WRMarketplace

An AALU Washington Report

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TOPIC: Moving On: Changing State Tax Residency – Easier Said than Done?

MARKET TREND: Individuals are on the move. While the new limits on the federal income tax deduction for state and local taxes ("SALT") may serve as an incentive to change residency to lower tax states, revenue-squeezed states are unlikely to let go without a fight.

SYNOPSIS: Each state has its own rules for establishing or terminating income tax residency; some use an objective test that counts days spent in the state, while others apply a subjective test that looks at the individual's overall state connections. The issue becomes more complicated if a family retains ties with the old state, such as splitting residency between spouses or maintaining a child in a school in the former state. Further, a successful residence change often does not prevent taxation by the former state if an individual earns income from businesses, employment, or real property held in the former state.

TAKE AWAYS: States have become more sophisticated in challenging residency changes. To ensure a complete change in tax residency, relocating families must know the requirements in both the new and old state, sever as many connections as possible with the old state, and create substantial ties with the new one. Business owners may face additional hurdles in making their residency change effective for tax purposes,

including the relocation of the business and/or a change from an active to more passive business role. Attention to detail is critical, whether it involves maintaining records of the number of days spent in state or ensuring address changes, updated registrations, and transfers of services to the new state. Failure to follow through can result in double state taxation.

WHY CHANGE RESIDENCY

Moves contemplated for financial reasons often involve tax considerations:

Income Taxes. The Tax Act may have pushed income tax considerations to the forefront of many contemplated residency changes. Under the new lax laws, the federal income tax deduction for SALT is limited to just $10,000 (per individual or married couple). This limitation effectively raises the combined federal and state tax rate on income, particularly for residents of higher income tax states – for example, places with top income tax rates include California (13.3%), New York (8.82%) (with an additional 3.876% city tax for New York City residence), New Jersey (8.97%), Minnesota (9.85%) and Washington D.C. (8.95%).

> ***Simple Example:*** Assume Diane, a California resident, has interest income of $500,000 that is taxable at a 35% federal rate and a 12.3% California rate. If Diane can take an itemized deduction for her California state income taxes, the combined effective tax rate on the interest income is roughly 43%,[1] resulting in total income tax of $215,000. Without the deduction, the total income tax is $236,500, based on a combined effective tax rate of 47.3%, resulting in over $20,000 of additional tax.

While individuals may have contemplated a move to a low or no income tax state (such as Florida, Nevada, Texas, or Washington) before the Tax Act, there may be even greater incentive to do so now.[2]

Other Taxes

- **Estate Taxes.** Individuals should consider the differences in state estate tax rates and exemptions when relocating. Residents of a state with an estate tax who move to a state without such a tax may reduce their potential estate tax exposure.

- **Real Estate Taxes**. The impact of a residency change on an individual's real estate tax liability also must be considered, since the move could generate a ***significant reduction or increase*** in real estate taxes depending on the applicable state's laws and the value of the new and old residence. Note that the deduction of real estate taxes falls under the new SALT deduction limits.

Asset Protection. States differ with respect to the creditor protection provided to their residents. Some states allow residents to exempt the full value of the principal residence from bankruptcy proceedings, leaving unsecured creditors unable to access the equity to satisfy debts, while other states limit this exemption. The following illustrates the disparity among states:

State	Exemption for Principal Home
Florida	Unlimited Value
Texas	Unlimited Value
California	$75,000-$175,000
New York	$75,000-$150,000
New Jersey	None (but survivorship interest in property held as tenancy by the entirety is exempt from creditors of a single spouse)

Other exempted assets may include those held by spouses as tenants by the entirety, life insurance policies and proceeds, college savings accounts, and IRAs. If asset protection is a consideration in relocating, the family should carefully analyze the protection afforded by the desired state and the length of time an individual must be a resident to claim these protections.

TIPS FOR MAKING THE CHANGE

1. **Know the Rules for Both States.** The requirements for changing tax residency vary by state but generally fall into two categories: (1) an objective "day-count test" or (2) a subjective "closer connection test." To illustrate, take the examples of New York, which uses a day-count test, and California, which applies the closer connection test.

    - ***Day-Count Test***. The day-count test typically looks at the number of days an individual is present in the state to determine residency. In New York, an individual is an income tax resident if he or she is domiciled in New York or spends at least 183 days of the tax year in the state **and** has a permanent place of abode in the state (i.e., any habitable place that is suitable for year-round use and is permanently maintained by the individual, whether rented or owned). For this purpose, any part of a day spent in New York counts as an entire day present in the state (e.g., an individual who arrives in New York at 11:50 pm is considered present for that entire day). So even short visits with clients, business associates, or friends can count as a day, although a travel exception applies if an individual is in New York solely for the purpose of traveling through

to another state or boarding a plane, ship, train, or bus for travel to a destination outside the state.

