Avoiding California Taxation: Considerations for Individuals Currently Domiciled in the State

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Introduction

This article considers how individuals who call California home (*i.e.,* those who are "domiciled" here) can avoid California income taxation in favor of a lower-tax state, such as Nevada.

As background, there are two ways an individual may owe California income tax:

If they have California-source income. Common examples include income from the rental or sale of California real property.

If they are a "California Tax Resident." The term "resident" in the Revenue and Taxation Code lacks intuitive meaning (see Rev & T C §17014), so this article will use the made-up term "California Tax Resident" (or "California Tax Residence"). An individual becomes a California Tax Resident in either of two ways: by being domiciled here, or by being present here.

- *Domicile*. Being domiciled in California makes a person a California Tax Resident until they acquire a new domicile or are "absent for a long-term purpose" (this is also a made-up term, used here as shorthand for "outside this state for other than a temporary or transitory purpose"; see Rev & T C §17014).
- *Mere presence*. Merely being present in the state also makes an individual a California Tax Resident, unless this person is here for a "temporary or transitory" purpose. See Rev & T C §17014(a)(1). A person can become a California Tax Resident in this way even if they are domiciled elsewhere. Thus, "residence" and "domicile" are not synonymous. Residence as a tax term (*i.e.,* the condition of a "California Tax Resident" herein) is more expansive than domicile.

If a person is a California Tax Resident, they are taxed on their worldwide income, regardless of source. For example, they could be taxed on earnings for services performed in Nevada for a Nevada employer. To report their income, they file Form 540, the income tax return for California Tax Residents.

In contrast, if they are a *not* a California Tax Resident, they are only taxed on their California-source income. They would owe this tax regardless of where they are "present" or "domiciled." For example, even if they have genuinely moved to Nevada, they would owe California tax if they sell real estate located in California. To report this California-source income, or to report income if they leave California partway through the year, they file Form 540NR, the income tax return for nonresidents or part-year residents.

This article is for clients who check one or both of these boxes (*i.e.,* they are a California Tax Resident and/or have California source income). Thus, to avoid California income taxation, they must relinquish their California Tax Residence, and they must also minimize their California-source income.

I. Residency = Domicile *or* Presence

To terminate California Tax Residence, one must negate both causes of tax residency. That is, one must *both*

1. Acquire a non-California domicile (or be absent for a long-term purpose), and
2. Not be present in California for a long-term purpose.

The term "domicile" refers to a person's one "true, fixed, permanent home," under California regulations. 18 Cal Code Regs §17014(c). The California Franchise Tax Board (FTB) elaborates within its publications guidelines (FTB Publication 1031 (Guidelines for Determining Resident Status), p 10):

> A change of domicile requires all of the following:
>
> - Abandonment of your prior domicile.
> - Physically moving to and residing in the new locality.
> - Intent to remain in the new locality permanently or indefinitely as demonstrated by your actions.

That is, physically leaving California is necessary, but not sufficient, to change one's domicile. Change of domicile has both an objective test (physical presence) and a subjective test (intent to remain, as demonstrated by actions).

The hard part is the subjective test—proving one's state of mind. The individual continues to "retain[] his California domicile as long as he has the definite intention of returning here regardless of the length of time or the reasons why he is absent from the State." 18 Cal Code Regs §17014(c). On the other hand, he "loses his California domicile the moment he abandons any intention of returning to California … with the intention of remaining there [*i.e.,* elsewhere] indefinitely." 18 Cal Code Regs §17014(c).

The FTB will not simply take a person's word for it; instead, it will scrutinize the individual's continued ties to

California. For example, in *Chapman v Superior Court* (1958) 162 CA2d 421, the court observed (162 CA2d at 426):

> Petitioner argues that residence (domicile) depends largely upon intention. This is undoubtedly true, but that intention is to be gathered from one's acts. … [T]he statement that he at all times subsequent to July 1, 1955, intended to remain permanently in Trinidad or some foreign country, did not foreclose the trial court from considering his acts and declarations indicating a contrary intention.

