A Guide for Determining State Residency and Preparing State Returns

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Course # 8162593, Version 1811, 2 CPE Credits

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Course CPE Information

Course Expiration Date
Per AICPA and NASBA Standards (S9-06), QAS Self-Study courses must include an expiration date that is ***no longer than one year from the date of purchase or enrollment***.

Field of Study
Taxes (in NY Taxation). Some state boards may count credits under different categories—check with your state board for more information.

Course Level
Overview.

Prerequisites
There are no prerequisites.

Advance Preparation
None.

Course Description
This course was created to provide information for tax professionals to properly complete the tax returns of states other than their home state. The main thrust of this course is to discuss how states look at residency in determining if a taxpayer should be treated as a resident for income tax purposes even if he or she doesn't live in the state. With many states having budget problems, the state revenue departments are looking at every possible means of increasing income. They are now looking at issues that never used to draw too much attention. This course will be an especially valuable reference guide for new tax preparers as this material is not taught in basic income tax courses.

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Instructional Design

This Self-Study course is designed to lead you through a learning process using instructional methods that will help you achieve the stated learning objectives. You will be provided with course objectives and presented with comprehensive information and facts demonstrated in exhibits and/or case studies. Review questions will allow you to check your understanding of the material, and a qualified assessment will test your mastery of the course.

Please familiarize yourself with the following instructional features to ensure your success in achieving the learning objectives.

Course CPE Information

The preceding section, "Course CPE Information," details important information regarding CPE. If you skipped over that section, please go back and review the information now to ensure you are prepared to complete this course successfully.

Table of Contents

The table of contents allows you to quickly navigate to specific sections of the course.

Learning Objectives and Content

Learning objectives clearly define the knowledge, skills, or abilities you will gain by completing the course. Throughout the course content, you will find various instructional methods to help you achieve the learning objectives, such as examples, case studies, charts, diagrams, and explanations. Please pay special attention to these instructional methods, as they will help you achieve the stated learning objectives.

Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

Review Question Answers and Rationales

Review question answer choices are accompanied by unique, logical reasoning (rationales) as to why an answer is correct or incorrect. Evaluative feedback to incorrect responses and reinforcement feedback to correct responses are both provided.

Glossary

The glossary defines key terms. Please review the definition of any words you are not familiar with.

Index

The index allows you to quickly locate key terms or concepts as you progress through the instructional material.

Qualified Assessment

Qualified assessments measure (1) the extent to which the learning objectives have been met and (2) that you have gained the knowledge, skills, or abilities clearly defined by the learning objectives for each section of the course. Unless otherwise noted, you are required to earn a minimum score of 70% to pass a course. If you do not pass on your first attempt, please review the learning objectives, instructional materials, and review questions and answers before attempting to retake the qualified assessment to ensure all learning objectives have been successfully completed.

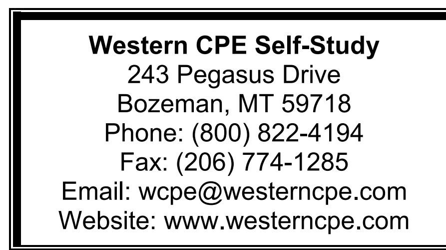
Answer Sheet

Feel free to fill the Answer Sheet out as you go over the course. To enter your answers online, follow these steps:

1. Go to www.westerncpe.com.
2. Log in with your username and password.
3. At the top right side of your screen, hover over "My Account" and click "My CPE."
4. Click on the big orange button that says "View All Courses."
5. Click on the appropriate course title.
6. Click on the blue wording that says "Qualified Assessment."
7. Click on "Attempt assessment now."

Evaluation

Upon successful completion of your online assessment, we ask that you complete an online course evaluation. Your feedback is a vital component in our future course development.



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Chapter 1 – Introduction to Preparing State Returns

Learning Objectives

After completing this section of the course, you will be able to:

- Note the various state policies for taxing income and ways that states discover that a taxpayer has failed to file a return
- Specify the potential repercussions for failing to file a return in another state and cite the applicable late filing or failure to file penalties
- Note the resources that are available to reference for help in preparing an unfamiliar state return

Introduction

This course is the result of over 35 years of experience the author has had in representing clients with state residency issues in two states. Early on, it became apparent that some sort of training materials were necessary to help newer preparers understand what was necessary in preparing returns of states other than their home state. A seminar was developed and used in several upper Midwest states and was constantly being updated as new client situations arose. Every illustration used in this course comes from actual client situations and it is from studying these examples that the tax professional understands what is necessary to best help the client achieve their filing requirements with the best possible result.

State Policies on Taxation

Many taxpayers think that only one state can tax income of the taxpayer. However, any state that has a valid reason to do so, can tax that income. The job of the tax professional is to reduce the tax liability as much as possible or to eliminate it through knowledge of the state's laws and procedures. States are looking for every penny they can collect through taxes and are using means that a few years ago weren't even thought of.

There are a number of ways the state may come after the taxpayer:

- State revenue departments exchange information with each other, so if a taxpayer has left, for example, state A and is now living in state B, state A will follow the returns the taxpayer files in state B to see if anything that was reported in state B should also be taxed in state A. We will see the significance of this when we get to the income chapter later.
- States pull information from K-1 forms that originate in states other than the taxpayer's home state.
- States examine property records and compare those to rental licenses to see if there are any nonresidents who are not reporting rental income.
- They will also compare the returns the state has on file against the IRS filings for that state to see if there should be returns filed. If the taxpayer has a new address in another state, the old state will look especially hard to see if they have truly moved or if they should still be considered a resident of the old state. See Chapters 3 and 4 for a discussion on this issue.
- The states also learn from the 1099s that are filed, including oil royalty payments.

Failing to file the return of another state can result in:

- Late-filing penalties and interest.
- Possible loss of credit for taxes paid to the other state due to a time deadline earlier than the deadline for the return.
- Additional tax preparation fees when the preparer has to do returns two or three years late rather than at the same time the current year's return is done.

The penalties for late filing a return or failing to file a return can be costly. Some states charge the same late filing penalties as the IRS—5% per month with a maximum of 25% of the balance due. Some states charge more. Here are a few examples:

- California and New York charge a minimum penalty of the lesser of $100 or 100% of the unpaid tax if that amount is less than 25% of the unpaid tax if the return is more than 60 days late.
- California can charge 25% of the tax liability prior to withholding credits if the taxpayer fails to file a return after being sent a Notice and Demand letter.
- Oregon's late filing penalty is 5% for the first month and 25% after three months.
- Oregon charges a penalty of 100% of the unpaid tax for each of the three years if a taxpayer fails to file a return by the due date including extensions for three consecutive years.
- In addition to the maximum 25% penalty, New Jersey may impose a penalty of $100 for each month the return is late.

In some cases, for example, the client might have a small amount of oil royalties from several states reported on the K-1. The inclination of the client is to not to file returns in those states. But as noted above, some states will charge a penalty not based on any balance due but at a flat rate which could be costly to the taxpayer. Therefore, it is important for you to check the failure to file penalties for each state listed on the K-1.

Office Policies

How are returns of states other than your home state handled in your office? To some degree, it will depend on the experience level of the tax associates working in the office. The more experience they have, the easier it will be for them to complete a client's return and any states that might be required. There are several approaches that might be used in an office.

- The same tax professional will complete the other states' return(s) during the initial visit. This is the ideal way and allows the client to leave the office knowing their refund or balance due for all the returns that need to be done. However, it takes a very experienced preparer to be able to do it this way.
- The same tax professional will complete the other states' return(s) after the client leaves. This method works best when an experienced preparer needs to do a return from a state that the preparer has not done before or one of the more complicated state returns. It is sometimes better to study the form and instructions when the client is not present. The preparer can also get help and can discuss the return with another associate easier than when the clients are sitting there.

- Another qualified tax professional in the same office will complete the state portion of the return after the client leaves. This arrangement works best when the office is staffed with a large number of newer associates. They have enough to learn without trying to figure out numerous other state returns.

Quality Control

This little segment on quality is being placed in here for two reasons: the first is because it is essential that the federal return be accurate before doing the state return, especially on states you're not familiar with, and second, accurate returns should be the goal no matter what the situation.

Before you get going too fast on the state return, be sure to check the federal return.

- It is CRITICAL that the federal return be completed correctly before any state returns are prepared.
- If the federal return is wrong, the state return is wrong. This can cause you to tell the client a wrong state result.
- Check and fix any diagnostics on the federal return BEFORE approaching the state return.

Likewise, don't ignore state diagnostics. There are numerous times where the state diagnostics are a warning as the program does not know enough about the tax situation to fully judge whether or not it is correct. Also, it is known that the amount of programming that goes into little used tax situations are directly proportional to the number of returns that have that situation. In other words, seldom used forms or calculations sometimes require more manual input and checking by the tax professional.

- Read the state diagnostics carefully. You MUST clear up every state diagnostic and especially the review the warnings. Ignoring them loses clients!
- When in doubt, ask another tax professional to review the state return.
- Perform a "reasonableness check."
    - Does the return look right to you? Does it match your expectations for the bottom line considering your experience? If your experience is not that high, have someone else review the return.
    - Did you think about the figures in relation to the client's occupation? For example, is it reasonable for a 9-5 daycare center to have 8,000 hours of business use? No, there is an entry error there.
    - Did you look at each page of the return? Don't just look at the base form. Review EVERY form and entry prior to completing the return.

- Why it is important?
    - There are Circular 230 rules which require due diligence in preparing returns.
    - The preparer penalty rules require that a preparer must have a reasonable belief that a position would be sustained on its merits. Penalties can be assessed against both the tax preparer and the firm for failing to maintain a quality review process in the office. This comes from actual an experience.

Terminology

Some terms used in this course:

- Home state - the return of the state you live in and usually work in. However, if you work in an area such as the Fargo–Moorhead area which covers both MN & ND, the home state would usually be the state in which the client lives.
- Other state - the return from a state other than the home state.

Resources

There is a wide variety of help available for doing returns of other states. These include:

- Your tax program's help feature. In some situations, it might be a little weak as it isn't possible to put all possible scenarios in the help area.
- Online state websites. Some states are better than others. (Wisconsin is <u>very</u> good; Montana is very poor.)
- State instructions. If you do lots of returns for a particular state, have a copy of this in the office for quick reference.
- *All-States Reference Book* by Quickfinder or *The Tax Book*.
- Review last year's return. This is essential. If the return wasn't prepared in your office, insist that the client bring in a copy or get a copy for you.
- Call the preparer of last year's return to see if they have any suggestions or things to call your attention to.
- Wikipedia sometimes has some interesting articles on specific tax topics and will even give a breakdown by state of how the subject is dealt with in each state.

Chapter 1 – Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

1. How does a state learn so much financial information about you?

   a. They read the financial section of the local newspaper.
   b. A questionnaire is sent to you as soon as you move in asking about your financial health.
   c. An auditor uses the Internet to find out everything they can about you.
   d. Generally speaking, the state revenue department doesn’t know anything about you unless you failed to file a return when there are indications that you should have.

Chapter 2 – The First Page Information

Learning Objectives

After completing this section of the course, you will be able to:

- Specify different state filing requirements for part-year or nonresidents
- Note circumstances where a state filing status may differ from the federal return as well as the availability of certain filing statuses for state filing purposes
- Recognize the different state definitions for dependents and their subsequent tax treatment

Recognizing the Need

One of the first things you need to do is to recognize when a return from another state might need to be done. The most common things you will encounter include:

- A state other than the home state is listed in box 15 on the W-2.
- The client presents last year's return with an address in another state.
- The client tells you that they moved to your state during the tax year.
- The client is a full year resident of your state and they have income documents that indicate a return from another state might need to be done. Examples of such documents include Schedules K-1 or Forms 1099-MISC for out of state income.
- Property in another state that is rented or sold during the year.
- The client is in the military and is stationed in your state, but they have a home of record in another state. See the military section in Chapter 4.

Don't let the client control the interview. The first thing the client wants to tell you is that they have just moved into your state and here are their moving expenses or their home sale figures. This can throw off your standard interview process and things get missed that way. Use an interview guide and checklist to gather information and check it off as you enter it throughout the input process.

Filing Requirements

Before you begin the return, you should determine if the client even needs to file the other state return. In most software programs, the federal return can be completed and e-filed before the state return is finished. If there are any tax-preparation fees being withheld from the refund, this usually occurs when the federal return is filed. Therefore, you need to know any state return fees that need to be included in the total. If you charge a fee for a state return that, later, you find the income is below the filing requirement, you then have a refund to be issued as well as clients wondering if you really know what you're doing.

The following are the requirements for part-year or nonresidents to file for some of the upper Midwest area states.

> **Note:** As you will see, most of the examples are from MT, ND, MN, WI, and IA. That is because this course started as a regional guide. However, these five states do have a wide variety in how they handle various topics and serve as a good core of examples. Since this course will be national in distribution, NY on the East Coast and CA on the West Coast are being added. Examples from other states will be added as appropriate.

> **Comment:** All state figures are current for the 2015 tax year.

- North Dakota – If you or your spouse had to file a federal return, and
    - you had any income from North Dakota sources as a nonresident, or
    - you had any income from inside or outside of North Dakota during the period you were a resident of North Dakota. (See residency discussion in Chapter 3.)