- ***Closer-Connection Test***. Many states, like California, determine tax residency by applying a subjective test based on where the individual has the closest connections, considering a variety of factors. For example, California's "Guidelines for Determining Residency Status" specifically state that the determination of California residency status is not solely based on an individual's occupation, business, or vocation but analyzes the overall facts and circumstances, considering all an individual's activities, including time spent in the state.

2. **Sever Old Connections & Create New Ones.** Some states, like California, have become very sophisticated in challenging residency changes, especially if the move occurs just before a significant tax event. If facing such a challenge, the individual will need to provide evidence that he has sufficiently severed ties to his former state and created the necessary ties to his new state to avoid the potential for double state taxation.

   For states with day-count tests, after relocation, the individual will need to minimize the number of days present in the old state and maximize those in the new state, as applicable. Maintenance of detailed records can help substantiate the number of days spent in either state, including a daily calendar or journal, receipts for airline or train tickets, hotels, taxi or rental car service, ATMs, etc.

   Due to the subjective nature of the closer connection test, however, evidencing the severance of old connections and the creation of new ones is far more challenging in these states. Courts and state taxing agencies look at a wide-variety of factors, from employment, sources of income, and the location of family members, residences, personal items, employment/businesses, community activities, etc. Attached at the end of this report is a checklist that outlines some general steps an individual can take to help document a change of state tax residence. As the state laws vary significantly, the list provides only a starting point, and the actual requirements of both the old and new state must be confirmed.

3. **Avoid Common Pitfalls.** Despite relocation, there may be lingering ties to the old state that cannot be easily severed. In these circumstances, planning for a residency change will require additional precautions:

   - **Ongoing Businesses**. The relocation of an individual with an ongoing business in the former state can make it difficult to change his tax residency under either test, particularly if the individual travels to a physical business location in the old state. Ideally, the individual will move the entire business to the new state. Otherwise, the following should be considered:

- Relocating the "headquarters," administrative functions, and/or financial aspects of the business (including financial accounts and advisors) to the new state.
- Changing from an executive-like position (e.g., chief executive or financial officer) to a board member position.
- Establishing a business office and employing administrative personnel in the new state.
- Updating state filings to reflect the individual's new residence, as applicable (e.g., if the individual is the manager of a business organized as an LLC, update state records for the LLC to reflect the individual's new address).
- Staying in a hotel or other temporary accommodations when conducting business in the old state.
- Limiting the time spent in the old state managing the business.

- **Income from Old State**. What may come as a surprise is that moving to a new state may not remove all income from the old state's tax reach. Post-relocation income received from any ongoing business or employment in the old state may still be taxed by the old state, as well as any rental income or capital gains from the rental or sale of real property owned in the old state.[3]

  The income's connection to the state, however, must be sufficient for the state to be able to tax a nonresident on it. For example, in *Swart Enterprises, Inc. v. Franchise Tax Board,* a non-California corporation's only connection with California was its passive minority interest in a LLC doing business in California. The California Court of Appeal held that this limited connection was not sufficient to subject the non-California corporation to California's Corporation Franchise Tax. Also, in *Corrigan v. Testa*, the Ohio Supreme Court concluded that Ohio could tax a nonresident owner's distributive share of an Ohio LLC's income as income generated by business activity in Ohio. However, with regard to the sale of the equity interests in the LLC, the Court found that the gain was generated by a transfer of intangible property *(i.e.,* the nonresident's LLC interests), which did not avail the nonresident of Ohio's protections or benefits in any way, so Ohio could not tax the gain because its connection to that gain was indirect.

- **Family Residence or Other Real Property**. Owning (or even leasing) a former residence or a smaller residence in the old state can be used as evidence that the individual's tax residency hasn't truly changed, particularly if the old state requires maintenance of a permanent abode as part of its residency test.

  Example: Julie is a freelance fashion photographer who recently purchased a home in Connecticut and considers herself domiciled there. However, she still leases a small studio in New York, where

she often spends many weeks for big fashion shoots and events during the year. Based on New York residency rules (a day-count test plus a permanent place of abode), if Julie spends at least 183 days of the year in New York, even inadvertently, she may still be a New York resident for income tax purposes, despite her Connecticut home and domicile.

