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Successfully Moving to a Zero or Low Tax State

SEPTEMBER 30, 2019 ~ JACLYN LEE

By Mark Klein & Dan Kelly

If you have ever moved, you know it's not easy! The same can be said about changing your domicile. Tax Departments are aggressive and thorough in their pursuit of taxpayers who claim to move, and taxpayers who are not focused on the most important actions, primary factors, and who do not keep excellent records can find themselves in a difficult position on audit – before even getting to the various other state residency tests and traps.

What do Florida, Texas, and Washington have in common? Each borders salt water, has a thriving economy, and *they are tax havens*. You read that last part right – tax havens. Compared to California, New York (essentially the entire North East), and a host of other states, Florida, Texas, and Washington[1] offer an excellent opportunity to preserve wealth, save tax in retirement, and lessen the sting of huge federal income tax obligations.

Effective state and local tax ("SALT") planning has been a useful tool for savvy advisors and taxpayers for decades. SALT planning became more important after the 2017 federal Tax Cuts and Jobs Act, which limited the federal itemized deduction for state and local income to $10,000 per year for taxpayers who itemize. And despite the efforts of enterprising high-tax States to find loopholes in the new $10,000 limitation (efforts which mirror planning work done by taxpayers to try and limit the sting of those same States' onerous laws …), the Internal Revenue Service has been in relentless pursuit of these

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workarounds,[2] closing nearly all of them.

Low or no-tax states provide an excellent opportunity for individual tax savings, but actually reducing SALT burdens requires careful planning, understanding the different – and often inconsistent – rules across different states, and understanding what a taxpayer faces after relocating as a nonresident. We address each of these topics in this article.

I. Effective and Careful Planning – Preparing Taxpayers to Apply State Residency Rules

If a taxpayer resides in a high-tax state, take New York and California as our best examples, and wants to limit the prospect of state income tax on worldwide income, a taxpayer must first effectively change his or her domicile (with limited exceptions, more on this below). As a general rule, a taxpayer can have only one domicile at a given time. A taxpayer's domicile is thought of as his permanent, primary home. If a taxpayer is domiciled in a state with an income tax, that state is usually allowed to impose its tax on just one thing: everything the taxpayer earns.

So, barring an exception to resident taxation based on domicile or a state that imposes a different kind of test (more on these below), a taxpayer's domicile is the first and most important issue to contend with. Changing domiciles is simple in theory, but often difficult in practice.

A. Changing Domiciles – the New York Example

People move and change domiciles for all kinds of reasons. New York's highest court summed up the reasons folks move over 100 years ago, and it still holds:

Motives are immaterial, except as they indicate intention. A change of domicile may be made through caprice, whim or fancy, for business, health or pleasure, to secure a change of climate, or a change of laws, or for any reason whatever, provided there is an absolute and fixed intention to abandon one and acquire another and the acts of the person affected confirm the intention.[3]

As the quote above notes, changing domiciles is all about ***intention***. A taxpayer must intend to abandon his old domicile, and take up a new domicile somewhere else, and then reinforce that intention with acts and actions. In theory, this is easy. In practice, changing domiciles is difficult.

The New York rules for changing domiciles are a good baseline. Most states across the United States share

very similar conceptions of "domicile" as New York, and apply similar factor-based tests to determine whether a taxpayer has successfully changed their domicile.

The law places a burden on a taxpayer to prove, by clear and convincing evidence, that at some point the taxpayer abandoned the historic New York domicile and established a new domicile elsewhere (the burden of proof is on the party asserting the change – the New York Tax Department shoulders the burden when it asserts that a taxpayer moved into New York, by comparison). Changing domiciles out of New York requires two distinct steps: The taxpayer must abandon the old domicile (leave), and take up a new domicile elsewhere (land). A taxpayer who succeeds in leaving New York, but who does not sufficiently set down new roots – and establish a new domicile elsewhere – will continue to be taxed as a New York resident.

When a taxpayer claims to move from New York to Florida, for example, and she goes from filing as a resident to nonresident – or to not filing at all – the New York Department of Taxation and Finance regularly starts an audit. The Tax Department's first request for information is really just the beginning of what can feel like the most invasive and difficult review the taxpayer has ever faced. The Taxpayer demonstrates that she intended to change her domicile from New York to Florida.

As a practical matter, many people change their domicile in connection with a significant life event or shift in pattern of living. Did the taxpayer retire or sell a business, take a new job, or place his children in a new school? Did the taxpayer have a health scare, or have a doctor suggest that a change of pace was appropriate? Did the taxpayer follow a path of prior generations, migrating when the time felt right? Taxpayers stand the best chance of proving a change of domicile, and defending a residency audit, when they build the change around a significant shift in pattern of living.