- Wisconsin – You were a nonresident or a part-year resident and your gross income was $2,000 or more. If you were married, you must file a return if your combined gross income was $2,000 or more for 2015. File Form N1PR.
- Iowa – If you were a nonresident or a part-year resident with income from Iowa sources of greater than $1,000, then you must file Form IA 1040 and IA 126.
- Minnesota – If your qualified income exceeds $10,300 for 2015.
- Montana – If your federal gross income was above $4,370 for single under 65 to $13,400 for married filing joint and both spouses over 65. Consult the chart found in the FAQ section toward the end of the course.

> **Note:** You might be surprised to note that inflation adjusted amounts for states can go both up and down. The last couple of years has seen some downward trends after years of going up. This is a good indication of the need to review the current year's information before telling the client something based on last year's figures.

Filing Status

Do not assume that the filing status used on the federal return will be the same on the state return. Many states do follow this procedure, but you must read the instructions to see what is most beneficial for the clients.

- Can be the same as on the federal return. Minnesota follows this rule. If you file joint on federal, then you will file joint on Minnesota.
- May be an additional filing status available. This usually occurs in states that allow the taxpayers to file separate when filing joint on the federal. For example, Montana has six filing statuses:
    - Single
    - Married filing joint
    - Married filing separate on the same form
    - Married filing separate on separate forms
    - Married filing separate and spouse not filing
    - Head of household

- A federal filing status might not be allowed on the state return. The most common example of this is that the Qualified Widow(er) status is not allowed. They use either the married filing joint status or do not get any special status at all.
- Some states recognize relationships that are not recognized on the federal return. These special statuses are allowed only on the state return and usually are not recognized by any other state.
- Civil Unions/Registered Domestic Partnerships. As used in the United States, beginning with the state of Vermont in 2000, the term civil union has meant a status equivalent to marriage for same-sex couples. Registered Domestic Partnerships (RDP) have been offered by some states, counties, cities, and employers since as early as 1985, However, the legislatures of the West Coast states of California, Oregon, and Washington have

preferred the term domestic partnership for enactments similar or equivalent to civil union laws in East Coast states.

The filing status of civil unions/RDPs will vary from state to state. Some states require that these couples file a joint state return even though they are not permitted to on the federal. In other areas, couples must register in order to receive legal rights similar to marriage, but they are not required to file a joint return. If you have couples who have moved from one of these states, they will probably know their filing status, but it doesn't hurt to check it out. In California, you can get Publication 737, *Tax Information for Registered Domestic Partners.* California has several other publications available on their website.

Oregon has a registered domestic partner law which gives domestic partners the same rights as a spouse. The Oregon Department of Revenue has ruled on how they should file their return. A registered domestic partnership is "a civil contract entered into between two individuals of the same sex who are, at least 18 years of age, who are otherwise capable, and at least one of whom is a resident of Oregon." Oregon doesn't recognize civil unions or domestic partnerships certified in other states.

Note the filing procedure in Oregon for RDPs:

1. Use the single or head-of-household filing status on your actual federal return and send it to the IRS.
2. Use the married filing jointly or married filing separately status on your second "as-if" federal return and attach this to your Oregon return only. Don't submit this form to the IRS.
3. The filing status on your Oregon return must match the filing status on your "as if" federal return. Remember to also complete alternate versions of all required federal schedules and include them with your Oregon return. If you and your partner are filing separately, you must each submit an "as-if" federal married filing separately return with your Oregon return, and mark the checkbox "calculated using 'as-if' federal return."

You should research all the options available to your clients. This is especially important when you have domestic partners from other states or the state allows you to file separate after filing joint on the federal. Most states follow the federal law in regard to the married filing separate status and many deductions and credits are disallowed. However, the lower tax from computing each spouse's tax separately frequently achieves a lower tax in spite of the lost deductions. Be sure to test your software to see how you must handle different situations.

Tax Tip: When in doubt, do the research. There is no substitute for research, which may provide additional tax benefits for the client

Dependents

Again, research is sometimes needed. You need to know how a dependent is claimed on the state return so that you can verify the accuracy when reviewing the return.

- Some states do not follow the federal Uniform Definition of a Child or have their own version of it. Montana finally adopted some of the qualifying child rules but retain some of their old dependent rules. You need to watch these states as someone who is a dependent on the federal return might not be on the state return and vice versa.

> **<u>Note</u>:** Sometimes you should call someone in the other state. Here is an example of where a preparer in the other state could help you. Numerous state's instructions on claiming dependents do not make any reference to children of divorced or separated parents. This is not a problem if the rules specify that you claim the same children you have listed on the federal return. Where it does run into a problem is when the state has its own dependent exemption rules which allows the parent who provided more than half of the support to claim the child. That is when you will need to talk to someone in that state to see if there are provisions for children of divorced parents that are not listed in the instruction manuals.

- Other states do not allow an exemption for a dependent but do allow a credit.
- Some states do not treat dependents separately, since they start with taxable income from the federal. Minnesota does this. Anyone claimed as a dependent on the federal is automatically claimed on the Minnesota return.
- A state can also allow an exemption for a dependent on the state return that was not claimed on the federal. Montana allows an additional dependency exemption for a handicapped child. Be sure to read the rules to see how they define handicapped and what statements have to go in with the return.

Chapter 2 – Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

2. Which filing status is sometimes **NOT** available on a state return?

   a. Single.
   b. Head of household.
   c. Qualifying widow(er).
   d. Married filing separately.

Chapter 3 – Residency and Domicile

Learning Objectives

After completing this section of the course, you will be able to:

- Define domicile, noting how the definition differs from residence for tax purposes, factors or acts that determine permanent domicile, and which states have the most comprehensive requirements
- Note how residency is defined and identify how states apply the residency rules to taxpayers domiciled in another state
- Determine the proper residency status when both spouses are living and working in different states

Introduction

Residency is the area that creates the most problems in doing not only the home state return but the returns of other states. If all states would treat residency the same, it would be easy, but they don't. Topics to be discussed in this section include:

- What is the difference between residency and domicile?
- How does each affect the filing of a state return?
- What do you need to know to do the return correctly?
- What are typical problems we see in this area with our clients?

Domicile Defined

The word "domicile" is derived from the Latin "domus" meaning a home or dwelling place. Throughout time, however, domicile has evolved in the legal sense to be the place where the taxpayer has his true, fixed, permanent home. The domicile is the principal establishment to which he intends to return whenever absent. The term domicile should not be limited to refer to a specific structure but rather a place/area to which the taxpayer expects to return.

The term "domicile" and "residence" are often used synonymously in our everyday discussions, but for tax purposes, the two terms have distinctly different meanings. Residence in a strict legal sense means merely a "place of abode." An individual may have many residences, or physical dwellings in which he resides, but can have only one domicile, or that permanent residence to which he intends to return. (New York State Nonresident Audit Guidelines)

New York uses five factors to judge if a domicile is in New York:

1. Home- the individual's use and maintenance of a New York residence, compared to the nature and use of a non-New York residence.
2. Active business involvement- the individual's pattern of employment, as it relates to compensation derived by the taxpayer in the particular year being reviewed. Business involvement also includes active participation in a New York trade, business, occupation or profession, and/or substantial investment in, and management of, any New York closely held business such as a sole proprietorship, partnership, limited liability company and corporation.
3. Time- an analysis of where the individual spends time during the year.
4. Items "Near and Dear"- the location of items which the individual holds "near and dear" to his/her heart, or those items which have significant sentimental value, such as: family

heirlooms, works of art, collections of books, stamps and coins, and those personal items which enhance the quality of lifestyle.

> **Comment:** This is a rather unusual requirement for domicile that the author has not seen before. But yet it makes sense in that if a taxpayer is going to change their domicile, wouldn't it follow that the items near and dear to them would be moved with them? Sort of like a domicile audit in Montana which the taxpayer lost because he left his possessions in Montana while he was claiming a Nevada residence.

5. Family connections - an analysis of those family connections that might indicate that the taxpayer's domicile hasn't changed.

While these points are unique to New York, they are similar in one way or another to things other states look at in determining domicile. A review of states' residency requirements show that 28 states use some definition of domicile to determine if a taxpayer is a resident.

If you move to another state and it is for a short time only, your domicile does not change. Short time can be anywhere from a month or two or up to a year or more. To make a change in domicile permanent, you must combine the acts of making a change in domicile along with the intent to change your domicile. Sometimes the intent is there but the acts the taxpayer makes do not indicate that they are making a change in domicile.

For example, to make a change in domicile permanent, the following acts would normally be accomplished:

- Change your driver's license to the new state
- Register your car in the new state
- Sign a lease or buy a home for your living quarters
- Enroll your children in the local schools
- Move your bank accounts particularly if they are with a local bank in the old location
- Move your possessions to the new state
- Register to vote in the new state

Permanent Place of Abode

Most states in their definition of domicile include the statement that the taxpayer has a permanent place of abode in the state. A permanent place of abode is a residence of some sort where a person permanently maintains their home whether they own it or not. It is usually defined as a rented, owned, or leased house, townhouse, condominium, apartment, mobile home, or cabin with cooking and bathing facilities for year around use. The following generally do not qualify as a permanent abode for domicile purposes:

- A military barracks
- Quarters on a ship
- Temporary housing provided by an employer
- On or off campus housing while attending college

Residency Defined

We will now look at how states define a resident. The reason this is important is because some states tax a person even though that state is not the taxpayer's domicile. They do this by making

you a resident of the state after you have been in the state for a certain number of days. This means you are taxed on your income in the states in which you have your domicile and also in the state where you have your residency. Let's look at Minnesota for an example.

Residency is generally defined by two rules:

- domicile (permanent residency), or
- the 183-day rule (a day counting rule)

As described above, if you are domiciled in Minnesota you pay tax on all income for the entire year to Minnesota. However, if you are domiciled in another state, you may still be taxed as a Minnesota resident under the 183-day rule.

The 183-day rule depends on two conditions:

- you spend at least 183 days in Minnesota (any portion of a day is counted as a full day), and
- you or your spouse own, rent, or occupy an abode in Minnesota. An abode is a self-contained living unit, suitable for year-round use that is equipped with its own cooking and bathing facilities.

You'll notice that both conditions have to be met to meet the 183-day rule. Let's look at some examples to understand this rule.

> **Example 1:** You live and work in Chicago, Illinois, and your work requires you to have frequent visits to the Twin Cities. Even if you are here for more than 183 days but you spend your nights in a hotel room, you do not meet the 183-day rule because the hotel room does not qualify as an abode. It is lacking its own cooking facilities.

> **Example 2:** The same situation as in example 1 above except that during each of your visits you rented an extended-stay facility which has its own cooking area. Now you would meet the 183-day rule assuming you were in the state for 183 or more days. In this situation you would be considered a part-year resident and would be taxed on all income during the periods of residency in Minnesota.

> **Example 3:** Assume the same situation as in example 2 above except that you rented the extended stay facility for the entire year which gave you a better price break and always guaranteed a place to stay no matter when you arrived. As soon as you met the 183 days, you would be considered a full year resident and taxed on all income from whatever source for the entire year. This is because you maintained a place of abode for the entire year even though you might have only stayed in it for 200 days.

Some states will say that the taxpayer must maintain a permanent place of abode in the state and spend the required number of days in the state. Permanent in this definition does not mean that you must have a long-term lease or own the property. It merely means that it is a fixed quarters as opposed to something more mobile like RV or a boat with living facilities.

The following states have a day counting residency rule: CT, DE, DC, IA, KY, ME, MD, MA, MN, MO, NJ, NC, PA, RI, UT, VA, and WV require 183 days. New York is 184 plus maintaining a permanent abode at least 11 months. NM is 185 days, HI & OR 200 days, and ND 210 days.

North Dakota has a system similar to Minnesota, except that the period in the state must be more than 210 days. If you maintain a place of abode consisting of cooking and bathroom facilities on a permanent or indefinite basis and meet the 210-day rule, then you are considered a full-year resident even though your domicile might be in another state.

Most states exempt you from the day counting rule if you are a part-year resident. For example, Bill moves from Montana on May 1 to his new home in North Dakota. Technically, he meets the 210-day rule and would be considered a full-year resident. Because of the exemption, the four months in Montana are not counted for North Dakota income purposes.

Iowa's code defines a resident as one who is domiciled in Iowa and maintains a permanent place of abode within the state. However, the administrative rule mentions 183 days. The rule says, *"There is rebuttable presumption that an individual is maintaining a 'permanent place of abode' if the individual maintains a place of abode within this state and spends more than 183 days of the tax year within this state."* It appears that Iowa gives you an opportunity to rebut the presumption with facts and intent to show otherwise.

Both Montana and Wisconsin base their residency on the domicile concept. If your domicile is in the state, then you are either a full-year or part-year resident. There is no day counting in either state. The only difference between the two states is that Montana doesn't pursue the issue nearly as much as Wisconsin. Wisconsin must have ten times the number of cases going to the Wisconsin Appeals Commission as Montana does going to the State Tax Appeals Board. Wisconsin will not process a part-year resident moving out without the completion of the Wisconsin Residency Questionnaire.

Regardless of the state, someone claiming to be a nonresident had better not be filing a homestead credit form which requires the taxpayer to be a resident. Most revenue departments cite this situation as one of the biggest problems they have.

Florida has established a list of eight factors that they consider an indication that a taxpayer is establishing domicile in Florida. Since Florida does not have an income tax, this becomes important when snowbirds want to claim Florida as their domicile state when dealing with residency issues in their summer home state, such as Minnesota. Too many "snowbirds" figure that their income while in Florida (or another southern state) should not be taxed in their Northern home state. The factors are:

1. Be in the state at least 183 days in the calendar year.
2. Have a Florida driver's license.
3. Have Florida automobile registration.
4. Have Florida car insurance.
5. Be registered to vote in Florida.
6. File a declaration of Florida domicile (this is optional but provides further proof of intentions).
7. Obtain Florida homestead exemption for personal residence. The state is no longer accepting landlord statements or lease documents as proof of domicile.
8. Filing nonresident income tax returns in the taxpayer's former state.