Maintaining a residence in an old state that applies the closer connections test also can be problematic for establishing residency in a new state. Ideally, an individual will sell or terminate the lease on any former residence in the old state. Otherwise, the following additional actions should be considered:

- Apply for a homestead exemption for the new residence and terminate any homestead exemption elected for the old residence.
- Arrange to have the property tax bills, mortgage statements, HOA assessments, insurance premiums, utility bills, etc., for the old residence sent to the new residence or use a bill paying service not in the old state.
- If property taxes for the old residence are based on use as a principal residence, notify the property tax collector of the changed status.
- Change property insurance coverage to reflect the changed status of the old residence to a vacation home or rental property.
- Move all personal items, such as family photographs, artwork, jewelry, important personal documents, and important furnishings and household items to the new residence. Keep only the bare essentials in the old residence.
- Limit the time spent in the old state and any use of the old residence.

- **Leaving the Family Behind**. Sometimes an individual leaves his or her spouse and children behind, for example, so the children can continue at their old schools. This is a particularly difficult situation in which to establishing a new tax residency, as the old state may see the move as only temporary or for convenience, especially if the move appears triggered by a one-off event (such as the sale of a business).[3] In this case, in addition to taking as many steps as possible on the new residency checklist, the family should consider:
  - Transferring the old residence to the spouse.
  - Acquiring a residence in the new state in just the individual's name.
  - If the individual is moving from a community property state, execute a post-marital agreement to provide that each spouse's earnings are deemed separate property.

- Having the spouse and children spend weekends, holidays, and vacations - as much time as possible - in the new state and limiting the individual's time in the old state.

TAKE AWAYS

States have become more sophisticated in challenging residency changes. To ensure a complete change in tax residency, relocating families must know the requirements in both the new and old state, sever as many connections as possible with the old state, and create substantial ties with the new one. Business owners may face additional hurdles in making their residency change effective for tax purposes, including the relocation of the business and/or a change from an active to more passive business role. Attention to detail is critical, whether it involves maintaining records of the number of days spent in state or ensuring address changes, updated registrations, and transfers of services to the new state. Failure to follow through can result in double state taxation.

DISCLAIMER
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NOTES

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[1] Calculated as follows: [(100%-35%) x 13.3%] + 35% = 43.6%.
[2] Note, as will be discussed in a future *WRMarketplace*, several higher tax states, like California, New York, and New Jersey, are considering state tax changes that would effectively place their individual residents in the same position with regard to federal income taxes as if the SALT deduction remained in full effect.
[3] Also note that, if the individual moves from a community property state to a non-community property state and the spouse continues to work and generate community income, the individual will still have to file income tax returns in the old state to report his or her half of that income.

Checklist: Changing State Tax Residency

Physical Presence & Property

Severing Connections in Old State

- Sell the family residence (or at least lease it to a third party).
- Close charge or other accounts with local merchants or stores.
- Close any safe deposit boxes.
- Close the old post office box and file a permanent forwarding address to the new state.

Creating Connections in New State

- Spend more days in the new state than in others, especially the old state, and maintain records to substantiate.
- Buy a new family residence and obtain property insurance.
- Move furniture/household items to new residence, especially family photographs, artwork, jewelry, and important personal documents.
- Change addresses of record for financial, business, and personal matters to the new residence (e.g., social security, tax filings, financial accounts, employer records, credit cards, magazine subscriptions, etc.).
- Establish charge accounts with merchants and department stores in the new state.
- Open safe deposit box, as needed.
- Hire health providers and veterinarians for any pets and transfer medical/pet records to the new providers.
- Execute estate planning documents under new state law (including powers of attorney) and include statements regarding residency in the new state.
- Limit political and charitable affiliations to national organizations and local organizations in the new state.

Registrations and Filings

Severing Connections in Old State

- Terminate any homestead exemption elected for the old residence.
- File declaration of non-domicile or non-residency, if provided.
- Revoke the voter registration and do not vote in the old state.

Establishing Connections in New State

- Apply for homestead exemption for the new residence.
- File declaration of domicile or residency in new state, if provided.
- File all personal tax returns from new home address and send to new state's IRS office.
- Change tax withholding on retirement and other accounts to the tax authority in the new state.
- Change address on passport (and use new address when applying for a new or replacement passport).
- Register to vote and actually vote – even if by absentee ballot.

- Apply for a new driver's license and register personal automobiles and obtain new automobile insurance.
- Register and license any pets.

Activities & Associations

Severing Connections in Old State

- If engaged in a business in the old state, consider transferring the administration and financial aspects of the business to the new state.
- Cancel or change to nonresident status any memberships in local clubs or social/professional organizations.

Establishing Connections in New State

- Make contributions to local organizations (or to local branches of national charitable organizations).
- Become a member of local clubs and social/professional organizations.
- Establish personal and business banking relationships.