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PERSPECTIVE

## The California Exodus

*Staying golden when migrating from the Golden State*

By Michelle B. Graham  
and Vivienne King

California has a lot to offer from good weather, a strong economy, an entrepreneurial environment where innovation abounds and an overall high quality of life. People come to California for a number of reasons, but taxes are not one of them. California boasts one of the highest state income tax rates (13.3%) and sales tax rate (7.25%) in the country. Combine that with increases in other taxes, such as the gas tax, and proposals to add additional taxes, such as a new estate tax, some Californians are starting to wonder whether the Golden State is losing its luster. Against this backdrop, California is experiencing a new wave — an exodus, some believe — of high net worth individuals and businesses seeking to find a new home, or more technically, “domicile,” outside of the state. This begs the question — *is living the California dream getting too expensive?*

### The Forms of Movement

Whether motivated by tax considerations or other, non-tax, factors, some taxpayers conclude that it no longer makes sense to reside in California as compared to other jurisdictions, domestic or foreign, and make efforts to move out-of-state. They discover later that the Franchise Tax Board takes an aggressive position that they had never left. These efforts vary in form, and we summarize a few common scenarios below:

*The “I’m Not a Californian” Californian.* There are individuals who, in form, move to a different state but, in substance, maintain connective ties to California — those who purchase a residence and a car, sets up a few accounts and/or entities, undertake credit card transactions, apply for a driver’s license, enter into employment agreements out of state that allow for a flexible travel schedule, and generally establish a center of sufficient activities in State 2 (i.e., Texas, Nevada, Washington, Colorado, Utah, Florida, etc.) — taking various actions to make it appear as if they have

in fact permanently and indefinitely left California state.

*The Move and Sell (and Move Back?) Californian.* While there are preferential tax rates in some states, California is not one of those states. Rather, California taxes capital gains at the ordinary income tax rates. Not surprising, there are a number of individuals who “move” from California state prior to the trigger of substantial capital gains (i.e., sale of substantial amount of stock or company interest, receipt of a large distribution from a trust, etc.) for purposes of mitigating — or eliminating all together — a potential California capital gains tax rate (effectively, the ordinary income tax rate) of 13.3%. The theory is that by qualifying as a tax resident of a state with no state income tax or lower income tax first, with the capital gain event to occur post-migration, there would be a potential income tax savings up to 13.3%.

*The Accidental Californian.* Consider, as well, the catch all category of individuals who do not realize that they may be California tax residents — those who, for example, lock their belongings up in a storage facility and backpack the world for a year (or maybe even more), travel to California to receive medical treatment or other services for extended periods of time, or seasonally vacation in California in increasing frequency and duration. As discussed below, they may be surprised to find out that they are a California resident.

### Who Is a “California Tax Resident?”

Whether someone is a resident or nonresident in California for income tax purposes depends, in large part, on the facts and circumstances of each particular case. The test for California residency has been developed statutorily, administratively, and jurisprudentially. For individuals who are not domiciled in California and who move into the state, the inquiry is whether their presence here is for other than a temporary

or transitory purpose.

The underlying theory of this definition of residency is that it is the state to which a person has the closest connection during the taxable year that is his state of residence and which should have the primary taxing right. A “resident” is defined as: (1) every individual who is in the state for other than a temporary or transitory purpose; and (2) every individual who is domiciled in the state who is outside the state for a temporary or transitory purpose. A “nonresident” is every individual other than a resident. See Cal Rev. & Tax Code Section 17015.

What does “temporary or transitory purpose” mean? There is no bright line rule for establishing California tax residency, rather it is analyzed on the basis of the totality of circumstances, taking into consideration all relevant facts and circumstances — the underlying theory of which, is based on the fact that one is a resident of the place where one has the “closest connections.”