> **Note:** In an attempt to verify if there was an updated listing from Florida on the eight points of establishing a domicile, the author discovered that he would have to purchase the Florida Residency Guide for $9.95 plus shipping and handling. Most unusual.

Part-Year Resident

To be a part-year resident, there has to be a clear and compelling abandoning of their previous domicile and the establishment of a domicile in a new state. This usually occurs when someone moves permanently from one state to another. They change their domicile and are taxed as a part-year resident of two states.

> **Preparation Tip:** If a client moves to your state in February 2017, for example, and they come to you in March to have their 2016 return done, prepare a state return for your state showing all zeros with a notation that they just moved to the state and there will not be any 2016 state return from this taxpayer. That keeps the state from sending a notice of a missing return when they match addresses with the IRS list of federal returns filed for 2016.

Nonresident

A nonresident individual is one who is not domiciled in that state and maintains a permanent place of abode in another state. Generally, a nonresident will flunk any state's day counting test to be a resident. If they didn't, they would be considered a part-year resident (as in Minnesota's case) or a full-year resident. In Montana, you would be a nonresident even after spending most of the year in the state as long as you didn't become domiciled in Montana. You are taxed in the state either because you worked in the state or had an interest in property in that state. See the discussion on income in Chapter 5.

Problem areas. The two main problem areas that you might see with all state returns is spouses living and working in different states and residency issues. Let's look at the spouse situation first. It is not at all unusual to have one spouse working in a state and the other spouse at home with the family working in the second state. The issue becomes one of determining the facts and then applying them to the law. Let's look at the following example to see how we should do this. We will work this same example using different combinations of the states.

Wife in Minnesota and husband in Illinois: Sharon and Bill are married, and both were residents of Minnesota last year. In January of this year, Bill gets a very good job in Chicago. Sharon doesn't want to leave her job in Minnesota or move the kids to new schools, so Bill gets an apartment in Chicago and goes to work there.

To determine the proper residency status for Bill, you will need to become an investigator and ask a lot of questions about what he is doing and his intentions.

1. You will need to know the number of days Bill spent in Minnesota and Illinois and how each state counts those days. Does a partial day, for example, count as a whole day in the state? Minnesota says that any part of a day in Minnesota for any reason counts.
2. You will need to know what each state says about temporary absences. This arrangement could go on for several years. Is there a point where Bill might not be domiciled in Minnesota any longer?
3. Does Minnesota have a checklist that they might use to determine where Bill's domicile is? With his home and his family in Minnesota, he more than likely would be domiciled in Minnesota. However, a study of case law in some states indicates that a person can be

domiciled in a state other than where his or her family is. This is where knowledge of your state's residency rules and case law is helpful.

4. Next, you will have to apply the facts to Minnesota rules.
    a. If Bill comes home every weekend, will he pass the 183-day rule and so be considered a full-year resident?
    b. Even if he kept under the number of days to pass the day counting test, would the Department of Revenue still consider him a resident applying the domicile rules?
    c. Would he be considered a resident of Illinois and thus paying tax on his worldwide income in two states? He would be able to claim a credit for taxes paid on the same income to the other state, but which state would he claim his credit on? Generally, it is going to be the tax return of the state in which his domicile is located.

In this example, Bill would probably be a full year Minnesota resident if he came home each Friday night and went back each Monday morning and spent his vacation time in Minnesota. Even if he didn't make the 183-day rule, the state would say that he was a Minnesota resident especially if his name was on the house title and it was homesteaded.

> **Note:** We will look at an actual situation like the above example where the couple said the spouse who lived in CO was not a MN resident. We'll see what the state said about that shortly.

Wife in Minnesota and husband in Wisconsin: Wisconsin says residency is based on domicile and if his domicile is in Minnesota, he would be taxed as a nonresident in Wisconsin. Bill will have to make sure that he doesn't do too many things that might give the state an idea that he is domiciled in Wisconsin.

Wife in Minnesota and husband in Montana: Similar result as in Wisconsin except that Montana isn't so picky in trying to establish domicile in Montana. However, if this arrangement went on for too many years, both states could become more aggressive in trying to prove Bill a full-year resident of the state.

Wife in Minnesota and husband in North Dakota: As soon as Bill was in North Dakota for 210 days, he would become a full-year resident and a full-year resident of Minnesota by either the 183-day rule or passing too many of the states domicile tests.

> **Note:** For North Dakota, the reciprocity rules could come into play. See the separate section on reciprocity later in this course.

Wife in Minnesota and husband in South Dakota: What bearing does South Dakota, a state with no income tax, have in this discussion? Well, there are two types of clients involved here: the ones, like Bill, who are sent to the state or find work in a non-income tax state and those who go to one trying to get out of paying any state income tax. Let's examine Bill's case first.

Bill's only thought was that South Dakota is where the work is, and he will go where the opportunities are. Assuming that Bill is still domiciled in Minnesota, he will have to report all of his South Dakota income to Minnesota, but he has not had any state tax withheld and so he will

have a big balance due. This is something clients don't expect, and you will need to be able to explain what happened and to get them set up on estimated state payments for next year.

Another variation of this situation is where the employer is headquartered in another state but is not registered as an employer in your state. They withhold state taxes for the headquarter state, but the employee has never set foot in that state. You don't have any choice but to file a return for the headquarter state as a nonresident showing no income. This will get their withholding back which they will need to pay the balance due in their home state where there was no withholding. It is almost impossible to get employers like this to change and get withholding established in the correct state. Their attitude is that this is the way they have been doing it for a long time and if you want to work for them, take it or leave.

The second situation arises when a taxpayer from a state that has an income tax goes to work in a state without income tax. With three states without income tax (SD, WY, & WA) in the Northwestern area, numerous clients have gone to these states with the goal of not paying any state income tax. If they do all the things necessary to change their domicile, they will succeed. The problem comes when they maintain too many ties to their home state.

> **Observation:** It was mentioned earlier that Montana doesn't go after the residency issue as much as other states. However, they have a pretty good track record of those returns that were audited on this issue. The following are just some of the points where the client lost their claim to be a nonresident after moving to a state without income tax.

- Taxpayer worked in the coal mines of Wyoming and got hurt. Went home to Montana to recuperate which wasn't the problem. It seems that he voted while in Montana and that made him a resident.

  > **Note:** Registering to vote doesn't always make you a resident. In Montana, it does but in Minnesota, it doesn't. What this means is that if you registered to vote in Montana, you have passed the one test that establishes residency and the state doesn't have to look at any other factors.

- Taxpayer gave up his apartment in Montana and went to work in Nevada doing mining work in the field. One of the main reasons he lost his case was because he stored his possessions in Montana. The Department of Revenue said that if he wasn't planning on coming back, he should have had his possessions closer to him.
- Taxpayer left his family and moved to Alaska to work on the oil pipeline. He did everything necessary to give up his domicile in Montana and establish it in Alaska. However, when he came back to visit his family, he showed too much interest in running the family ranch (which his wife was doing) and the state said he didn't really give up his domicile.

When the client first comes in and starts telling you all kinds of living arrangements, you may begin to wonder how to figure it out. But as you can see, it is just a matter of obtaining the facts, knowing the law, and then applying the facts to the law. This kind of a situation is easier, however, then when two people get married and continue to live in their respective home states. The following is an actual question that came up during a past tax filing season. (Names are changed for obvious reasons.)

Fred is a Minnesota resident in 2009, and Ginger is a Wisconsin resident in 2009. Both are renting, and both are students at their respective universities. At the Minnesota-Wisconsin football game, they meet, fall in love, and get married during Christmas vacation. Since both are on a course of study unique to their university, they agree that they will continue at their schools.

Minnesota says that they must file a joint state return if they file a joint federal return. Yet, Ginger has never set foot in Minnesota. Since she fails all the tests for domicile and residency, there is no question that none of her earnings should be taxed in Minnesota. In this situation, you file Form M1NR to remove Ginger's income from Minnesota taxation. The total income would be listed in column A and only his income would be listed in column B.

In Wisconsin, the marital property law generally applies only while both spouses are domiciled in Wisconsin. Since Fred has never established a domicile in Wisconsin, the marital property law will not apply. Ginger has the option of filing a joint return or filing a separate return. It might be easiest to file separate and report all of her income as non-marital property income. She should attach the W*orksheet for Married Persons Filing Separate Returns* and list her income in the "other amount you are reporting" column. Since none of the first five boxes at the bottom of the worksheet fit her situation, she should check the sixth box and explain that her new husband has never established a domicile in Wisconsin.

North Dakota says that in this situation, they would file a joint ND return and complete Form ND-1NR to exclude Fred's income. In Iowa, Ginger would file using Filing Status 4, married filing separately on separate forms. Fred would not have to file as he did not have any Iowa source income. The same situation in Iowa would also apply to Montana.

How would you handle this client? A recent article in the Minneapolis paper told of a female executive for the Best Buy Co. It mentioned that she lived in New York and commuted each week to corporate headquarters in Minneapolis. When she was in town she stayed at her parent's house. Is she a full-year resident, a part-year resident, or a nonresident in your state? In some states, the key question is going to be, "is her parents place a permanent abode for her?" Since this is a typical situation that might come up in the tax season, no answer is provided. You will need to research this on your own.

Residency issues can arise from several different situations:

- People move out of your state and move back in a year or two later. They say they are part-year residents in the years they move out and move in. But the state says they actually are full-year residents for the whole time they were living in another state.
- People moving to a new state in a piecemeal fashion. This happens when one spouse gets a new job in a new state and the rest of the family either moves before or after the time the spouse switches states. This spread of time can sometimes be up to a year or more and creates domicile issues.

The first question to ask clients in the first situation would be why they moved back. This is going to be one of the questions the state will ask in trying to determine their intent. The client will have to show that it was not their intent to move back so soon and that they had intended to make the move to the new state a longer lasting one. Complete details of what they did to

establish their new domicile in the new state will be necessary, as well as what happened beyond their control that caused them to move back.

The act of moving out of your state must be accompanied by most of the acts in the following list from the Minnesota Administration Rules. This list of factors is one of the most comprehensive ones published by any state, but even if they are not published in instructions or administrative rules, they are still what auditors use to help determine residency. You will see how this list gets used in an audit a little further on.

8001.0300.3 Considerations
The following items listed will be considered in determining whether or not a person is domiciled in this state:

- A. *location of domicile for prior years;*
- B. *where the person votes or is registered to vote, but casting an illegal vote does not establish domicile for income tax purposes;*
- C. *status as a student;*
- D. *classification of employment as temporary or permanent;*
- E. *location of employment;*
- F. *location of newly acquired living quarters whether owned or rented;*
- G. *present status of the former living quarters, i.e., whether it was sold, offered for sale, rented, or available for rent to another;*
- H. *whether homestead status has been requested and/or obtained for property tax purposes on newly purchased living quarters and whether the homestead status of the former living quarters has not been renewed;*
- I. *ownership of other real property;*
- J. *jurisdiction in which a valid driver's license was issued;*
- K. *jurisdiction from which any professional licenses were issued;*
- L. *location of the person's union membership;*
- M. *jurisdiction from which any motor vehicle license was issued and the actual physical location of the vehicles;*
- N. *whether resident or nonresident fishing or hunting licenses purchased;*
- O. *whether an income tax return has been filed as a resident or nonresident;*
- P. *whether the person has fulfilled the tax obligations required of a resident;*
- Q. *location of any bank accounts, especially the location of the most active checking account;*
- R. *location of other transactions with financial institutions;*
- S. *location of the place of worship at which the person is a member;*
- T. *location of business relationships and the place where business is transacted;*
- U. *location of social, fraternal, or athletic organizations or clubs or in a lodge or country club, in which the person is a member;*
- V. *address where mail is received;*
- W. *percentage of time (not counting hours of employment) that the person is physically present in Minnesota and the percentage of time (not counting hours of employment) that the person is physically present in each jurisdiction other than Minnesota;*
- X. *location of jurisdiction from which unemployment compensation benefits are received;*
- Y. *location of schools at which the person or the person's spouse or children attend, and whether resident or nonresident tuition was charged; and*
- Z. *statements made to any insurance company, concerning the person's residence, and on which the insurance is based.*

Any one of the items listed above will not, by itself, determine domicile. Charitable contributions made by a person will not be considered in determining whether that person is domiciled in Minnesota.

Example 4: (real life) In 2011, the taxpayer and family moved to Idaho and filed a part-year Montana return and a part-year Idaho return. In 2013, they moved back to Montana and filed a part-year return for coming into the state. The Department of Revenue's computers caught this in a hurry and the return was examined. The state

didn't really look at why they came back to Montana as they had another ace up their sleeve. When the taxpayers maintained they were residents of Idaho in between the moves, the state said fine, show us the Idaho returns that you filed as Idaho residents and we will turn you over to the Game, Fish, and Parks Department for having a resident hunting and fishing license while you were Idaho residents. The taxpayer actually had to stop and think; was it better for him to pay the resident Montana tax or to pay the fine for having a resident hunting and fishing license?

While this case was a few years ago, it goes to show how states cross reference information with other departments, other state revenue departments, and the IRS. Today, they have access to so much information and can match that against information on the return. Residency cases are sometimes lost even before they begin because the taxpayer's actions did not tie in to what they claim their intent was.

