

THE GENETELLI CONSULTING GROUP  
*State and Local Tax Services*  
431 FIFTH AVENUE  
NEW YORK, NY 10016

(212) 684-4111  
FACSIMILE: (212) 213-1020  
EMAIL: [rgetelli@genetelli.com](mailto:rgetelli@genetelli.com)

**Subject: Focus on Individuals for Audit Activity Continues**

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To Our Clients and Friends:

We have observed the continued targeting of individuals for audit activity over the past year. The focus on individuals is likely motivated by the states' need to raise additional revenue, and can be expected to continue in the months ahead. New York typifies the focus by states on audit activity against individuals. For example:

- . New York is placing a greater emphasis on residency audits, the result of which can be the taxation of an individual's income from all sources rather than only from New York sources.
  - .. Resident status in New York depends on where an individual is domiciled and where an individual maintains a permanent place of abode during the taxable year. The residency rules are complex, and common errors with respect to issues such as use of an abode and the level of physical presence in New York can lead to unintended residency status and a large tax assessment that could otherwise have been avoided.
- . New York is also focusing on the allocation of wages for a nonresident working for a New York employer.
  - .. The crux of this issue is the "convenience of the employer test" (whereby work done outside New York by a nonresident is treated as work done within New York unless the employer's necessity requires it to be done outside New York).
- . New York has also been busy targeting individuals seeking to avoid sales/use tax on big ticket purchases such as artwork, jewelry, antiques and watercraft.
  - .. In fact, the personal income tax return now contains a line requiring a declaration of use tax liability. We believe that if the use tax liability declared is significant, it may trigger a use tax audit for prior years. Of course, if a prior use tax exposure does exist, there are ways to mitigate such an exposure.
- . New York has implemented a withholding/nonfiling initiative aimed at nonresidents who enter New York on a limited basis to perform services.
  - .. Similar to use tax, if a nonfiling exposure exists, there are ways to mitigate such an exposure.

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Given the aggressive posture of the states, planning and upfront implementation of strategies are more critical than ever in successfully defending audit inquiries at the individual level. Planning and implementation include the development and maintenance of supporting documentation on an ongoing basis. Planning and documentation are crucial for a myriad of issues, including change of domicile, taxation of bonus or deferred compensation payments, taxation of income stemming from the exercise of employee stock options, establishing an individual's whereabouts throughout the year, taxation of compensation of transferred employees on temporary work assignments, use of an abode, and allocation of income.

Once an audit inquiry occurs, the factual record will already be set by the conduct of the taxpayer during the audit years. Thus, the best opportunity to impact the results of a future audit inquiry is to modify behavior in the present. For example, in many instances, a nondomiciliary with a permanent place of abode in a state is taxed as a resident if more than 183 days are spent in that state during the tax year. However, if an audit is commenced in 2005 for the 2001 tax year, it is too late in 2005 for an individual to change the amount of days spent in the state in 2001. Thus, if an individual spent more than 183 days in the state in 2001 due to one visit late in the year that could have been avoided, all income becomes subject to tax.

Of course, even if an audit is commenced, the outcome can be greatly impacted by properly evaluating the information to be provided, and presenting same in a credible manner. Even with a difficult fact pattern, it has been our experience that the presentation of information in an appropriate light can be the difference between a large assessment and no assessment at all.

If you have any questions regarding how to properly position and document an individual's activities to ward off potential audit challenges, as well as audit strategies to mitigate a potential assessment, please do not hesitate to contact me.

Richard W. Genetelli  
The Genetelli Consulting Group  
State and Local Tax Consultants  
431 Fifth Avenue, 3<sup>rd</sup> Floor  
New York, NY 10016  
Tel: (212) 684-4111  
Fax: (212) 213-1020  
Website: [www.genetelli.com](http://www.genetelli.com)