FTB Publication 1031 includes a list of "factors to consider" in making this determination. Below is this author's attempt to assimilate this list with similar lists found in secondary sources. See, *e.g.,* Gerson, *A Primer on California Residency for California State Income Tax Purposes,* 18 Cal Trusts & Estates Q, Issue 1 (Spring 2012). To reduce the risk of being classified as a California Tax Resident, the taxpayer should take these steps:

1. Sell their former California principal residence as soon as practical.
2. If they retain the former principal residence, rent it out, and not claim the California Homeowner's Property Tax Exemption of $7,000 on the county property tax bill.
3. Reduce the amount of time spent in California—by the taxpayer, their spouse or registered domestic partner, and their children. Retain records to reflect this, *e.g.,* bank records, credit card records, phone records, road toll charges, plane tickets, phone GPS records, and utility bills showing usage.
4. If the taxpayer does visit California and does retain California real property, do not stay there—stay in a hotel or with friends or family instead.
5. Retain records showing date of initial occupancy of the out-of-state residence, and the purchase and shipment of household goods and furnishings.
6. Transport all vehicles, RVs, ATVs, motorcycles, boats, and aircraft out of California. Register vehicle(s) outside of California.
7. Obtain a non-California driver's license; relinquish the California driver's license.
8. Maintain professional licenses outside California.
9. Register to vote at the new home, and vote there; relinquish California voter registration.
10. Maintain bank accounts outside California.
11. Use non-California professionals—*e.g.,* health care, veterinarian, accountant, and attorney. If the taxpayer does retain a California professional, correspond from out of state via U.S. mail or telephone rather than visiting the office in person.
12. Update estate planning documents to reflect the new residency. (For example, the existing Last Will and Testament may currently state, "I am a resident of Los Angeles County.")
13. Sever California social ties, and strengthen non-California social ties, such as place of worship, professional associations, and/or social and country clubs. Identify persons who can provide affidavits in case of audit.
14. Minimize California investments, including real property.
15. Avoid work assignments in California; if California work must be performed, opt for nonpermanent assignments.
16. Maintain a diary of personal and business activities conducted in the new state of residency.
17. If the taxpayer cannot accomplish an item on this list, retain records of the unsuccessful attempt to do so.

Following all of this advice is onerous, and the process has been likened to "going into the witness protection program, except you get to keep your name" (as heard by this author).

And yet it is hard to know whether all the effort is worth it. The cards are stacked in the government's favor, and the rules are vague. Even people who genuinely intend to leave permanently can get caught in the tax web if the FTB forms a negative impression of their incidental social, business, or family ties to California.

California regulation *presumes residence* by stating: "The type and amount of proof that will be required in all cases to rebut or overcome a presumption of residence … cannot be specified by a general regulation, but will depend largely on the circumstances of each particular case." 18 Cal Code Regs §17014(d)(1). It is unclear how many factors in the above list are "enough"; the notion of severing all ties to California is not really attainable in real life, and nothing in principle stops the FTB from finding a person is a California Tax Resident based on a single factor.

In one article surveying published opinions of California's Office of Tax Appeals (OTA) over the last 3 years, the author commented that "it is an understatement to say that taxpayers have not fared well so far on the residency/domicile issue at the OTA," and that these cases "are of little assistance in charting a course for a successful move out of California," in part because of "the OTA's heavy focus on the burden of proof issue. The devil is truly in the details." Coffil, *The California Office of Tax Appeals Looks at Residency,* available at https://news.bloombergtax.com/daily-tax-report-state/the-CA-office-of-tax-appeals-looks-at-residency.

As a result, advice on this topic can only be tentative. Taking these steps *will aid in* proving a change in tax residency, but it is anybody's guess as to whether the FTB will respect the change.

If a person cannot show they have changed their domicile, their final hope is to show they were absent from California

for a long-term purpose. In theory, this is a different test: It is possible to successfully prove a change of domicile, yet be present in California for a long-term purpose. For example, in *Whittell v Franchise Tax Bd.* (1964) 231 CA2d 278, the court noted that, although the family moved from California to Nevada, "a domicile in Nevada is not irreconcilable with the existence of tax liability in this state [under Rev & T C §17014 et seq.]." 231 CA2d at 288. The family's activities in California made it "abundantly clear that their presence here was neither temporary nor transitory," the court held. 231 CA2d at 288. However, if an individual cannot prove a change of domicile, then they will probably have a hard time proving absence for a long-term purpose. This is because both tests (domicile and presence) take into account similar factors. This is illustrated in the list of factors from FTB Publication 1031 at p 5, some of which are paraphrased above. Notably, the FTB describes these as factors used "to help determine your residency status"; it does not articulate *which* residency test these relate to (*i.e.,* domicile or long-term presence).