Example 5: In another Montana-Idaho case, the taxpayer was transferred to Idaho by the BNSF railroad and the family moved there in one year, but they moved back the next year. In an examination of this taxpayer, the state tried to say they were residents the whole time they lived in Idaho because they came back to Montana so quickly. It turned out that the reason they came back was because, in the railroad system, the taxpayer's seniority put him at the bottom of the seniority list and when another railroad employee transferred in who had higher seniority, the taxpayer dropped off the bottom and the railroad sent him back to Montana.

The taxpayer was doing everything correctly in this case. He was buying a home in Idaho, had his kids registered in school, and had done all the other things to establish a domicile in Idaho. The thing that caused the state to recognize that his move back to Montana was beyond his control was a letter from the railroad explaining why he was sent back to Montana.

Preparation Point: You should get in the habit of asking any part-year taxpayer moving into the state if they have ever lived in your state previously. If the answer is yes and they have only been gone a year or two, then you should investigate further to determine why they came back so quickly and tell them the state might look into the situation. By doing this, you are giving the taxpayer a heads up that something could happen from the Department of Revenue and the taxpayers then will not think you made an error if they do get a letter.

There are three items that will generally shoot your case down in a hurry. The first is to have a resident hunting or fishing license if you are trying to say you are a nonresident. The second is to register and vote in a state where registering to vote requires the voter to be a resident of the state. And the third item is to claim some sort of homestead credit when you are a nonresident. Be sure to ask the client about these items.

Here is another situation that could happen. Let's say you have a tax office in Bismarck, North Dakota. The client comes in who is an oil field worker and has been assigned to work in his occupation as an oil well driller by his company in California. The assignment is expected to last two years and he has already been in the state for 19 months. His domicile is California, as once his work gets done in North Dakota, he will return home to California. How do you file his California return?

California has a rather unusual law that says that if someone domiciled in California is assigned by his employer for an out-of-state contract that will keep him out of the state for 546 days, he is considered to be a nonresident and will only report his income to North Dakota. However, he must be careful not to visit California for more than 45 days in the taxable year or he will be considered a California resident. Another interesting twist in a state's non-residency laws

What else does California say about residents and nonresidents? In the first place, they have a law that says that any individual who spends in the aggregate more than nine months of the taxable year in California is presumed to be a resident. This presumption may be overcome by satisfactory evidence that the individual is in the state for a temporary or transitory purpose. Then, in a case that went through the California appeals process, the appeals board ruled that just because you are in the state for less than nine months, it does not mean that you are a presumed nonresident. In other words, it gets down to the old facts and circumstances test.

Next, California says that an individual whose presence in California does not exceed an aggregate of six months of the taxable year and whose domicile is outside of California is presumed to be a nonresident if:

- the taxpayer does not engage in any activity other than that of a
    - seasonal visitor,
    - tourist, or
    - a guest of a California resident.

What California is saying is that to be a presumed nonresident, you had better not be conducting a trade or business while in the state as a snowbird, for example, or excepting pay from a friend or relative to care for them while they recover from a medical condition. Does your state have any unusual residency rules that you need to be aware of for people temporarily residing in your state? Another state with unusual residency rules is New York. You can find more information in their 128-page audit guideline for part-year and nonresidents.

Minnesota Residency Case: The following case study occurred in the summer of 2010 and represents how states are going after residency. The taxpayers, Doug and Cindy, lived in Minnesota, and in 2007, his company transferred him to Colorado. For various reasons, she elected to remain in Minnesota with their child. So, they downsized their property by selling their house and purchasing a smaller condominium. They filed their 2007, 2008, and 2009 tax returns with Doug as a nonresident of Minnesota. In an audit of these three years of returns, the Department of Revenue maintained that he was a resident of Minnesota during those three years.

The auditor quoted several Minnesota Supreme Court tax rulings including the case of *Sanchez vs. Commissioner of Revenue* where the court stated, “that when the taxpayer announces an intent to make a new abode one’s home, the trier of fact may be considered the facts and circumstances of that person in evaluating the sincerity of the announced intent.” Intent is evaluated on a case-by-case basis, and the taxpayer's actions are of more significance than his or her statements.

She then went on to prove that the acts did not match the intent by using the 26 points in the Administrative Rules (listed earlier) used to determine if a taxpayer is a Minnesota resident. The first point was the physical presence of Doug and Cindy in the state. Since he was in Colorado most of the time, he did not meet the 183-day test, but that didn't matter because an administrative rule says that “the domicile of the spouse is the same as the other spouse unless there is affirmative evidence to the contrary or unless the husband and wife are legally separated or the marriage has been dissolved” (Rule 8001.0300.2).

The auditor then addressed each of the 26 points. We are only going to look at the most significant of these points.

- Location of the domicile for prior years- for several years prior to the audit, Doug and Cindy maintained their personal residence and then sold that and bought a condominium in 2007. The auditor said that by continuing to maintain a residence in Minnesota, they were domiciled in Minnesota and that by buying a new house, they showed that there was no intent to leave the state.

> **Comment:** In today's lifestyle, maintaining a residence in two different states is not that unusual especially when each spouse is working in a different state. What really made this situation bad for them was the fact that they homesteaded the new condominium. Minnesota law says that to homestead a property, you must be a resident. In looking into the situation further, it was learned that to remove a person's name from the homestead declaration requires the removal of that name from the title. This, of course, raises issues with the right of survival of the property should the spouse with the title die.

- Voters registration - Doug did not register to vote in Colorado and did not vote in Minnesota during the years under review. The auditor concluded that since he did not register in Colorado, he was still a Minnesota resident.

> **Note:** Depending on the state, voting registration may be a significant factor. Some states, like Montana, say that when you sign a voter's registration card, you are declaring yourself to be a resident of the state. In other states, signing the voter's registration card merely indicates that you have been in the state so many days prior to the election. In states like Montana, taxpayers have been declared residents of the state just because they voted in the state.

- Location of newly acquired living quarters- when Doug first went to Colorado, he rented on a daily basis and then signed an apartment lease for a term of six months. Every six months, he renews the lease. The auditor held that since the job in Colorado was permanent, he should have been leasing for longer periods than six months. Therefore, she said, he had not established a permanent domicile in Colorado.
- Ownership of other real property- Doug and Cindy owned lakefront property in Minnesota. The auditor said that ownership of recreational property in Minnesota indicates strong ties to the state, and she held that that point favored a Minnesota domicile.

> **Comment:** This factor should not have had that much weight put on it. A lot of people own recreational property in another state and this does not make them residents. But since Cindy continued to live in Minnesota, the auditor held that it was a strong tie to Minnesota for Doug to come back to.

- Jurisdiction of a valid driver's license- this is one point Doug really goofed on as he renewed his Minnesota driver's license and never got a Colorado one. It is hard to prove that Colorado is your resident state, but you continue to hold a Minnesota driver's license. This is one of the key things taxpayers need to do when moving to another state.
- Jurisdiction of any motor vehicle registrations- both of their cars are licensed in Minnesota and are located in Minnesota. There is no indication in the audit report of what he might have driven in Colorado. It is possible that he had a company vehicle to drive. The auditor zeroed in on the fact that they had a scooter and trailer at the cabin and that they maintain recreational vehicles in Minnesota.

- Location of any bank accounts- the auditor said that since they had a joint account in Minnesota, this indicated a Minnesota domicile. The problem with this line of thinking is that it's hard to determine where the account is really located with so many banks being national in scope. Does the fact that a taxpayer uses a Minnesota branch of Bank of America, for example, indicate that it is a Minnesota account?

When she got done, the auditor had tallied 16 of the 26 points in favor of a Minnesota residency and only two in favor of a Colorado residency. All the rest were not applicable or inconclusive. So, what does this audit teach us? Here are some points to consider:

- Make certain that your clients notify you as soon as they get any indication of questions or an audit from either the IRS or a state Department of Revenue. In this case, the taxpayers were sent a three-page questionnaire which asked questions about the 26 points the state looks at to determine residency. Cindy filled this one out herself and sent it back. This author's experience has been that clients should never fill out questionnaires on their own as they don't always understand what information the questions are looking for and how a slightly inconclusive answer can cause the auditor to make a wrong assumption. There were some things in this audit that could have tilted more points toward a Colorado residency, but the crucial ones were in the states favor and nothing would have been gained by an appeal.
- Make certain that when clients come in with this situation, you thoroughly brief them on how their tax situation might be perceived by your state revenue department. Be familiar with those credits or other items that require the taxpayer to certify that he or she is a resident of your state and recognize that it might be impossible to separate the two spouse's domiciles.
- Have a copy of your state's rules, worksheets, or questionnaires that are used to determine residency situations. Use these to review with your clients what the state might ask them with one spouse living in another state if they want to declare that spouse as a nonresident of their home state. The printed word from the state tax department carries far more weight than our spoken words of advice.

Chapter 3 – Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

3. What is the difference between being domiciled in a state and being a resident of a state?

   a. Being domiciled in a state means you always come back to that state on the completion of any travel while being a resident of a state means you are in the state for so many days.
   b. Domicile and residency always mean the same thing.
   c. You must own a home to be domiciled in a state, but you don't have to be a resident.
   d. Your family must live in the state you are domiciled in, but they don't have to in a state you are a resident.

Chapter 4 – Residency (More Details)

Learning Objectives

After completing this section of the course, you will be able to:

- Note the federal residency rules for military personnel and their spouses, including circumstances where federal rules override state rules
- Recognize residency situations in community property states, noting the tax treatment resulting from living in a community property state as well as the impact of reciprocal agreements
- Identify the advantages and disadvantages of working from home when the employer is in another state, noting which states believe income should be taxed in the employer's home state

Military Residency Issues

The issue of military clients is fairly straight forward. This is because the main issue of residency is settled, and most state's instructions spell out exactly how a military return is done. The key points are:

- You are a resident of your home of record state, which is the state you lived in when you enlisted, unless you have taken steps to become a resident of another state.
- You can change the state of legal residence for tax purposes by filing the appropriate forms with the military personnel office and taking the necessary steps to become a resident in the new state.
- The nonresident state where you are assigned to a duty post, under military orders, cannot tax your military wages. You generally do not have to file a return if your only income was military wages.
- They can tax some non-military wages earned in their state (see below).
- Accurate coding of the W-2 in your W-2 entry screen is necessary as well. Correctly coding the W-2 allows the software to properly handle the tax treatment of the military wages on the state tax return.

> **Caution:** Be sure to check the military section in the state instructions. The reason is because states allow different types of exclusions of military income. These exclusions might be different depending on whether the military person is regular Armed Forces or in the National Guard/Reserves. There are also deductions or credits for time spent in a combat zone or even just being sent overseas. Generally speaking, the guards and reserves will have their return done in their home state as they normally are not assigned to other states other than for some pre-deployment training.

Military Spouses

In November of 2009, Congress passed the Military Spouses Residency Relief Act which somewhat simplified tax issues dealing with spouses of military members who worked in the state the military member was stationed in. The law has two main provisions:

- The first is that a spouse will not acquire a residence or domicile for purposes of income tax or personal property tax because the spouse is present in a state solely to be with a service member serving in compliance with military orders.
- The second is that income for services performed by a spouse is not deemed to be income earned in a state if the spouse is not a resident or domiciliary of the state in which the income is earned because the spouse is in the state solely to be with the service member

serving in compliance with military orders and both spouses have the same home state domicile.

A nonmilitary spouse no longer meets the requirements of the act and his or her wages are sourced to the state they are in if any of the following disqualifying events occur:

- the military spouse leaves the military;
- the nonmilitary spouse becomes a resident of the state they are stationed in;
- the marriage to the military spouse terminates; or
- physical separation due to a duty change when the military spouse's orders move him or her outside of the state and the spouse is allowed to join the military spouse but chooses not to.

The act applies only to wages or self-employment income of the nonmilitary spouse and other types of income might be taxable by the state they are in. The following chart will help distinguish where different types of income are taxed.

Chart on Taxes of Military Member and Spouse		
Income type	**Military member**	**Spouse**
W-2 wages from military	Taxable to home state	N/A
W-2 wages – non-military	Taxable to state in which income earned*	Taxable to home state
Self-employment income	Taxable to state in which income earned*	Taxable to home state
LLC- income from service	Taxable to state in which income earned*	Taxable to home state
LLC- income from property	Taxable to state where property located*	Taxable to state where property located**
S Corporation K-1	Taxable to state where business located*	Taxable to state where business located**
Rental property	Taxable to state where property located*	Taxable to state where property located**

*Also taxed in the home state of the military member.
**Also taxed in the military spouse's home state.

Most states have some form that the nonmilitary spouse can complete and give to an employer to stop state withholding on his or her wages. Of all the states this author checked on this issue, South Carolina has issued the best instructions on how it is to be applied. In a question-and-answer format, they have looked at several possible scenarios and explained how the act did or didn't apply in that situation. You can find this write up in the South Carolina Temporary Revenue Ruling #10-5, dated March 22, 2010.

If you are a preparer in a town with a military base, what types of problems are you likely to run into?

- If the client is a resident of your state, you will need to be familiar with your state's tax rules for military income. This is a matter of reading the instruction book. Be sure to distinguish between active duty pay of career military persons and active duty pay of national guards/reserves. See next caution point.
- Next, you have a resident military person who has married a spouse from another state. Generally, if the nonresident spouse gives up their domicile in their home state to join the

resident military person in your home state, then they become a resident of your home state. If this occurs during the year, you will have a part-year return for that spouse. The residence of a spouse does not automatically follow that of the military spouse. Each state's domicile rules decide whether the spouse is a resident or not.