“Residency” is not the same as “domicile”. Section 17014(c) of the California Code of Regulations or 18 CCR 17014(c) provides that domicile is the place where the taxpayer has his or her permanent home, and to which he or she intends to return whenever absent. Accordingly, one may be resident although not domiciled in California, and conversely, may be domiciled in the state without being resident. *Whitell v. Franchise Tax Board*, 231 Cal. App. 2d 278 (Cal. Ct. App. 1964). Questions of domicile ordinarily arise where a taxpayer who was at one point resident in California leaves the state and thereafter files as a nonresident based on his connection to another state or jurisdiction. See, e.g., *id.*

Questions concerning residency under the first definition in 18 CCR 17014 (presence in the state for other than a temporary or transitory purpose) are implicated when someone from another state moves to California. See, e.g., *Klemp v. Franchise Tax Board*, 119 Cal.



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Rptr. 821 (Cal. Ct. App. 1975). 18 CCR 17014(b) states that “[w]hether or not the purpose for which an individual is in [California] will be considered temporary and transitory in character will depend to a large extent upon the facts and circumstances of each particular case.”

To aid in this interpretation, the California Franchise Tax Board provides the following partial list of factors that will be considered when determining whether an individual is a California resident:

- The amount of time the taxpayer spends in California versus the amount of time the taxpayer spends outside California;
  - The location of the taxpayer’s spouse and children;
  - The location of the taxpayer’s principal residence;
  - Where the taxpayer was issued a driver’s license;
  - Where the taxpayer’s vehicles are registered;
  - Where the taxpayer maintains professional licenses;
  - Where the taxpayer is registered to vote;
  - The locations of banks where the taxpayer maintains accounts;
  - The locations of the taxpayer’s doctors, dentists, accountants and attorneys;
  - The locations of church, temple or mosque, professional associations, and social and country clubs of which the taxpayer is a member;
  - The locations of the taxpayer’s real property and investments;
  - The permanence of the taxpayer’s work assignments in California; and
  - The location of the taxpayer’s social ties. FTB Pub. 1031, Guidelines for Determining Resident Status (2010).
- Under 18 CCR 17016, anyone who spends more than nine months in California is presumed to be a resident. However, the presumption is not



conclusive and may be overcome by satisfactory evidence (based on the foregoing factors) that the individual is in the state for temporary or transitory purposes only. 18 CCR 17016. There is no presumption of non-residence if the taxpayer spends less than nine months in California; a person may be a resident due to his domicile in the state even though not in the state during any portion of the year. *See id.*; *see also Appeal of Morgan C. and Ann M. Jones*, SBE, 72-SBE-033 (Oct. 24, 1972).

Nevertheless, a person whose presence in California does not exceed an aggregate of six months within the taxable year and who is domiciled without the state and maintains a permanent abode at the place of his domicile, will be considered as being in California for a temporary or transitory purposes (and therefore a nonresident) provided he does not engage in any activity or conduct in the state other than that of a seasonal visitor, tourist or guest. "An individual may be a seasonal visitor, tourist or guest even though he maintains an abode in California or has a bank account here for the purposes of paying personal expenses." 18 CCR 17014(b).

In light of the foregoing rule, the importance of establishing a taxpayer's domicile is paramount. The R&T Regulations expand the definition of domicile by providing that "[i]t is the place in which a man has voluntarily fixed the habitation of himself and family, not for a mere special or limited purpose, but with the present intention of making a permanent home, until some unexpected event shall occur to induce him to adopt some other personal home."

An individual can have only one domicile at any one time. 18 CCR 17014(c). Generally, if an individual who is domiciled outside of California comes to California for a limited purpose without any intention of making it his permanent home, he does not abandon his original domicile simply by virtue of spending time in California "even if he maintains a home here, has his family with him, and remains here a considerable period of time." *Id.*

If an individual is presumed to be a tax resident for any tax year by virtue of spending more than nine months in the state, such presumption can be overcome through affidavits of the individual, his friends, and business associates that the individual was in California for a discrete purpose and for a limited time. However, the fact that an individual files income tax returns as a resident of another state or country, although relevant in determining domicile, will not overcome a presumption of residence. Conversely, the fact that someone states his residence as California on his US federal income tax returns is generally seen as

evidence that they are a California resident for state tax purposes. *See, e.g., Appeal of C.I. Schermer*, SBE, 61-SBE-065 (Nov. 6, 1961).