Auditors typically compare a taxpayer's connections under a set of five "primary" factors – a comparison of a taxpayer's ***home***, ***active business***, ***time***, ***possessions***, and ***family ties*** in the old and newly established domiciles before and after the move. The tax department examines and compares these five "primary" to try and determine a taxpayer's subjective intent regarding his or her domicile. When reviewing the primary factors, auditors will look at the extent to which the taxpayer retained ties in the old state after the claimed move, and whether the taxpayer's actions indicate an intent to abandon her historic domicile and acquire a new domicile in the new state. We often refer to this as the "leave and land" test. Other "secondary" factors are also reviewed – such as the state of the taxpayer's driver's license, location of bank accounts, where the taxpayer's primary physician is located, etc. – but these are actually less important to most auditors. The focus instead is on the strength of the taxpayer's case under the "primary" factors – and the primary factors are where cases tend to be won and lost.

While the rules for changing domiciles are vague, as a best practice the taxpayers should be prepared to demonstrate material steps to sever his historic domicile, and to take up a new domicile elsewhere, following a comprehensive playbook tailored to each taxpayer's specific facts. An invasive audit process is coming, and even though taxpayers can win challenges to domicile changes when the facts are not crystal clear,[4] taxpayers are better served to understand the challenge ahead of them when changing domiciles, plan accordingly, and complete the move (and begin saving tax).

Dozens of unique taxpayer-specific facts and circumstances impact a domicile change analysis, and alter the steps necessary to prove the change. From case-to-case, there are a handful of principles that provide value, even if they aren't determinative. Keep the following points in mind when planning with your client:

1. ***Stating the date***. Select an accurate date to claim the change of domicile on a tax return, when changing addresses, etc. Taxpayers rarely (although it is certainly possible) move on January 1, New Year's Day. Instead of defaulting to a January 1 move date, work to determine the exact date the change of domicile occurred, and prepare a corresponding part-year tax return to reflect the change.
2. ***Proving the change***. The taxpayer must provide documentary proof of his move on audit. The taxpayer needs to generate, and then save, records that substantiate the change, from moving bills, to copies of letters of resignation, to credit card and flight records to prove his or her location. The more proof a taxpayer has, the better off she is.
3. ***Valuing testimony***. Documentary proof, along with a clear shift in lifestyle/pattern of living, can take a taxpayer across the finish line in many domicile audits. Sometimes, a taxpayer's credible testimony can make all the difference, especially in close cases. Keep this in mind if needed, as no one knows better than the taxpayer about what he or she intended, and the specific actions that reinforced that intent.

II. Clear of Domicile, but not of State Tax Residency

It's natural for a taxpayer to let out a sigh of relief after surviving, and winning, a domicile audit. That relief may be short-lived. After a taxpayer succeeds in changing domiciles to a low-tax state, the taxpayer's work is not over. Instead, the taxpayer and his representative have to keep their heads on swivel, paying attention to non-domicile-based state residency tests and traps to ensure she can benefit from the move.

A. In-State Presence is Non-Temporary or Non-Transitory – The California Example

A few states deploy a state tax residency test based not on domicile (although they will fully tax their

domiciled residents), but instead on whether the taxpayer's presence in-state was for a "temporary or transitory" purpose. Taxpayers who are in the state temporarily won't be taxed as residents, and those whose presence appears non-temporary get treated as full-blown residents.[5]

If you feel this "temporary or transitory" standard seems like a slippery slope, you are not alone. For California income tax purposes, an individual is taxed as a resident if he or she is: (1) in California for other than temporary or transitory purposes, or (2) domiciled in California, but outside the state for temporary or transitory purposes.[6]

Domicile is an important tax residency concept under California law, but domicile is not the only basis for taxing an individual as a California resident. As noted in California decisions on this issue, "the key question under either facet of the 'resident' definition is whether the individual is present in California, or absent from California, for a temporary or transitory purpose."[7] In cases where a taxpayer has significant contacts with more than one state, the "state with which the individual maintains the closest connections during the taxable year is the state of residence."[8]

California defines "temporary or transitory" in the following way:

Whether or not the purpose for which an individual is in this State will be considered temporary or transitory in character will depend to a large extent upon the facts and circumstances of each particular case. It can be stated generally, however, that if an individual is simply passing through this State on his way to another State or country, or is here for a brief rest or vacation, or to complete a particular transaction, or perform a particular contract, or fulfill a particular engagement, which will require his presence in this State for but a short period, she is in this State for temporary or transitory purposes, and will not be a resident by virtue of his presence here.

