Preece v. Commissioner, 95 T. C. 602 (1990)

The residency of U. S. citizens in U. S. territories for tax purposes under Section 935 is determined by the facts and circumstances test, not the substantial presence test.

Summary

In Preece v. Commissioner, the U. S. Tax Court addressed whether U. S. citizens, Debra and David Preece, who moved to the Northern Mariana Islands (CNMI) to take advantage of tax benefits, were residents of CNMI under Section 935 of the Internal Revenue Code for the tax year 1985. The core issue was whether the substantial presence test or the facts and circumstances test should determine their residency status. The court ruled that the facts and circumstances test applies to U. S. citizens' residency in U. S. territories for tax purposes, rejecting the use of the substantial presence test. This decision impacts how U. S. citizens' tax obligations are assessed when residing in U. S. territories, emphasizing a detailed analysis over a mechanical test.

Facts

In January 1985, Debra and David Preece were informed at a family meeting about potential tax savings if they established residency in the Commonwealth of the Northern Mariana Islands (CNMI) before selling their stock in Diet Center, Inc. In March 1985, they moved to Saipan, CNMI, where they rented an apartment, enrolled their children in school, purchased a car, opened bank accounts, registered to vote, obtained driver's licenses, and joined a local church. On April 1, 1985, they sold their stock in CNMI, realizing $5,258,840 in proceeds. They filed a 1985 tax return with CNMI in April 1986 and returned to the U. S. in July 1986. The IRS issued a deficiency notice in April 1989, claiming the Preeces should have filed a U. S. federal return for 1985.

Procedural History

The Preeces filed a petition in the U. S. Tax Court challenging the IRS's deficiency notice in July 1989. They moved for summary judgment in June 1990, asserting they were CNMI residents under the substantial presence test. The IRS objected, arguing that the facts and circumstances test should apply. The court heard arguments in July 1990 and issued its opinion in December 1990, denying the motion for summary judgment regarding residency under the facts and circumstances test but ruling that the substantial presence test did not apply to U. S. citizens in CNMI.

Issue(s)

1. Whether the substantial presence test of Section 7701(b)(3)(A) applies to determine the residency of U. S. citizens in CNMI for purposes of Section 935?
2. Whether the Preeces' residency in CNMI for the tax year 1985 should be determined under the facts and circumstances test?

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Holding

1. No, because the legislative history of Section 935 and Section 7701(b) indicates that Congress intended to retain the facts and circumstances test for determining U. S. citizens' residency in U. S. territories.
2. The issue of whether the Preeces were residents of CNMI under the facts and circumstances test was not appropriate for summary adjudication due to the need to assess their intent regarding the length and nature of their stay in CNMI.

Court's Reasoning

The court applied the principle that the legislative intent behind Section 935 was to use the existing facts and circumstances test for determining residency, as evidenced by the House Report and Section 1. 935-1(a)(3) of the Income Tax Regulations. The court noted that the substantial presence test under Section 7701(b)(3)(A) was designed for aliens and not intended to replace the facts and circumstances test for U. S. citizens in territories. The court also highlighted the anti-abuse policy in Section 7701(b)(10) and the retention of the facts and circumstances test for foreign residency under Section 911(d)(1)(A), indicating a stricter scrutiny for U. S. citizens' residency claims. The court rejected the Preeces' argument that applying different tests for aliens and citizens was inequitable, citing the different tax policy interests involved. Finally, the court determined that the Preeces' intent, crucial under the facts and circumstances test, could not be resolved without a trial.

Practical Implications

This decision clarifies that U. S. citizens cannot rely on the mechanical substantial presence test to establish residency in U. S. territories for tax purposes; instead, a detailed facts and circumstances analysis is required. This impacts tax planning for U. S. citizens considering moving to territories like CNMI, requiring them to establish a genuine intent to reside there rather than seeking tax benefits alone. The ruling also reinforces the IRS's ability to challenge residency claims based on intent, potentially affecting how similar cases are litigated. Subsequent cases involving U. S. citizens' tax residency in territories continue to apply this ruling, emphasizing the need for a thorough examination of the taxpayer's intentions and actions.

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