### **Exit Strategy: Staying Golden Away from the Golden State**

Regardless of the underlying rationale for migrating out of California, we include below a non-exhaustive list of summary considerations when assisting individuals with strategizing the optimal approach to "staying golden" — miti-

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gating risk exposure of FTB penalties — and ensuring the proper transition to California non-tax residency.

*Know the Law (and Hire Advisors).* Some individuals fall under a belief that their matter is straightforward and not controversial — that there is no questionable doubt that they will be deemed to be California non-tax residents upon making the "move." A couple of google searches and review of the above mentioned Bragg factors later, they conclude that they will do everything properly and on their own accord, without proper professional advice (i.e., physically relocate, maintain day-to-day contacts elsewhere, and otherwise register, file, and transact items out-of-state). However, it is important to understand that properly severing one's ties to California is often times more involved — even for the simplest matters.

While undertaking self-help measures may seem more efficient, it may be easy to lose sight of certain important issues. For example, it is common for individuals to forget to update their tax and estate planning documents to align with their hope to leave California. Often, an individual has physically relocated out-of-state, but has inadvertently left, in California, his or her revocable trust, will, durable power of attorney, advance health care directive, appointment of guardian, or other important document, without realizing the adverse impact and substantial costs to resolve issues should he or she suddenly suffer from an illness or other condition — or go through a divorce or separation. The rules involving transition from California (a community property state) to other states (whether community property or not) can be complicated and a legal advisor can help with the important step of ensuring that an individual does not

carelessly transmute his or her property, triggering serious U.S. gift and estate tax consequences.

In addition, an individual will often times fail to retain an accountant or tax advisor to properly report their status on their federal and California tax returns, electing simply to begin not filing California tax returns in a given year point-blank. Even assuming proper California outbound migration, there may be important California tax returns to file on the basis of non-residency. These

examples are merely illustrative — there are many more examples — however, it is clear that when migration out of California state, one needs to receive proper counseling from an experienced tax advisor and/or accountant as to avoid subsequent issues down the road.

*Personal Considerations.* In addition to retaining experienced tax and legal advisors to protect your interests, it is also important to reflect deeply about the (short-term, mid-term, and long-term) reasons and goals for migrating out of California — and ensure one's family is on the same page! In practice, individuals who have a long term vision backed by a meaningful narrative — communicated clearly to one's family and tax advisors — fare better. It is not all about taxes and savings (which can often be properly managed and planned for,

California resident or not). It is about making a personal life decision — one that often factors in the closest circle of friends and family; quality of education, health, and life; and general happiness. In fact, it is surprisingly common to find that sometimes individuals (especially those born outside of the U.S.) after careful consideration, elect to remain in California for its higher quality of water!

*Proper Management of Expectations.* Another consideration is the "where to?" factor — the individual who has decided to leave California state, and has multiple options on where to go or does not know where to go. Often times, it is easy to have unrealistic expectations about moving to a new state or a new country. It may seem enticing, at first blush, to begin a new life and adventure elsewhere (which could be an ideal resolve for some), however, "the grass is always greener" fallacy applies — once settled, the issues arise — the longing to see family and friends, the familiarity of surroundings (even the traffic on the 405), the weather, the local culture and language, etc. It is important to properly manage one's expectations — within the immediate family unit as well as towards the future.

Thoughtful and strategic planning needs to be undertaken to achieve optimization of severing ties with California and becoming a California non-tax resident — and determining whether this is the right path for you. Granted, living the California dream may be expensive, but perhaps the alternative is even more expensive (if it can be computed) — than the cost of sacrificing the intangibles such as family and friends, center of activities, familiarity of surroundings, and quality of life. ■

**Michelle B. Graham** is a partner at Withersworldwide, operating as Withers Bergman LLP in the US, and sits in the firm's San Diego office.



**Vivienne King** is an associate at Withersworldwide, operating as Withers Bergman LLP in the US, and sits in the firm's San Diego office.

