would like to discuss federal or state residency planning and audit defense.

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