In the midst of this confusion, some practitioners assert that there is one true "safe harbor" that a taxpayer can use to sever their ties to California with certainty. Under Rev & T C §17014(d), a person will be deemed to be absent for a long-term purpose, and thus not a California Tax Resident, if they are absent

1. For an uninterrupted period of at least 546 consecutive days (disregarding up to 45 days in California per year);
2. Under an employment-related contract;
3. If they do not have income from intangible property (including stocks and bonds) in excess of $200k in any year in which the employment-related contract is in effect; *and*
4. If the principal purpose of absence from California is not to avoid California tax.

See Rev & T C §17014(d); see also FTB Publication 1031, p 4.

However, this purported safe harbor may be illusory, since the FTB can always make the amorphous claim that the taxpayer's absence had the principal purpose of avoiding California tax.

II. California-Source Income

The second basis for California taxation is California sourcing. Even if an individual is not a California Tax Resident, they must report their California-source income on the nonresident tax return, Form 540NR. California-source income includes (18 Cal Code Regs §17951–2)

- Income from real property, or personal tangible property, located in California.
- Income from a business, trade, or profession carried on in California.
- Income from personal services performed in California.

The rule for real property is the simplest: The sale of California real property will trigger California taxes. One might sense an opportunity here: That if the taxpayer does a "1031 exchange" (*i.e.,* swapping one investment property for another) into Nevada or Texas, then when the non-California replacement property is later sold, the gain will not be subject to California tax. However, this sense is incorrect; the FTB requires annual disclosures about the status of the non-California replacement property and imposes California tax when it is eventually sold. See Weller & Marques, *State Income Tax Conformity With Section 1031,* 34 Real Est Tax'n 4 (2006); Hellerstein, State Taxation, 7.09[2] *Nonrecognition Transactions Involving More Than One State,* 1999 WL 1398903.

Intangible property is also straightforward. Generally, income from intangibles is sourced to the *location of the owner*. This category includes stock (in C- or S-corporations), LLC membership interests, and partnership interests. See, *e.g., Appeals of Amyas & Evelyn P. Ames* (87-SBE-042) (sale of limited partnership interests). As a result, business owners are good candidates for emigration: If the taxpayer sells stock or other ownership interests after successfully terminating California residency (*e.g.,* by moving to Nevada), the income will not be California-sourced. Still, there are exceptions. For example, income from intangible property will be California-sourced if the intangible acquired a business or tax "situs" in California (see Rev & T C §17952). Thus, each case must be analyzed on its own facts.

Other sourcing rules are harder. For example, consider professional services. If an individual is employed by a California company but works outside California, their wages and salaries will have a non-California source. See 18 Cal Code Regs §17951–2. See also Publication 1031, p 6 ("Wages and salaries have a source where the services are performed. Neither the location of the employer, where the payment is issued, nor your location when you receive payment affect the source of this income.") However, if they perform the same services as an independent contractor, they may have business, trade, or profession income that is California-sourced, based on California's market-based sourcing rules. See *In re Appeal of Blair S. Bindley* (May 30, 2019, CA OTA Case No. 18032402) (freelance writing); see also 18 Cal Code Regs §§17951–4 and 17951–5.

The interpretation of these rules can be complex. For example, imagine a Nevada-resident attorney who is a partner in a nationwide law firm and who bills hourly for litigating cases in California and Nevada courts. Assume further that this partnership carries on a single "unitary business" (basically, this means the partners share resources and benefit from one another's involvement in the partnership), and that all its income is "business income" (rather than nonbusiness income, which must be allocated under different rules). If so, then the partnership's worldwide business income is first apportioned to California at the partnership level; each partner will then receive a distributive share of this business

income, regardless of their state of residence. 18 Cal Code Regs §17951–4(d), (e). Non-California partners who did no work in California would still be allocated their prorata share of any California-source partnership income.