If, however, an individual is in this State to improve his health and his illness is of such a character as to require a relatively long or indefinite period to recuperate, or he is here for business purposes which will require a long or indefinite period to accomplish, or is employed in a position that may last permanently or indefinitely, or has retired from business and moved to California with no definite intention of leaving shortly thereafter, he is in the State for other than temporary or transitory purposes, and, accordingly, is a resident taxable upon his entire net income even though he may retain his domicil[e] in some other State or country.[9]

What's a test like this actually mean? To us, it's that many taxpayers will find themselves domiciled outside California, but spending a fair deal of time in California, and without fitting cleanly within this

definition. California law offers rebuttable presumptions of residency (for those who spend lots of time in California) and nonresident (for those who are essentially vacationers), but those presumptions won't help in the more difficult cases.[10] If the definition of "temporary or transitory" and the residency presumptions are inconclusive, California's rules require the application of a "closer connections test" to resolve the California residency question.[11]

California's "closest connections" test is similar to New York's factor-based domicile analysis, only it's applied on a year-to-year basis, where a taxpayer's domicile remains in a certain location unless and until he takes steps to change it. California's test is premised on the underlying theory that a taxpayer is a tax resident at the place where he or she has the closest connections. Several objective factors are considered when applying the California "closest connections test," and "the weight given to any particular factor depends upon the totality of the circumstances."[12]

The common "closest connections" factors and criteria used in California residency analyses can be split into three groups: (1) Registrations and Filings, (2) Personal and Professional Associations, and (3) Physical Presence and Property. A number of California cases outline the various facts and connections the State's Franchise Tax Board considers. Despite the checklists and factors, each case and taxpayer are unique, and whether or not a taxpayer is temporarily in, or just transiting through California will be decided based on the various factors present – no list of connections or factors is exclusive.

B. Days-and-Abode Based Residency – Statutory Residency Tests

States with "temporary or transitory" residency tests pose unique risks, since a taxpayer can establish her domicile clearly outside the state, but still be hit with full resident taxation based on his presence and connections in the state. Several other states deploy non-domicile residency tests, but they are bright-line tests, not dependent (at least not on the surface) on a taxpayer's intentions, closer connections, etc.

We often refer to these non-domicile bright-line tax residency tests as "Statutory Residency" rules. They take a common form across states, and taxpayers should not confuse these rules with those for changing domiciles. Once a taxpayer is firmly domiciled outside a given state, then "Statutory Residency" comes into play. Let's look at a few examples.

Connecticut: If a taxpayer is not domiciled in Connecticut, but (1) maintains a permanent place of abode in Connecticut, and (2) spends in the aggregate more than 183 days in Connecticut during the taxable year, the taxpayer will be subject to Connecticut resident income tax as a statutory resident.[13]

New York State/City (each jurisdiction has an identical test): If a taxpayer (1) maintains a permanent place of abode ("PPA") in New York for substantially all of the year, and (2) spends in excess of 183 whole and part days in New York during the year, the taxpayer will be subject to New York resident income tax as a statutory resident.[14]

Oklahoma: If a taxpayer spends in the aggregate more than seven months of the year in Oklahoma (approximately 215 days), he is presumed to be an Oklahoma resident "in the absence of proof to the contrary." Those in Oklahoma for less than seven months may be part-year residents, in the absence of proof to the contrary.[15]

Oregon: If a taxpayer is not domiciled in Oregon, but (1) maintains a permanent place of abode in Oregon, and (2) spends in the aggregate more than 200 days in Oregon during the taxable year, the taxpayer will be subject to Oregon resident income tax – unless the taxpayer can prove she was in Oregon only for a temporary or transitory purpose (both tests merging in one!).[16]

The thrust of these rules is roughly the same, with case law and taxpayer-specific tweaks required state-by-state. Some of the states that deploy a "temporary or transitory" basis residency test also have statutory-residency thresholds, although they are often rebuttable (if a taxpayer spent 10-months in California to complete an employment assignment, and promptly left after the assignment ended, the taxpayer could push to rebut the 9-month presumption of California residency, for example). If a taxpayer maintains an abode in a state, and exceeds a threshold of days spent in a certain state, he or she may end up being taxed as a resident, even though "home" is someplace else. This can create a true worst-case scenario for a taxpayer who remains domiciled in a high-tax State: Full resident tax at home, and full resident tax someplace else, without a guarantee of offsetting credits in either State!