- Now, we have a nonresident military person whose home of record is another state other than your home state.
    - If they have nonmilitary wages, these will be taxed in both their home state and in your home state. Their home state will generally allow a credit for taxes paid to another state.
    - If the nonresident military person buys a house in your home state, that does not make them a resident of your state. Remember, that to become domiciled in your state, there must be a union of act and intent. The intent is usually missing with the nonresident military person. Some states will pointblank say that purchasing a house, paying property taxes, or registering a car will not automatically make the nonresident military person a resident of that state.
    - If the nonresident military person marries a spouse from your home state, it becomes a little bit more of a challenge. The "local" spouse is a resident and would file a full-year resident return for your home state. The nonresident military spouse would either: 1) have no income to report if they didn't work off-base and their military income would be removed from a joint return on the line just for nonresident military income; and 2) report their nonmilitary income on your home state return and remove the military wages on the above mentioned line. The details will depend on how your state handles part-year and nonresident income on its system. However, you will need to know what the result should be so that when you review the return, you can be sure it is correct.

> **Caution:** A person who is a resident of a state in which there is a military base and marries a nonresident serviceperson stationed at that base is not eligible for exemption from withholding. This is because they did not come to the state as a result of military orders issued to the nonresident military person. This is also true if, for example, a couple are residents of North Carolina. She is in the military stationed in North Carolina and he works at a civilian job in South Carolina. He is not eligible for any withholding exemption and his pay will be taxed in both South Carolina and his home state of North Carolina. This is because North Carolina is his residence and to be eligible for the military spouse's provisions, her home of record would have to be in another state.

-
    - In these nonresident military returns, you will more than likely have to do the return for the nonresident's home state. Again, be sure to review the military instructions so that any exclusion the serviceperson is entitled to is taken.
    - Sometimes a military member has moved during the year and more than two states are involved. Just list where they were at the beginning of the year, when they moved, and the income associated with each state. The important thing is not to panic but to gather the facts and apply the law.

> **Caution:** Some states distinguish between military wages paid under Title 10 and Title 32. Title 10 is those wages paid to the regular armed forces members and are always considered active duty wages. Title 32 is for the wages paid to guards and reserves from the reserve funds. They may or may not be considered active duty paid depending on state law. For example, Montana has an active duty military pay exclusion on the state return. But the wages

> must be paid under Title 10. The guards and reserves are paid under Title 32 unless called to active duty under Title 10. The service person's orders will always show what title they are serving under.

It is also important to distinguish guard/reserves wages from active duty for state exclusions. Minnesota's exclusion for guard/reserve wages is different from those for active duty wages. Knowledge of where the wages were earned is necessary to determine the correct exclusion.

Residency Situations in Community Property States

As was mentioned in Chapter 3, an individual can have at any one time only one domicile. If an individual has acquired a domicile in one place, it is retained until another domicile is acquired elsewhere. Domicile is important because a taxpayer's domicile determines whether income is community property or separate property. Generally, the spouse who remains in Idaho is domiciled in Idaho and community property laws will apply. If the nonresident spouse's income is community property, one half of it is taxable to Idaho because it belongs to the resident spouse.

The following states are community property states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Of these nine states, Nevada, Texas, and Washington do not have an income tax. Wisconsin is not a true community property state, but they have a form of marital property divisions which are similar to community property. For our illustrations, we are going to use Idaho as the base community property state.

Alaska is another state which is not a community property state, but it does allow married couples to form community property agreements or trusts. These agreements and trusts allow spouses to identify which property and income is to be classified as community property.

The following chart will be helpful in determining where income is taxed depending on where the nonresident spouse is domiciled.

Type of income	Percent of income taxable to Idaho (or other community property state) when nonresident spouse is domiciled in a:	
	Community-property state	Separate-property state
Resident spouse’s wages	100%	100%
Nonresident spouse’s wages	50%	0%
Idaho-source interest - joint account	50%	50%
Other state-source interest - joint account	50%	50%
Resident spouse’s separate interest	100%	100%
Nonresident spouse’s separate interest	0%	0%
Idaho real property - jointly owned	100%	100%
Out-of-state real property - jointly owned	50%	50%
Resident spouse’s non-Idaho real property - separately owned	100%	100%
Nonresident spouse’s non-Idaho real property - separately owned	0%	0%
Idaho-source partnership income - jointly owned	100%	100%
Out-of-state source partnership income - jointly owned	50%	50%
Resident spouse’s non-Idaho partnership income - separately owned	100%	100%
Nonresident spouses non-Idaho partnership income - separately own	0%	0%
Sale of jointly owned the stock	50%	50%
Idaho stock sales and dividends - jointly owned	50%	50%
Out-of-state stock sales and dividends - jointly owned	50%	50%
Resident spouse’s sale of separately owned stock	100%	100%
Nonresident spouse’s sale of separately owned stock	0%	0%

Example of a Nonresident Spouse Domiciled in a Community Property State
In 2016, Bill lost his job when his company, the Quickie Mortgage Company, went bankrupt. He was unable to find any work in his line of expertise in Idaho and so he accepted a job with Quality Mortgage Company in Washington, a community property state. During 2016, he moved permanently from Boise where he had some separate property and a separate savings account, both of which he acquired before he was married. Judy, his wife, decided to stay in Idaho until she was eligible for retirement in 2018, at which time she planned to join Bill in Washington. Bill is domiciled in Washington because he does not intend to return to Idaho and has done everything to make certain his domicile status will survive any scrutiny by Idaho.

In 2017, Bill and Judy had income from various sources which was taxable to Idaho, and, therefore, reported on their Idaho return as follows:

Judy's wages	$ 40,000	x	100%	=	$ 40,000
Bill's wages	60,000	x	50%	=	30,000
Interest from joint account in Idaho	2,000	x	50%	=	1,000
Interest from joint account in Washington	800	x	50%	=	400
Interest from Bill’s separate Washington account	100	x	0%	=	0
Loss from Idaho rental property	(3,000)	x	100%	=	(3,000)
Income from Bill's separate Washington land rental	3,600	x	0%	=	0
Income from joint Idaho partnership	2,200	x	100%	=	2,200
Income from jointly owned stock	400	x	50%	=	200
Income taxable by Idaho					$ 70,800

Example of a Nonresident Spouse Domiciled in a Separate Property State
In 2016, Bill lost his job when his company, the Quickie Mortgage Company, went bankrupt. He was unable to find any work in his line of expertise in Idaho and so he accepted a job with Quality Mortgage Company in Montana, a separate property state. During 2016, he moved permanently to Missoula, MT, where he had some separate property and a separate savings account, both of which he acquired before he was married. Judy, his wife, decided to stay in Idaho until she was eligible for retirement in 2018, at which time she planned to join Bill in Montana. Bill is domiciled in Montana because he does not intend to return to Idaho and has done everything to make certain his domicile status will survive any scrutiny by Idaho.

In 2017, Bill and Judy had income from various sources which was taxable to Idaho, and therefore reported on their Idaho return as follows:

Judy's wages	$ 40,000	x	100%	=	$ 40,000
Bill's wages	60,000	x	0%	=	0
Interest from joint account in Idaho	2,000	x	50%	=	1,000
Interest from joint account in Montana	800	x	50%	=	400
Interest from Bill’s separate Montana account	100	x	0%	=	0
Loss from Idaho rental property	(3,000)	x	100%	=	(3,000)
Income from Bill's separate Montana land rental	3,600	x	0%	=	0
Income from joint Idaho partnership	2,200	x	100%	=	2,200
Income from jointly owned stock	400	x	50%	=	200
Income taxable by Idaho					$ 40,800

Reciprocal Agreements

A reciprocal agreement between two states is an agreement where states will not tax the income of residents that cross a border to work. For example, a Minnesota resident living in Morehead and who works in Fargo, North Dakota, will not be taxed by North Dakota on his or her wages. The reciprocal agreements state that the state of residency of the worker will tax the income and not the state where the job is. If everything is working the way it should, the Fargo employer will withhold Minnesota tax and the employee will only file a Minnesota return. These reciprocal agreements apply only to wages and other forms of compensation. Other types of income could require the filing of the other states return.

> **Caution:** The agreements between states do not require the Fargo employer to withhold Minnesota tax if they are not doing business in Minnesota. The employee could wind up with a large Minnesota balance due as there would not be any state withholding. You will need to get these clients set up on state estimated payments or increase the Minnesota spouse's withholding.

> **Caution:** Reciprocal agreements might place requirements on the nonresident taxpayer in order to qualify for the reciprocal tax treatment. For example, North Dakota says the Minnesota resident working in North Dakota must return to Minnesota at least once per month.

Your role as a tax preparer is to know how the client should file if they begin work in a reciprocal state and don't file the proper paperwork with the employer so that the wrong state's tax is withheld. All states having reciprocal agreements have instructions as to how to file to get the refund from the other state. Be sure you know where to find these instructions and forms as new clients pop up every year that have not followed the proper procedures.

Telecommuting Employees

What exactly is telecommuting? The word "telecommuting" was first coined by Jack Niles to describe a work arrangement in which employees enjoy flexibility in work, place, and time (within certain limits). Workers can telecommute from home or a location other than their primary place of work. Management cares only that the work is done efficiently. A secondary goal is that, through telecommuting, management can minimize costs.

The big question is which state is going to tax the telecommuting employees? In the controversial case of *Huckaby v. New York State Division of Tax Appeals,* Thomas L. Huckaby's home was located in Tennessee and his employer was in Queens, New York. In the course of his work, 75% of his income was earned in Tennessee and 25% was earned in New York. He prorated the numbers accordingly and paid the appropriate tax to New York and to Tennessee.

New York did not agree with this. Because the telecommuting was for Huckaby's convenience, not the employer's, and the work Huckaby performed could have been performed in New York, the court ruled that 100% of Huckaby's income was taxable in New York. Fortunately, only four states follow this line of thinking when taxing telecommuters. They are Delaware, Nebraska, New York, and Pennsylvania with New York being the most aggressive at pursuing this type of taxpayer.

> **Comment:** Aggressive isn't strong enough to describe New York's efforts in this area. There is a six-page bulletin *New York Tax Treatment of Nonresidents and Part-Year Residents Application of the Convenience of the Employer Test to Telecommuters and Others* (TSO-M-06(5)I) as well as a 124-page *Nonresident Audit Guideline.* This is probable the most comprehensive discussion on state residency issues this author has ever seen from any state.

The other states tax on a system of where the employee is located. If Huckaby's employer, in the above case, had been in Minnesota, for example, then he would have allocated 25% of his income to Minnesota. He would have, however, reported all of his income to Tennessee, as that is the state, he is domiciled in, and taken a credit for taxes paid to Minnesota.

> **Note:** Although most states provide a credit for personal income taxes paid to another state, that credit mechanism has been found not to be required under the U.S. Constitution, leaving the potential for double taxation a real and serious problem.

There are numerous other tax aspects of the telecommuting employee which are beyond the scope of this text. These include such things as:

- Withholding income taxes for the proper state. Many employers will take the path of least resistance and withhold for the state that the company is located in. This causes the employee to have a large balance due in their home state while applying for a refund from the employer state.
- Along with the issue of the income taxes, there is also payroll taxes on the employer's part that needs to be addressed.
- There are numerous tax articles about the possibility of an office-in-home deduction for telecommuting employees. As you can imagine, a lot of people will not qualify for this deduction as it is not for the convenience of the employer.
- There is also the issue of travel expense deduction when the employee goes back to the home office periodically which is usually required of telecommuting employees.
- Another big issue deals with the right of the state in which the telecommuting employee works, to tax some of the gross income of the employer. The state is saying that the employer has a presence (nexus) in the state and therefore has income sourced to the state. For example, Dick writes training manuals from his home in Missouri for his employer located in Ohio. The fact that Dick is working for his employer in Missouri gives his employer a business situs in Missouri which opens the door for Missouri to attempt to tax the employer.

A Review of Residency Situations

Here is a trick question for you. Is a pipeline worker from Wyoming who does pipeline work in Mississippi subject to Mississippi tax?

No—all employees of rail, rail-water, express, pipeline, and motor carriers operating under the jurisdiction of the ICC and employees of private motor carriers are taxed in their home state. You might have known about the railroad workers and motor carriers, but you probably didn't know about the pipeline workers.

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1. A Minnesota taxpayer's dependent daughter is living in New York. She is a student and works in New York. Further facts include:
    A. She has a one-year lease on her apartment in New York
    B. Still has her Minnesota driver's license
    C. She is registered to vote in Minnesota
    D. She has bank accounts in both Minnesota and New York
    E. Was in Minnesota during the year only for the holidays

2. What is her status in Minnesota?
    A. First question to the parents is has she moved out completely—has her domicile switched to New York? Maybe she is no longer a dependent of her parents, but they don't realize that yet.
    B. If it has, then she is no longer a Minnesota resident. Don't get hung-up on the issue of her being a dependent of her parents. Residency has nothing to do with dependency. One of the requirements for a qualifying child is to be a resident in the parents' home for more than half the tax year, but there is the temporary absence for school provision. What this is really trying to say is that state residency rules are not tied to any dependency rules.
    C. The Minnesota driver's license is not fatal to her situation because it is just one of the many tests the Department of Revenue uses. Also, registering to vote in Minnesota does not require a statement declaring that she is a resident of Minnesota. The fact that she registered at some time does not bind her to that status for future elections.

