An Honest Look at Saving Taxes by Relocating from California or New York

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Market Trend: Individuals and businesses in high tax jurisdictions have been expressing unprecedented interest in relocating to states with more manageable tax regimes. This is especially the case with business owners looking to sell their businesses. But whether this trend rises to the level of an "exodus"—as many characterize it—is up for debate. The impetus for moving typically runs deeper than just taxes, though taxes often are the proverbial final straw. This article analyzes tax issues individuals and businesses should consider when evaluating whether to relocate from California or New York.

Synopsis: California has the highest marginal individual income tax rate and is in the top ten for corporate income tax. New York is in the same high tax club, especially for individuals and business also subject to New York City local taxes. When the 2017 Tax Cuts and Jobs Act limited individual taxpayers from deducting more than $10,000 in state and local taxes, the tax bite worsened. Taxpayers squeezed by California and New York taxes often instinctively feel that moving their family or relocating their businesses will cause these pressures to evaporate. But will they?

As with most things related to taxes, the answer is more nuanced. Relocating businesses often experience unexpected tax results. Business taxation has little to do with where a business is incorporated/organized or where it maintains its headquarters; actual sales and operations tend to dictate where tax is paid. In many circumstances, a company can completely relocate its business operations and domicile but end up paying essentially the same amount of tax to California and New York. To avoid this unexpected result, businesses should understand and model tax savings before investing resources in planning or executing a relocation.

For individual taxes, California and New York are reluctant to relinquish residency jurisdiction over relocating taxpayers. To ensure a clean break, taxpayers must

understand residency laws and carefully plan their departure. On top of that, many taxpayers that become nonresidents are surprised to learn that California and New York may continue to tax them on certain types of in-state income.

Take-aways: Business taxpayers should consider the following questions when considering a relocation designed to minimize business income taxes:

- Will relocating business operations eliminate California or New York's jurisdiction to tax my business?
- Will apportionment rules enable California and New York to impose the same amount of income taxes despite relocating?

Individual taxpayers should consider the following questions when making a tax-motivated move:

- Am I willing to make a move that reflects a genuine change of residency?
- If I become a nonresident of California or New York, will nonresident sourcing rules cause my income to remain subject to California or New York tax?
- Do I understand the law for changing residency?
- Do I know what steps I should take and what documents I should retain to ensure that my residency position survives an invasive residency audit?
- Will a residency change prevent California or New York from taxing deferred compensation?

Business Taxation Principles for Relocating Businesses

Nexus: A state's jurisdiction to tax

The best way to avoid California or New York business tax—though not always practical—is to escape their constitutional jurisdiction to tax. The United States Constitution allows states to tax businesses only if they have sufficient connections with the state.

So, what corrections? Over the decades, the answer to that question has been foggy at best. And the US Supreme Court's recent landmark decision in *South Dakota v. Wayfair* provides more questions than answers. Connections can now be satisfied by such abstract concepts as economic or virtual presence in the state. As a practical matter, this means that businesses may be subject to tax in a state due to business connections that do not involve physical presence.

As an example, consider a corporation that moves from California and severs all physical ties to the state, but makes over $600,000 of sales into California. Under California's "factor presence nexus threshold" California would continue to have jurisdiction to tax the corporation even though it moved out of state. Similar examples would play out in New York.

The upshot is that the constitutional tax reach of states is as broad as ever. Due to this broad reach, relocating a business rarely eliminates business taxes in California or New York unless the taxpayer is also willing to forgo the California and New York markets for customers.

Apportionment: A state's ability to tax a percentage of an out-of-state business's income

States typically, may tax a portion of the income earned from out-of-state businesses that do business in the state. The principles that govern how much they may tax—often referred to as apportionment and allocation—is a labyrinth of statutory and constitutional rules that are beyond the scope of this article. But businesses contemplating relocation should understand the basic principle: states may tax that portion of a company's income that "fairly reflects" the proportion of business done in the state.

Recent trends make it even more difficult for service providers seeking to reduce taxes by relocating from California or New York. This is due to a concept called "market-based sourcing" which sources sales of services (and income from intangibles) to the customer market. For example, consider a company that provides services to customers around the country through employees working in its California facility. If the company moves those employees to Texas, but the customer base remains unchanged, then it will still be subject to roughly the same amount of California tax. And, it is quite possible, that Texas, which sources service receipts to the location where they are performed, could tax that same income—a true planning disaster.

Taxation Principles for Individuals

Residency affects individual taxation

There are two overarching rules that individuals must understand in determining whether a residency change makes sense from a tax perspective. The first is that states may tax 100% of a resident's worldwide income, regardless of where earned. The second is that a state may also tax a nonresident on income sourced to the nonresident state. To mitigate duplicative taxation, resident states typically provide a credit for some or all taxes paid to nonresident states.