The partnership-level apportionment is achieved by multiplying worldwide business income times the "California sales factor." Rev & T C §25128.7. The sales factor equals sales "in this state" divided by worldwide sales. Rev & T C §25134. For services, "in this state" means "to the extent the purchaser received the benefit of the services in" California. Rev & T C §25136(1).

This last term (the location where clients "received the benefit of" services) is subject to interpretation. 18 Cal Code Regs §25136–2. For example, one option might be to simply assign to California any hours billed for California litigation. However, in this author's opinion, the problem with this analysis is that the amount billed by the attorney may not be a meaningful approximation of the value created by their work. What if the plaintiff in the California case sought $5 million in damages and ultimately settled for $1 million, and the attorney billed 100 hours of time for this work, while another plaintiff in a non-California case sought $50 million of damages and ultimately settled for $10 million, and the attorney billed 10 hours of time for this work? Did the attorney create that value, or did the plaintiff plead unrealistically high amounts? The bottom line is that there is arguably no method for determining the extent of the benefit of the service received in California. In these cases, the regulation provides that the income should be "presumed to be in this state if the location from which the taxpayer's customer placed the order for the service is in this state"—assuming the FTB agrees with this logic.

III. Mitigating California Taxation Without Moving: NINGs

What if the taxpayer wants to sell stock but cannot change domicile in time for the sale? Moving is hard. Unless the taxpayer's whole family is enthusiastic about the move, they will be tempted to maintain their California ties, which the FTB may use against them. Changing neighborhoods, selling one's home, changing schools, burdening existing friendships, creating new ones—the cost of individual happiness may be more than the tax savings.

If moving is not an option, the next best solution is to transfer the shares to a person who resides in a low-tax state. This sort of planning is hard to do—at least where the transferee is a natural person.

- For example, one might gift the stock to a family member. But this has the potential to be either abusive (a sham, not respected by the FTB) or self-defeating (prematurely impoverishing the transferor, while incurring federal gift tax).
- Similarly, a married couple will sometimes arrange for one spouse to "reside" out-of-state, then claim certain items of income on that spouse's separate return. But the termination of residency can be hard to prove, since people tend to view their family home as "home." Even if the FTB accepts this premise, the nonresident spouse's income may still be community income (*e.g.,* if the spouse moves to a zero-tax, community-property state like Nevada, Texas, Washington, or Alaska). California will tax one-half of that amount, regardless whether the spouses file jointly or separately. See Publication 1031, Example 3. (Community property can be avoided with a prenup or postnup, but the nontax side effects are significant and are beyond the scope of this article.)

A more sophisticated solution is to create a new legal person—a trust. If the trust is based in Nevada, it is commonly called a "NING" (*N*evada *I*ncomplete-gift *N*on-*G*rantor Trust). A NING can have California beneficiaries and a California grantor, while still avoiding California taxation. To achieve this, it is structured as an irrevocable, nongrantor trust. The trustees must reside and manage the trust from outside of California. These trustees must have full discretion over when to make distributions to the California beneficiaries (although the beneficiaries do have a limited role in these decisions, in that they can veto distributions).

As long as the assets stay in the NING, and as long as the income is not California-sourced, the NING avoids California taxation. However, distributions to a California Tax Resident are included in that person's California taxable income. Thus, the value of a NING is limited. A NING will not convert California income into non-California income. It merely delays imposition of tax on the beneficiaries. At a minimum, the value of the NING is that it allows sales proceeds to be reinvested and grow for some time without California taxation. At best, the NING buys the family some time to later change their domicile to a lower-tax state.

NINGs are complex. They are also controversial: The California FTB has proposed legislation to shut them down effective 2022. See, *e.g.,* https://www.ftb.ca.gov/tax-pros/law/regulatory-activity/lp-c.pdf. Thus, the concept should be discussed with a specialist. The client must also consider their own comfort level with the arrangement.

Disclaimer: *This article does not constitute legal advice. Individuals should consult with qualified legal counsel to address specific questions and circumstances.*