3. What about New York?
    A. It appears that she has met New York's 183-day rule and has a permanent place of abode. Therefore, she would be considered a resident of New York.

Here is a good one for a discussion:
The taxpayer used his daughter's home in your state as his mailing address for any important mail. He worked the entire year in South Dakota. He does not own a house nor rent an apartment. His possessions fit into his vehicle. He lives in a hotel for each job he works on. He works for a firm in your state which builds prisons. His job is to supervise the construction and then he moves on to the next project. The employer withholds your state taxes. Does he owe taxes to your state? This is from a tax professional who had this person as a client. (His tax home for federal purposes does not enter in here.)

Here is the author's opinion.

- I do not believe that the state the daughter lives in has any bearing in this situation. Just maintaining a mailing address of her home is not sufficient for any residency or domicile analysis, to make him taxable in her state.
- So now we look at the state he is working in. South Dakota doesn't have an income tax return to do. But what about the withholding from the employer's home state (assume it

is Colorado). He could file a Colorado nonresident return using his daughter's address and claim zero income.

- If he was working in one of the states that counted days in the state, he would probably flunk the test as he would not have a permanent place of abode as his vehicle, for sure, does not qualify in this regard. Therefore, he would file as a nonresident but report the earnings to that state and have a balance due. But he would file the Colorado return claiming full refund of the taxes withheld.
- The same thing would be true in those states that did not count the days.

Situation from a tax professional: Question 1 - I have a client who moved from Minnesota to Arizona in 2010. She filed as a part year Minnesota and Arizona resident that year. She rented out her home in Minnesota in 2010 through 2012 and sold it in 2013. She filed as an Arizona resident in 2011 and 2012 with Minnesota tax liability for rental income. However, I just realized that she never gave up her homestead rights to Minnesota. Should I have been filing her differently in 2011 and 2012?

Question 2 - The other question I have is do I just show capital gains on the sale of the home in Minnesota, or is she eligible for the section 121 exclusion (she lived in it 2 out of the last 5 years)?

Question 3 - The other twist to this is that she has purchased another home in the Minneapolis area in which her son is living. But the loan and real estate taxes are in her name. Does that make her a Minnesota resident?

Answer 1 - Generally speaking, in most states, homestead provisions are only for personal residences. Thus, if it ceases to be a personal residence and is rented, the homestead provisions are generally lost. The taxpayer's property tax statement will usually indicate if the property is still homesteaded. If anything, having the homestead provisions lost in this situation would be to the client's benefit as the residency certification would be eliminated and she could not be a Minnesota resident by virtue of the home being homesteaded. Assuming the client has done all of the other things to abandon her domicile in Minnesota, you can file her as a nonresident.

Answer 2 - Since Minnesota's taxable income starts with the federal taxable income, anything taxed or not taxed on the federal return would be the same on the Minnesota return unless there was a specific provision where it was different from the federal. Many states have what they call additions and subtractions where the state law, which is different from federal law, is taken into consideration. See the discussion on this topic in the next chapter. It would be advisable to file a Minnesota 2013 tax return to report the sale of the rentals even though the gain is fully excluded. However, there will be unrecaptured section 1250 gain to be reported. Even though that gain might fall below the Minnesota filing requirement and thus not taxed, the sale of the rental should be reported so that Minnesota doesn't associate them with a nonresident. States are getting very good at tracking property owned by nonresidents. This is also discussed in the next chapter.

Answer 3 - Owning property in another state generally does not make you a resident of that state. There is no intent to become domiciled in that state and no actions were taken to change the domicile. So, it's like she owns a second family home in Minnesota. Just be careful she doesn't spend more than 183 days visiting her son.

Residency Cases
Stamp v. Commissioner of Revenue (1980): Taxpayer was a pilot for Northwest Orient Airlines and planned to move to Florida. In late 1974, they purchased a condominium in Florida and lived down there for the first four months of 1975 when they returned to Minnesota to live in their home on Lake Minnetonka. They did the following things to establish Florida residency:

- They homesteaded their Florida property.
- They licensed one of their vehicles in Florida.
- They obtained Florida driver's licenses and allowed the Minnesota licenses to expire.
- They joined a Florida golf club and social organization.
- They registered to vote in Florida and voted there in the local elections.
- He notified his employer to stop Minnesota withholding on his paychecks.

However, they continued to do the following things in Minnesota during the last seven or eight months in 1975:

- Taxpayer's spouse spent seven months in Minnesota.
- They continued their principal checking and savings accounts in Minnesota and obtained a loan from a local bank in late 1975.
- Taxpayer's spouse continued to maintain charge accounts with Minneapolis stores.
- They continued to be members of the golf club and they continued to be members of the Minnesota flying club.
- Their expenditures for normal household expenses were at a much greater rate in Minnesota than they were for Florida.

The court stated that the taxpayer's acts contradicted their stated intention of making Florida a new domicile. Since an existing domicile is presumed to continue until a new one is established, and new domicile is proved by showing physical presence coupled with intent to make a home, the record established that they intended to retain their existing home in Minnesota.

> **Note:** Even though this case is over 35 years old, the law as expressed in it is as valid today as it was then. Minnesota law has not changed on residency issues and if anything, application of the law has gotten stricter as the Department of Revenue keeps tightening up their audit procedures based on case results.

Sanchez v Commissioner Revenue (2009): In this case, the taxpayers went to South Dakota in May and started the process of establishing a domicile in South Dakota. They established a mailing address through a commercial mailbox company, they obtained South Dakota driver's licenses, and registered to vote. Then, they came back to Minnesota and remained there until their house sold in June and after purchasing a RV motor home, they left Minnesota and never returned.

The Department of Revenue maintained that they were full-year Minnesota residents by virtue of the fact that they failed to establish a new domicile in South Dakota. This was because they spent

the rest of the year traveling around the country in their motor home and never actually set roots in South Dakota. The fact that they did all of the things to establish residency was not sufficient to establish intent to make it their home and integrate their lives in the community or establish connections to South Dakota. All parties agreed that the Sanchez's left Minnesota with no intent to return. The issue is whether the Sanchez's established a new domicile in South Dakota. According to the Supreme Court, they did not establish a domicile in South Dakota.

Manthey v. Commissioner of Revenue (1991): This taxpayer went to Alaska to work on construction projects relating to the Alaskan pipeline which lasted for about nine years. He spent most of his time working. In Alaska, he was registered to vote and voted in elections there, he obtained an Alaskan driver's license, performed jury duty, join organizations in Alaska, registered and licensed his car and trailer, purchased resident hunting and fishing licenses and purchased real estate in Alaska. The state of Alaska certified him as being an Alaskan resident. He finally left Alaska when his declining health forced his retirement and the work slowed down.

During the years in Alaska, however, the taxpayer maintained significant ties with the state of Minnesota. He provided all of the support for his family in Minnesota, maintained his Minnesota driver's license and purchased resident hunting licenses in Minnesota. He owned, licensed, and registered motor vehicles in Minnesota and purchased and maintained rental property.

The court, in upholding the Minnesota Tax Court opinion, said that because the intent to remain in a fixed place is determinative, mere physical removal is insufficient. The inquiry focuses on intent, examining actions and words to discover that intent. Even though the taxpayer enjoyed certain rights peculiar to Alaskan citizens and established social and fraternal relations there, at the same time he continued to enjoy the benefits accorded Minnesota residents. When the work ran out, he returned to Minnesota which demonstrates that he never intended to uproot himself from Minnesota.

Sandberg v. Commissioner of Revenue (1986): The taxpayer spent quite a bit of time out of Minnesota, mostly living in hotels during his travels. The court said, "the mere intention to acquire a new domicile, without the fact of physical removal, does not change the status of the taxpayer, nor does the fact of physical removal, without the intention to remain, change the person's status. A domicile once shown to exist is presumed to continue until the contrary is shown. An absence of intention to abandon a domicile is equivalent to intention to retain the existing one. A person can live in another state fora period of time but shall be considered domiciliary of Minnesota if he has not, through his acts, demonstrated his intent to establish a new domicile."

Dreyling v. Commissioner of Revenue (2006 & 2008): Two recent cases are for the same taxpayer who challenged the state saying he was a resident while he was in Alaska for three years and then two years later, when the state challenges Florida residency, he again went back to the Supreme Court and lost both times. While this taxpayer had purchased a Florida residence, he continued to maintain his Minnesota living quarters and a Minnesota Homestead election. He also owned other property in Minnesota, had multiple vehicles located and registered in Minnesota and the bulk of his financial dealings was in Minnesota including checking accounts, retirement assets and investments.

Marks v. Commissioner of Revenue (2016): In a February 2016 case, the Minnesota Supreme Court ruled that the 183-day counting rule, as described in Chapter 3, was a valid law even though it could be interpreted two ways. The taxpayers had moved to Florida in early 2000 and established their domicile in Florida, but they kept a Minnesota residence and various contacts in the state. In 2007, on August 1, they moved back to Minnesota and established their domicile in the state. They filed their 2007 return as part year residents. The Department of Revenue, in an audit, said they were full-year residents.

The taxpayers maintained that the 183 days in the state had to be met between January 1 and August 1 of 2007, and since they didn't do that, they were only part year residents. The DOR said that since they had maintained a permanent place of abode in Minnesota during the first seven months of the year, that all days in the state counted and since that was over 183, they were full-year residents. While the definition of a resident could be interpreted in two ways, the court said they looked at what the legislature intended in writing the law and how it had been interpreted in past case law.

Chapter 4 – Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

4. In which of the following situations would a military spouse be exempt from withholding for wages earned working for an employer in state A where the service member spouse is stationed? (Assume Dick is the service member spouse and Jane is the military spouse.)

   a. Dick and Jane are both from their home state of B and she follows him to state A in compliance with military orders.
   b. Dick is stationed at a military base in their home state of B and Jane is working across the border in state A.
   c. Dick is a resident of state B and he marries Jane, who is a resident of state A.
   d. Dick and Jane are registered domestic partners.

Chapter 5 – Income, Deductions, and Credits

Learning Objectives

After completing this section of the course, you will be able to:

- Note the starting point requirements for computing a state's taxable income, citing reasons why the state taxable income may differ from the federal taxable income
- Identify what income is taxable to the nonresident state, noting applicable adjustments to income resulting from deductions or credits
- Cite how to allocate income to each state depending on whether the taxpayer is a resident, part-year resident, or a nonresident

Income Starting Point

The jumping off point for computing the states' taxable income varies from state to state. The reason it is important is because that determines what adjustments the state needs to make to arrive at the taxable income. You will see how this works as we go through the steps to complete a state return.

- The state return mimics the federal 1040 page 1. Montana, and to a lesser degree, Iowa, does this. The state wants to know what makes up the federal AGI and so the front page mirrors the federal 1040. On the Montana return, the federal AGI as reported on the Montana Form 2 must match the federal AGI. If it doesn't, an explanation must be sent in.
- State starts with federal AGI. These states don't care what makes up the federal AGI and so the return starts with the federal AGI.
- State starts with federal taxable income. Minnesota and North Dakota do this. This simplifies the state return, for example, as there is no separate schedule for itemizing or computing the allowable exemptions and dependents.
- Read the form carefully. This is true with any state return, but these states build their return from scratch so to speak and do not rely on input from the federal.

No matter what method the state uses to start calculating the taxable income, there are going to be adjustments to the federal AGI or taxable income. This is due to several reasons:

- The first is that there are items of income that are taxed on the federal level but, by federal law, they cannot be taxed on the state level. Two common items are U.S. Government interest and Tier II Railroad Retirement benefits. This requires the states to have a section where items not taxed on the state return are subtracted from the federal amount.
- Likewise, there will be items of income not taxed on the federal return, but the state will tax it. A common item added back into federal income, is the municipal bond interest of states other than the taxpayer's resident state. States will tax-exempt their municipal bond interest but not that of other states.
- The second reason is that states are free to elect not to tax an item of income that is taxed on the federal return or vice versa. A perfect example of this is that Montana does not tax tip income received while working in a food/beverage business or in a lodging facility.
- The third reason is that states do not always follow federal law. They look very carefully at the impact of new federal legislation on the state's financial picture. As a result, they might adopt all of a new law, part of it or none of it. Also, state legislative sessions might

be over when new federal tax laws are passed which requires the state to make adjustments for tax laws not adopted yet.

- For example, any tax law changes made on the federal level in 2015 were not adopted by Minnesota until early April 2016. This meant that many Minnesota returns had a "nonconforming" form so that Minnesota taxpayers followed the old federal law. By the time the legislature adopted the 2015 changes, the tax season was almost over, and the Minnesota Department of Revenue advised tax professionals and the taxpayers to file their returns with the nonconforming provisions in the return. The state would make changes as necessary automatically and contact those taxpayers were additional information would be needed. That usually means the taxpayer comes in when they get the notice from the state wondering what you did wrong.
- Some states, like Montana, have it in the statutes that any change made on the federal level that affects the federal AGI is automatically adopted by the state. This greatly simplifies things if Congress has had a busy year making tax changes.

It is essential that you review this section of any state return very carefully to find these little known state adjustments. Only by reading each line and following the instructions can these be properly entered.

> **Note:** Now you can see why it might not be possible to finish a client's other state return while they are at your desk. Can you imagine how much confidence a client would have in you if you sat there reading each line in the adjustments section and wondering what it was for? Montana's subtraction section is 33 lines plus, of course, the all-inclusive "other" line. You have to study the instructions to see what the "other" line is for.