Taxpayers should keep in mind that a "day" spent in a given state (New York, as one key example) is often satisfied by spending only part of the day in-State. So, if a taxpayer arrives in New York for a short meeting, and leaves two hours later, this amount of presence typically counts as a full "day" towards the 183-day limit. There are very few exceptions to these broad definitions of a "day" – military service, transiting through a state on the way to someplace else, and involuntary confinement are the three we see most often, but not always. Taxpayers must also keep immaculate records, generated by third-parties, substantiating their whereabouts on a day-to-day basis, as the burden is on the taxpayer to prove that she did not exceed the statutory day count limit.

III. Limiting State Tax after the Move – Nonresident Income Allocation

If a taxpayer completes a move out of a high-tax state, and saves no or little tax, will the Taxpayer feel like it was worth all the effort? Many taxpayers still want to move without major tax savings, but many others may decide to postpone the move or first determine whether there are ways to mitigate high state tax, even as a nonresident.

Nonresident income allocation rules are varied and can be complicated, and a deep dive into those rules is a topic for another article. Just keep this in mind as you work with a taxpayer to plan a change of residency: Depending on the source and character of a taxpayer's income, it may be that some or all of it will still be taxed back in the home state or in other high-tax states, and some tax savings may not be immediate. There are still several other tax benefits to consider, even if year-to-year the taxpayer still has a fairly high state tax bill. These benefits include reduced or eliminated state/local estate or gift taxes, the possibility to pay low or no tax on the sale of capital assets at a later point in time, and reduced indirect or property taxes.

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[1] In addition to Florida, Texas, and Washington, Alaska, Nevada, New Hampshire, Tennessee (on certain income) and Wyoming have no personal or individual income taxes.

[2] Richard Rubin, *Treasury Finishes Rules Ending Blue-State Tax-Cap Workarounds*, The Wall Street Journal (June 11, 2019), https://www.wsj.com/articles/treasury-finishes-rules-ending-blue-state-tax-cap-workarounds-11560284101.

[3] *See generally* New York Tax Law § 605(b)(1) and 20 NYCRR § 105.20(d); and *Matter of Newcomb's Estate*, 192 N.Y. 238 (1908).

[4] *See Matter of Patrick*, Administrative Law Judge DTA No. 826838 (June 15, 2017); *and Matter of Blatt*, Administrative Law Judge DTA No. 826504 (Feb. 2, 2017); *and Matter of Irenee D. May*, DTA No. 825173 (January 8, 2015).

[5] Several other states apply some form of "temporary or transitory" residency standard, along with other residency tests, including Hawaii (*see* Haw. Rev. Stat. § 235-1), Illinois (ILCS § 5/1501(a)(20)(A)), and North Carolina (N.C. Gen. Stat. § 105-153.3(15)) as three other examples.

[6] Cal. Rev. & Tax Code §§17014(a)(1), (2); Cal. Code Regs. tit. 18, §17014(a) ("If an individual is domiciled in [California], he remains a resident unless he is outside of this State for other than temporary

or transitory purposes.").

[7] *Appeals of Stephen D. Bragg*, Cal. St. Bd. of Equal., 2003-SBE-002 (May 28, 2003).

[8] *See Appeal of Anthony V. and Beverly Zupanovich*, Cal. St. Bd. of Equal., 76-SBE-002 (Jan. 6, 1976).

[9] *See* Cal. Code Regs. tit. 18, §17014(b).

[10] Cal. Rev. & Tax Code §17016; Cal. Code Regs. tit. 18, §§17014(b), §17016.

[11] Cal. Code Regs. tit. 18, §17014(b) ("The underlying theory of Sections 17014-17016 is that the State with which a person has the closest connection during the taxable year is the State of his residence.")

[12] *Appeals of Stephen D. Bragg*, Cal. St. Bd. of Equal., 2003-SBE-002 (May 28, 2003); *Matter of Jerome James*, Cal. St. Bd. of Equal., Docket No. 596166 (Feb. 26, 2013) (non-precedential decision).

[13] Conn. Gen. Stat. § 12-701(a)(1)(B).

[14] New York Tax Law § 605(b)(1)(B).

[15] Okla. Stat. § 2353(4).

[16] Or. Rev. Stat. § 316.027(1)(a)(B).

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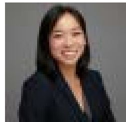

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