What does this mean for the individual? It means that becoming nonresidents of California or New York reduces taxes only if the taxpayer's income does not have California or New York sources. For example, if a taxpayer were to own commercial real estate in California and move to Nevada, it would still be subject to California income tax on rents—that would be California-source income. Similarly, if a New Yorker were to move to Tennessee, but continue to receive income from renting equipment in New York, New York would tax that income as New York-source income.

Understanding this concept—sourcing income of nonresidents—is most important to understand when planning for major liquidity events. Far too often, sophisticated business owners change residency before selling their businesses, only to discover that the gain is sourced to California or New York. This frustrates the purpose of the residency change.

Another example of a move defeating the purpose is for a taxpayer working in New York moving to avoid New York tax on his or her salary. This is due to New York's controversial practice known as the "convenience of the employer rule." This rule means that if an employee is connected with a New York office, income paid to that employee is New York source even if the employee lives and works in another state. The exception is that if the employee works outside New York for purposes that benefit the employer, the income is not New York sourced. This issue has come to the forefront again with the rise in pandemic-related telecommuting.

California and New York residency rules

If a taxpayer finds a residency change would produce tax benefits and would be desirable, it is important to understand how California and New York define residency and how to change residency. The following explanation provides the highlights; it would take pages to tease out all of the nuances.

California defines a resident for tax purposes to be “any individual who is in California for other than a temporary or transitory purpose and, any individual domiciled in California who is absent for a temporary or transitory purpose.” California uses subjective factors to determine whether California is truly your home (see the discussion of these factors in the discussion of New York residency). Although California has some time-based presumptions, it is possible for someone outside California for an entire year to be a resident and for someone within California for an entire year to be a nonresident.

New York takes a similar approach to California, though it relies much more heavily on time-based formulas. The primary test that New York uses is the subjective domicile test:

the test of intent with respect to a purported new domicile [depends on] whether the place of habitation is the permanent home of a person, with the range of sentiment, feeling and permanent association with it.

New York auditors typically apply five primary factors (along with more minor factors) to evaluate domicile. These five factors include:

- Home – The taxpayer’s subjective treatment of the residence as a home.
- Active Business Involvement – The taxpayer’s pattern of employment or active business involvement in New York.
- Time – The amount of time spent at the new residence and within New York.
- Near and Dear – The location of items of most monetary and sentimental value.
- Family – The place where the taxpayer’s spouse and minor children live.

New York provides two time-based safe harbors against the domicile test: the 30-Day Safe Harbor and the 548-Day Safe Harbor. The 30-Day Safe Harbor applies if the taxpayer (1) does not maintain a permanent place of abode in New York for any part of the tax year, (2) maintains a permanent place of abode outside New York for the entire tax year, and (3) spends no more than 30 days in New York during the tax year. The 548-Day Safe Harbor is complex, but basically applies to taxpayers who are present in a foreign country for 450 days of a 548-day period and are not in New York for more than 90 days in that 548-day period (among other things beyond the scope of this short article).

As a back stop to the primary domicile test, New York provides a statutory residency test. Like the 548-Day Safe Harbor, this test is deceptively complex. But the basic premise is that a taxpayer is a New York resident if they (1) maintain a permanent place of abode in New York and (2) are in New York more than 183 days during the year. Where taxpayers often go wrong is assuming that if they are in New York for less than 183 days, they are not a resident. But this test is not a safe harbor to being New York domiciled under the domicile test described above.

California and New York residency audits

Of all the states, California and New York are considered to be the most sophisticated, aggressive, and invasive when it comes to auditing high net worth individuals who claim to have changed residency. Audits are virtually a given, so any taxpayer seeking to change residency—especially if that change is being timed with a liquidity event—must (1) ensure that the residency change satisfies state law and (2) document and preserve facts supporting the change.

The overarching principle applicable to both California and New York audits is that the residency change must be bona fide. Often, taxpayers buy a house in another state and change their driver's license but continue life as normal. That is rarely enough.

Each residency change is different, and each should have a well-designed plan that assumes an audit. With that caveat, common steps taxpayers take to demonstrate a genuine change of residency include the following:

- Selling the current home and acquiring a home in the new jurisdiction.
- Avoiding unnecessary time in the old state.
- Enrolling children in schools in the new state.
- Ensuring that time spent in the new state clearly indicates that it is the new home and not a vacation spot.
- Limiting business activities in the old state.
- Moving intimate and valuable possessions, including pets, to the new location.
- Changing voting records, drivers' licenses, occupational licenses, vehicle registrations, etc. to the new state.
- Establishing ties with social clubs and other civic organizations in the new state.

- Establishing relationships with new medical, financial, legal, and other professionals in the new state.

Audits may not occur for some time after the residency change. Documents and evidence supporting the residency change quickly evaporate. Therefore, taxpayers should document and collect these items into a file (including logging daily locations) to produce in the inevitable audit.

Conclusion

In certain circumstances, businesses and individuals may realize significant California or New York tax savings by relocating business operations or changing residency to other states. But often the tax savings are illusory. Therefore, before committing to a move, taxpayers should carefully evaluate whether the move would actually save taxes and whether the logistical and personal costs of moving are worth the effort.

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