The next item to be considered is to be sure that you are using the proper forms. Some states have a separate return for nonresidents and part-year residents. Others have a schedule that attaches to the base form. Other than items directly related to a state such as W-2 wages earned in the state, most items of income will require allocation based on either time spent in the state or other factors. The same is true with deductions. Reading the instructions is essential as some states do not allow some credits or deductions to part-year residents while other will allow a pro-rated amount. (There will be a further discussion on this topic later.)

There are three typical classifications for part-year and nonresidents:

1. States that require reporting of only income received during the period of residency.
2. States that require reporting of all income received during the year and subtract income from sources outside the state from total income.
3. States that prorate the tax computed as if the taxpayer is a full-year resident by the ratio of income from that state to total federal income. Most states follow this method as it produces the higher tax.

Income Taxed

What is taxed to the nonresident state? The following list is what is generally going to be taxed to nonresidents by most states:

- W-2 wages
- Schedule C if the trade or business is located in the nonresident state. What about professional speakers who teach a tax class, or do a motivational presentation, or any other presentation? The states are pursuing these people based on the 1099-MISC sent to the speaker by the organization. So, your client who does this type of work might have many nonresident tax returns to file. That leads to the question of- how are the expenses allocated? Are they divided by the percent of income from that state to the total income or is it the actual expenses for that engagement? The states allocation rules might be of help here.
- Schedule F if the farm was located in the nonresident state and the taxpayer had a farm manager or a relative running the farm
- Schedule E income
    - Rentals
    - Royalty income (oil, gas, etc.) - generally, there is no question that the royalty income from oil, gas and other mineral deposits is taxable in the state where the mineral is extracted from. But what about royalties from creative works? For example, California taxed a nonresident on the royalties he received from a New York publisher because he did the writing while in California. What does your state say on this situation?
    - S Corp income
    - LLC & partnership income
    - Income from trusts and estates originating in the nonresident state. However, here is another one that will need to be checked as some states say that if the beneficiary just received his or her share of income without it being connected to any income producing activity, then it wasn't taxable to the nonresident beneficiary.

- Unemployment compensation
- Sale of real property located in and out of that state

A couple other items that you will need to watch for include carryover losses from Schedule D, net operating losses, or passive activity losses. Numerous states will not allow carryover losses to be brought into the state when a taxpayer is moving into the state and becomes a resident. Thus, the losses carried forward at the state level could very well be smaller than the losses carried forward on the federal level.

States are really going after K-1 income especially from partnerships and corporations. They are getting their computer systems updated to handle entity returns and can now keep track of K-1s to determine if the income is being reported, especially by nonresident partners and shareholders. While some of these K-1s are below the filing requirements of many states, other states have a requirement that any income from a nonresident is reported.

Here is a new one that states are starting to look at. Let's say that you owned some rental properties in Montana and in anticipation of moving to Iowa, you did a like-kind exchange for property in Iowa. Let's also say that $50,000 of gain was deferred into the Iowa property. Now five years later, you sell the Iowa property. Montana says that you must report the deferred gain to Montana in the year of sale. Montana is going to tax you on the $50,000 of gain that you would have paid tax on had you not exchanged the rentals for property in another state.
How are they going to know? In the first place, they know of the deferred gain because you filed a Form 8824 showing the deferred gain in the year of the exchange. Then, they can track your later years' returns through the IRS, or property sale reports in the state you moved to, or through other records we don't even know about. Montana actually has administrative rules for this situation and other states do as well. Be sure to check with clients who sell property to see how they obtained it.

> **Caution:** You might think that these provisions are so much talk but be careful. Montana has a whole department just to track and pursue income from out-of-state sources.

Income from real property and tangible personal property is taxable to the state in which it is located. Most states conform to federal deferral of tax when property is exchanged in an IRC §1031 exchange. Here are the exceptions:

- Pennsylvania taxes all gains and does not allow deferral of gain under IRC §1031.
- Mississippi and Vermont do not allow gain deferral under IRC §1031 if the new property is located out of state.
- An Oregon law, which disallowed gain deferral if the new property was located out of state, was overturned by the court as unconstitutional. Oregon now requires, as does California, that the deferred gain be reported to the state when federal gain is reported (these rules apply to both residents and nonresidents).
- In California, individuals and business entities must file FTB 3840, *California Like-Kind Exchanges,* to report previously deferred California sourced gains or losses if they do both of the following:
    - Perform like-kind exchanges of California property for property outside of California.
    - Defer any gain or loss under Code Sec. 1031.

> **Note:** FTB 3840 is filed every year as long as the property is still owned.

New York tops the like-kind exchange process one better. If you have a right to receive income without restriction or contingencies at or before the date you change your residence, the tax is due on this accrued income on your tax return for the year you move out of New York. This would include such things as income from installment sales, lottery winnings, bonuses, and severance pay. You can escape paying the tax all at once by posting a bond or other security to cover the total tax that would be due on the income and then you report the actual income each year on a New York nonresident return.

More for nonresidents:

- Investment income is NOT taxable to a nonresident, even if the financial institution that paid the income is located in the nonresident state
- Pro rata allocation of the following items may be needed if the client changed domiciles during the year (this is applicable to part-year residents):
  - Alimony paid or received
  - Investment income
  - IRA contribution
  - Unemployment
  - Pensions

Caution: You need to find out when the client received the income, especially the five mentioned above. You CANNOT assume that the income was received equally over the year. For example, the interest on the 1099-INT might have been from an account opened after they arrived in your state and so none of it would be taxable in the state they left.

Caution: Clients think that since they retired while in the state they left and that all the paperwork was completed while in that state, the pension check received after they arrived in your state, is not taxable in your state. Dead wrong. States go by the rules of constructive receipt and it is taxed in your state whenever it is received.

Adjustments to Income

All adjustments to income are accepted by the states. Depending on the state's financial condition, they might think the federal is giving too much away and they will not adopt federal changes or adopt just part of them. The key adjustments that may or not be accepted by the states include:

- Tuition and fees deduction
- Educator's expenses
- Student loan interest
- HSAs

Be sure to read the instructions to see how the states handle adjustments. Some states allow adjustments based on residency status and sometimes nonresidents must calculate the amount of an adjustment allowed based on state income to total income. Others say you must deduct only what was paid while you were a resident of that state. Most states only allow a moving expense deduction if you move into your state. An exception is Montana where the return is figured as if you were a full-year resident and moving expense is allowed regardless of whether you are coming or going.

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Deductions

Schedule A differences. There is a wide variety of ways the states handle itemized deductions. The states in the upper Midwest use the following methods;

- North Dakota and Minnesota start with the federal taxable income and so there are no separate Schedule A forms for the states. However, if there is a change in itemized deductions on the federal level, Minnesota doesn't adopt them automatically. Therefore, it might be necessary to make an adjustment on the Minnesota Schedule M1NC (Non-Conforming) for those items where Minnesota doesn't yet conform to federal law.

- Wisconsin doesn't allow itemized deductions but instead has an itemized deductions credit. Only three deductions can be used to figure the credit and those are medical, interest, and contributions. You need to check the instructions on those as there are some limitations.
- Montana and Iowa allow you to itemize on the state even if you used the standard deduction on the federal or to use the standard deduction on the state after itemizing on the federal. Both states allow additional deductions than are allowed on the federal Schedule A, so be sure to go down through the form line by line so you will not miss any deductions.
- In some states, the federal Schedule A is the state Schedule A with some items disallowed, and other items added.

States allow deductions not on the federal return for unusual things:
- MN-qualified computer education software expense.
- MN-deduction for kids in elementary and secondary school.
- MT-Ecco Compost (fertilizer made from sewer treatment plant sludge)
- CA-state lottery winnings not taxed to CA
- DE, MA-ride share deduction or credit
- Voluntary contributions to charities (Meals on Wheels, Chickadee Check-off)
- The most common—contributions to state 529 plans!

Research is required. Failure to research possible deductions can cost your clients money! It can also cost you repeat clients. Here is why—a client has been going to their preparer in California for a long time. As would be expected, the preparer is very familiar with California tax laws. Now the client moves to your state where you are very familiar with the tax laws of your state, but you haven't done that many California returns. However, the client expects you to know California. If you miss deductions or credits, the clients will lose confidence in you and might not return. This is why it is important when doing the more complicated states that you do not attempt to complete it during the initial client visit but work on it after the client has left.

Credits

This is another area where you will need to review the list of credits for the state you are working on. Some states have a very long list of tax credits on a wide variety of topics. Generally, federal credits do not carry over to the state return. The state might have a similar credit but on their own forms and their method of calculating it.

Chapter 5 – Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

5. Why does a state return have an "additions and subtractions" section?

   a. It makes a convenient place to add or subtract dependents.
   b. The taxpayer reconciles the state return to the federal return in this section.
   c. It is a checklist of items that must be added to income or subtracted from income.
   d. It is where the taxpayer reports those items taxed by the state but not by the federal and those items that are taxed by the federal but not by the state.

6. A taxpayer lived and worked in another state. He retired and completed the paperwork to receive a check for a lump-sum distribution. Before it arrived, he had moved and become a resident of your state. Is that income taxable in your state?

   a. No – it was earned in the other state and the paperwork was completed to receive the income, but it had not arrived before he moved.
   b. Yes – under the rules of constructive receipt, it is taxable where the taxpayer is when it is received.
   c. No – it is taxable in the state where it was accrued.
   d. No – the company withheld the other state income tax withholding and so therefore it has to be taxed in that state.

Review Question Answers and Rationales

Review question answer choices are accompanied by unique, logical reasoning (rationales) as to why an answer is correct or incorrect. Evaluative feedback to incorrect responses and reinforcement feedback to correct responses are both provided.

Chapter 1

1. How does a state learn so much financial information about you?

   a. They read the financial section of the local newspaper. Incorrect. Not really true in the case of individuals, but sharp eyed auditors do watch the financial pages for business transactions that might be applicable to the state return.
   b. A questionnaire is sent to you as soon as you move in asking about your financial health. Incorrect. The most likely time you would get a questionnaire is when the state is questioning your residency status. This is discussed in Chapter 3.
   c. An auditor uses the Internet to find out everything they can about you. Incorrect. An auditor will use the Internet when they are doing an audit and will have checked up on your mortgages, your taxes, and even have a picture of your house especially if you are claiming an office in-home.
   d. Generally speaking, the state revenue department doesn't know anything about you unless you failed to file a return when there are indications that you should have. Correct. If the IRS has a record of your filing a return at an address and the state doesn't have a state return, then the Department of Revenue will start looking into all kinds of things to find out why you haven't filed a return.

Chapter 2

2. Which filing status is sometimes **NOT** available on a state return?

   a. Single. Incorrect. The single status is always used on a state return.
   b. Head of household. Incorrect. On a few states, this status has a slightly different name.
   c. Qualifying widow(er). Correct. Some states do not allow this status.
   d. Married filing separately. Incorrect. This status is always on a state return.

Chapter 3

3. What is the difference between being domiciled in a state and being a resident of a state?

   a. Being domiciled in a state means you always come back to that state on the completion of any travel while being a resident of a state means you are in the state for so many days. Correct. Generally, 183 days coupled with a permanent place of abode will make you a resident of the state even though your domicile is in another state.

   b. Domicile and residency always mean the same thing. Incorrect. In a number of states, this would be a true statement as the state assumes that if you're there for any length of time, you are a full year resident. In this answer, the word "always" makes it a wrong answer.

   c. You must own a home to be domiciled in a state, but you don't have to be a resident. Incorrect. You do not have to own a home to be domiciled as renting a home or living with another family member qualifies you to be domiciled.

   d. Your family must live in the state you are domiciled in, but they don't have to in a state you are a resident. Incorrect. The word must make this answer incorrect. Usually, this is an issue if you are married and your spouse is domiciled in one state and you are trying to be domiciled in another state. It is much harder to prove to separate domiciles in this situation.

Chapter 4

4. In which of the following situations would a military spouse be exempt from withholding for wages earned working for an employer in state A where the service member spouse is stationed? (Assume Dick is the service member and Jane is the military spouse.)

   a. Dick and Jane are both from their home state of B and she follows him to state A in compliance with military orders. Correct. This is one of the requirements for a military spouse exclusion from withholding.

   b. Dick is stationed at a military base in their home state of B and Jane is working across the border in state A. Incorrect. Jane did not follow Dick to his military assignment since their residence is already in state B.

   c. Dick is a resident of state B and he marries Jane, who is a resident of state A. Incorrect. Here again, Jane did not follow Dick and she is already a resident of the state she is working in.

   d. Dick and Jane are registered domestic partners. Incorrect. The fact that they are RDPs does not make Jane a military spouse. This is true even if their home state requires them to file a joint return.

Chapter 5

5. Why does a state return have an "additions and subtractions" section?

   a. It makes a convenient place to add or subtract dependents. Incorrect. Generally, dependents on a state return are the same as on the federal return. However, under some state's laws, dependents might qualify on the federal return but won't on the state return. The software is overridden to remove the nonqualified dependent.
   b. You reconcile state return to the federal return in this section. Incorrect. An interesting concept but the program doesn't always know if there is income to be added or subtracted from the federal return.
   c. It is a checklist of items that must be added to income or subtracted from income. Incorrect. In some states it would be a very long checklist. The best method is to go line by line on the additions and subtractions form.
   d. It is where you report those items taxed by the state but not by the federal and those items that are taxed by the federal but not by the state. Correct. This is why there is an "additions and subtractions" section on the state return.

6. A taxpayer lived and worked in another state. He retired and completed the paperwork to receive a check for a lump-sum distribution. Before it arrived, he had moved and become a resident of your state. Is that income taxable in your state?

   a. No – it was earned in the other state and the paperwork was completed to receive the income, but it had not arrived before he moved. Incorrect. See answer B.
   b. Yes – under the rules of constructive receipt, it is taxable where the taxpayer is when it is received. Correct. This is an important concept to keep in mind when taxpayers move into your state has a part year resident. You will need to know the dates that any funds arrived.
   c. No – it is taxable in the state where it was accrued. Incorrect. Under current federal law, pensions are taxed in the state the retired taxpayer is a resident of or is domiciled in. This law change came about because prior law allowed the state the taxpayer worked in as well as the state the taxpayer resided in two taxed the same pension. Depending on various factors, the taxpayer didn't always get a credit for taxes paid on the same income to his home state.
   d. No – the company withheld the other state income tax withholding and so therefore it has to be taxed in that state. Incorrect. There is no law that says that just because there was state withholding on a payment, that it has to be taxed in that state. However, keep in mind situations like the New York law where accrued income must be reported when leaving the state. In this situation, the income would be reported in two states.

Appendix

State Revenue Departments Listing of Phone Numbers & Websites

State	Website	Phone Number
Alabama	www.revenue.alabama.gov	334-242-1170
Alaska	www.revenue.state.ak.us	907-465-2300
Arizona	www.azdor.gov	602-255-3381
Arkansas	www.accessarkansas.org/dfa	501-682-1100
California	www.ftb.ca.gov	800-852-5711
Colorado	www.taxcolorado.com	303-238-7378
Connecticut	www.ct.gov/drs	860-297-5962
Delaware	www.state.de.us/revenue	302-577-8200
District of Columbia	www.cfo.dc.gov	202-727-4829
Florida	www.dor.myflorida.com/dor	800-352-3671
Georgia	www.etax.dor.ga.gov	877-423-6711
Hawaii	www.state.hi.us/tax	808-587-4242
Idaho	www.tax.idaho.gov	800-972-7660
Illinois	www.iltax.com	800-732-8866
Indiana	www.in.gov/dor	317-232-2240
Iowa	www.state.ia.us/tax	515-281-3114
Kansas	www.ksrevenue.org	785-368-8222
Kentucky	www.revenue.ky.gov	502-564-4581
Louisiana	www.rev.state.la.us	225-219-0102
Maine	www.maine.gov/revenue	207-626-8475
Maryland	www.marylandtaxes.com	410-260-7980
Massachusetts	www.mass.gov/dor/	617-887-6367
Michigan	www.michigan.gov/taxes	800-487-7000
Minnesota	www.taxes.state.mn.us	651-296-3781
Mississippi	www.dor.ms.gov	601-923-7000
Missouri	www.dor.mo.gov	573-751-7191
Montana	www.revenue.mt.gov/default.mcpx	406-444-6900
Nebraska	www.revenue.ne.gov	402-471-2971
Nevada	www.tax.state.nv.us	775-687-4892
New Hampshire	www.nh.gov/revenue	603-271-2186
New Jersey	www.state.nj.us/treasury/taxation	609-826-4400
New Mexico	www.tax.newmexico.gov	505-827-0827
New York	www.tax.ny.gov	800-225-5829
North Carolina	www.dor.state.nc.us	919-733-4684
North Dakota	www.nd.gov/tax	701-328-1032
Ohio	www.tax.ohio.gov	800-282-1780
Oklahoma	www.oktax.state.ok.us	405-521-3160
Oregon	www.oregon.gov/dor	503-378-4988
Pennsylvania	www.revenue.state.pa.us	717-787-8201
Rhode Island	www.tax.state.ri.us	401-222-1040

State	Website	Phone Number
South Carolina	www.sctax.org	800-763-1295
South Dakota	www.dor.sd.gov	800-829-9188
Tennessee	www.tn.gov/revenue/index.shtml	615-253-0600
Texas	www.cpa.state.tx.us/taxes	800-252-1381
Utah	www.tax.utah.gov	801-297-2200
Vermont	www.state.vt.us/tax	802-828-2865
Virginia	www.tax.virginia.gov	804-367-8031
Washington	www.dor.wa.gov	800-647-7706
West Virginia	www.wva.state.wv.us/taxdiv	304-558-3333
Wisconsin	www.dor.state.wi.us	608-266-2486
Wyoming	www.revenue.wyo.gov	307-777-7961

Glossary

This is a glossary of key terms with definitions. Please review any terms with which you are not familiar.

Abode/permanent place of abode: According to the dictionary, an abode is a place in which a person resides; residence; dwelling; or home. For an Indian, it could have been a teepee; for a military person, that could be a place in the barracks; for a college student, it could be a dormitory room; and for a homeless person it could be a place under a bridge. However, states had to tighten up that definition when trying to determine where a person was a resident of. So, they added three conditions for an abode to become a residence for state law. The first is it had to have living quarters, the second is that it had to have cooking facilities, and the third is it had to have a restroom. So, when an abode met all three requirements, it became a permanent place of abode and this is what most states use as a residence that counts for domicile purposes and for determining if a taxpayer is a resident of the state even though they have a domicile in another state.

Administrative rule: State laws are generally called statutes. If they use the term "code," they generally have other words added to separate the state code from the Internal Revenue Code such as Montana Code Annotated. States are much better at defining what they want their tax law to do and they don't have massive amounts of regulations like the IRS does. When they do need to clarify a point, they usually do it through administrative rules or directives from the Atty. Gen. Montana has administrative rules for each code section, but if you went down the list, you would find many that have been repealed or are in reserve status for a potential new one. They are short and to the point and generally address an issue that wasn't thought of when the code was written.

Base form: A base form contains all the pages that are part of the form that has the heading section and other identifying information. Thus, page 1 and 2 make up the base form for Form 1040. All other forms, statements, and worksheets are attached to the base form and constitute the tax return.

Civil unions: Civil unions started on the east coast as a means of allowing same-sex couples to consider themselves legally married in the state. It gave the couple some of the same privileges enjoyed by regular married couples. They filed married filing joint on the state return which, of course, was not recognized either federally or by any other state. Since the *Windsor* decision, their purpose has changed, and registered domestic partners could take advantage of the civil union laws. See also *Registered Domestic Partners* in the glossary.

Diagnostics: A checking program in the tax preparation software which generally points out tax theory errors caused by checking a wrong box or putting a figure on a wrong line. Returns cannot be passed on to the next step in the sequence if severe diagnostics are not fixed. However, it is the "warning" type of diagnostic that are sometimes ignored by preparers as they don't prevent the return from being completed. See also *state diagnostics.*

Due diligence: Due diligence is spelled out in Circular 230 and is a requirement of all preparers when preparing returns. It means basically, that the preparer will look into any information presented by the client that is suspected of not being proper. Perhaps one of the most important areas where a preparer is subject to due diligence is in the area of dependence and claiming child tax benefits. The preparer is supposed to perform due diligence in checking to make certain the taxpayer is entitled to claim any children. This doesn't mean auditing the return, but it does mean asking enough questions so that the preparer is satisfied that the taxpayer is entitled to the dependents.

Filing requirements: Filing requirements are similar to the federal filing requirements in that they tell you how much income at the state level the taxpayer must have to be required to file a state return. However, the requirements are so varied from state to state that a preparer must review the requirements before beginning work on the state return. This is important for two reasons: the first being that the preparer might miss doing a state return when the income is so low that they think it doesn't have to be done. Even though there might not be any tax due, failing to file could result in penalties to the client. The second reason is because if fees are withheld from the refund, including a state preparation fee that isn't necessary, it causes a refund that has to be made to the client.

Home of record: The home of record is where a military service person's home was when they enlisted in the service. It stays with them their entire career in the military unless they take the necessary steps to change it to another state. This home of record is especially important when applying the military residency rules for both the service person and his or her spouse. See Chapter 4 for details.

Homestead Credit: The homestead credit is available in most states and is either an actual credit on the tax return or is a credit applied on the property tax bill. When the homeowner applies for the credit, they are certifying to the state that they are a resident of the state and that this is their primary residence. Minnesota, for example, has a homestead credit on the property taxes and a property tax credit on the return based on income and the amount of real estate taxes paid. The property tax credit is also available to renters who share in the landlord's real estate tax credit. Montana has a property tax credit that is available only to those over 65.

"Near and dear": Most states are more down to earth and call this personal property but New York uses this term to define possessions that are more personal to the homeowner than just a bunch of ordinary dishes. They use it to describe family heirlooms, works of art, and other possessions that are "near and dear" to the homeowner. This means to the state that if the taxpayer claims another state has their residence, but they leave the near and dear items in New York, then that is a sign that they haven't given up their New York residence. Other states also look at where the taxpayer's possessions are and can sometimes present a valid reason for leaving them in the state they moved out of.

Quality review: A process whereby every return prepared in an office should be reviewed by a tax professional other than the one who prepared the return. The object is to ensure that the return is accurate as far as theory goes. See also *reasonableness check* in this glossary.

Reasonableness check: As part of the quality review, the reviewer checks to see if the figures entered as either income or a deduction are reasonable given other factors of the return. For example, is a figure of $50,000 reasonable as a home mortgage deduction, given the area the house is located in? Did an extra zero get entered and the deduction is really $5, 000. All figures on a return should be reviewed in light of the taxpayer's occupation, age, home, family size, etc.

Registered Domestic Partners: The term domestic partners first came into use in the 1980s to signify a couple (usually a man and a woman at that time) who had a committed relationship. Companies and some local governments started providing benefits for the partner of an employee. The employee generally had to pay for their partner's benefits, but it was at the group rate thus saving them money. As the domestic partner movement began to grow, some states adopted benefit programs but required the couples to register their committed relationship. A few states now require Registered Domestic Partners to file a joint return. Since this is a constantly changing landscape, check Wikipedia under Registered Domestic Partners to see the latest on each state. Also, see *Civil Unions* above.

State diagnostics: State diagnostics are similar to the federal diagnostics except that they check state returns. Close attention must be paid to the "warning" diagnostics because frequently the program does not know enough about the tax situation to tell the preparer whether the theory is right or wrong and so they give a warning which requires the preparer to review it. The preparer begins to get careless and ignore warning diagnostics when a warning is not applicable in a majority of the returns.

Telecommuting: Another concept that grew from today's modern communications methods. Some companies allowed employees to work from home when home was in the same town as the company's office. Sometimes there wasn't enough room in the office as the company grew and new employees were added so this was a cheap way to expand the office. But then the employees begin to get bold and want to work from home when their home was a cabin on a lake in another state. They could communicate by Skype, emails, Facebook, and, of course, the old-fashioned methods of mail and faxes. As noted in the text, it is now creating unforeseen problems and whether employers will begin to curtail this privilege remains to be seen.

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Qualified Assessment

A Guide for Determining State Residency and Preparing State Returns
Course # 8162593, Version 1811
Publication/Revision Date:
November 2018

Course Expiration Date

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1. Which of the following states has a late filing penalty of 5% for the first month and 25% after 3 months?

   a. Montana.
   b. New Jersey.
   c. New York.
   d. Oregon.

2. Which of the following resources is recommended as the first "go to" if a preparer needs help completing a state tax return?

   a. Tax program's help feature.
   b. Online discussion forums.
   c. Wikipedia.
   d. The preparer who prepared last year's return.

3. Which of the following states has a filing requirement of only $1,000 in income from that state?

   a. Iowa.
   b. Minnesota.
   c. Montana.
   d. Wisconsin.

4. Which of the following statements is accurate regarding the treatment of dependents by states?

   a. All states follow the federal definition of dependent.
   b. Some states provide a tax credit for handicapped children.
   c. Some states start with federal taxable income so the dependents from the federal return are already taken on the state return.
   d. All states allow an exemption amount for dependents when calculating taxable income, but the amount of the allowance will vary.

5. In order to determine the proper residency state and appropriate filing requirements for a married couple who work in different states, one must:

   a. Use the state where the taxpayers own a home as the resident state.
   b. Use the highest income state as the resident state.
   c. Apply the "counting days" rule for each state.
   d. Look at all of the facts and apply those facts to the specific rules of the two states in question.

6. Which of the following states has one of the most comprehensive questionnaires for determining domicile within the state?

   a. California.
   b. Minnesota.
   c. Oregon.
   d. Wisconsin.

7. Bob and Sue live in a community property state. Bob works outside the state 100% of the time, is domiciled in that state, and made $60,000. Sue lives and works within the state and made $50,000. Their joint savings account had $200 in interest during the year and Bob's separate savings account, located outside the state had $50 in interest. How much income will they report on the community property state return?

   a. $50,200.
   b. $60,050.
   c. $80,100.
   d. $110,250.

8. Of the states which follow reasoning that the telecommuting employee should be taxed 100% in the employer's home state, which is the most aggressive in pursuing this?

   a. Delaware.
   b. Nebraska.
   c. New York.
   d. Pennsylvania.

9. Which of the following items of income would be excludable for a nonresident?

   a. Schedule C income for a speaker who presented within the state.
   b. Passive partnership income for a partnership within the state.
   c. Gain on sale of property when the property is subject to a §1031 exchange for out-of-state property and the exchanged property is sold.
   d. Investment income when the financial institution is in the nonresident state.

10. Which of the following statements is accurate regarding deductions and credits?

    a. Federal tax credits do not transfer to the state although the state may have a similar credit.
    b. Most states allow the same adjustments for AGI as the federal return.
    c. Most states have a similar Schedule A for itemized deductions.
    d. Most states begin with federal taxable income, so adjustments are already factored in.

Answer Sheet

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