Creeping Palm Disease: State Tax Residency & Domicile Planning for Clients

(And when do U.S. Citizens and residents living abroad have to file U.S. Income tax returns?)

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State Tax Residency & Domicile Planning for Clients

"I just need to be in Florida for 180 days, right?" or "I live overseas now, I haven't filed a U.S. return in years!"

Unfortunately, the day count is just one of more than twenty factors states generally look at when determining if they can drag your client (and their income and assets) back into the state for tax purposes. And we've seen situations where multiple states claim a taxpayer as a resident! We will cover the factors states look at and what tax professionals can do to help clients plan properly to change their status and defend it later if it is tested.

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Disclaimer

The state aspects of the following presentation are based largely on Connecticut regulations and experiences with taxing authorities from states in the northeast. All state domicile / residency matters are governed by state laws and restricted by federal law and the constitution. Most states define domicile as the place to which one intends to return whenever absent, or similarly, but state specific criteria must always be reviewed and understood.

The Basics on Domicile and Residency

- Generally, place of domicile and place of residence are the same, but…
- Individuals can only have one domicile, but may have multiple places of residence
- Generally, a taxpayer pays tax on all of his or her income in their place of domicile
- Often a taxpayer receives a credit for taxes paid on income sourced to other places when filing their return in their home state
- When someone is resident in multiple states that have an income tax, those states generally DO NOT provide a credit for tax paid to the other state
- It therefore is imperative to not be found a resident of multiple states with an income tax
- Similarly, if one moves from a high tax state to a low tax state but is unable to prove the change of domicile under audit, a person can find himself or herself paying tax someplace they didn’t plan to

The Notion of Domicile

- As stated in the disclaimer, one's place of domicile is the place to which one intends to return whenever absent.
- One's place of residency is just where one lives at the moment.
- A person may be domiciled in California but move to work in Maryland for five years
- That person would be a Maryland resident, but would always intend to return to California when circumstances permit
- Most states tax domiciliaries and have a threshold at which they also tax residents (so called statutory residents) as if that person were domiciled in the state
- Most states will also NOT tax domiciliaries that are present in the state of domicile for some de minimis amount of time and/or if the person does not maintain a home in the state of domicile, as in the example of a California domiciliary moving to Maryland

Statutory Residents and a Shrinking World

- Some states have the concept of a statutory resident wherein the state does not argue that person in domiciled in that state only that a taxpayer spent over a certain number of days in said state and now must pay tax as a resident of this state
- This can clearly be problematic for traveling workers and others
- For example, if you have your home in state A but rent an apartment to work a seasonal job in state B, you would be tax as a resident of both states
- Since wages are generally sourced to where work is done (but see New York and other "convenience of the employer" states) this does not usually cause double taxation
- However, residence in multiple states becomes an issue if you have "unsourced" income such as interest, dividends, or capital gains
- As noted above, while convenience of the employer rules are outside the scope of this presentation, as the "world becomes smaller" due to ever improving communication systems, issues around multiple states seeking to tax the same income are bound to continue to arise

Why do People Move to Florida, Texas, etc.

- Some states do not impose a traditional income tax on residents, examples include Florida, Texas, and New Hampshire
- Most states do not impose an estate tax
- Often individuals may move to a state without an income or estate tax simply because they prefer the climate, cost of living, or lifestyle in that state
- Other times individuals may move specifically for tax reasons
- Moving to a lower tax jurisdiction can reduce someone's effective tax rates by several percent per year and allow a lot more money to be passed on to heirs if there is no estate tax
- Many individuals move and retain their original homes in higher tax states but are never subject to a domicile audit (I note that domicile audits can impact income tax, estate tax, or both, and may not occur until after a taxpayer has died)
- Those individuals with significant "unsourced" income in retirement and sizeable estates are more likely to have their moves scrutinized through a domicile audit

What Does a Domicile Audit Involve?

- Taxpayers subject to a domicile audit will be left to prove that (1) they were not a statutory resident of the auditing state and (2) that they were domiciled outside of the auditing state
- While domicile is an intangible concept, it is still proved through evidence
- State auditors will view anything indicating domicile in the audit state as important while discounting evidence that indicates domicile outside of the state
- It is therefore important to have an abundance of evidence supporting domicile outside of the auditing states

Factors Connecticut Considers

Connecticut regulations define the specific facts that the Department of Revenue Services will consider when determining a resident's domicile

In reality, other factors that support domicile in Connecticut will also be consider and any factors that support domicile outside of Connecticut will be discounted

Here are the factors:

(A) location of domicile for prior years;

(B) where the individual votes or is registered to vote (casting an illegal vote does not establish domicile for income tax purposes);

(C) status as a student;

(D) location of employment;

(E) classification of employment as temporary or permanent;

Factors Connecticut Considers (Cont.)

(F) location of newly acquired living quarters, whether owned or rented;

(G) present status of former living quarters, i.e., whether it was sold, offered for sale,

rented or available for rent to another;

(H) whether a Connecticut veteran's exemption for real or personal property tax has been claimed;

(I) ownership of other real property;

(J) jurisdiction in which a valid driver's license was issued and type of license;

(K) jurisdiction from which any professional licenses were issued;

(L) location of the individual's union membership;

(M) jurisdiction from which any motor vehicle registration was issued and the actual

physical location of the vehicles;

(N) whether resident or nonresident fishing or hunting licenses were purchased;

(O) whether an income tax return has been filed, as a resident or nonresident, with Connecticut or another jurisdiction;

Factors Connecticut Considers (Cont.)

(P) whether the individual has fulfilled the tax obligations required of a resident;

(Q) location of any bank accounts, especially the location of the most active checking account;

(R) location of other transactions with financial institutions, including rental of a safe deposit box;

(S) location of the place of worship at which the individual is a member;

(T) location of business relationships and the place where business is transacted;

(U) location of social, fraternal or athletic organizations or clubs, or a lodge or country club, in which the individual is a member;

(V) address where mail is received;

(W) percentage of time (excluding hours of employment) that the individual is physically present in Connecticut and the percentage of time (excluding hours of employment) that the individual is physically present in each jurisdiction other than Connecticut;

Factors Connecticut Considers (Cont.)

(X) location of jurisdiction from which unemployment compensation benefits are received;

(Y) location of schools at which the individual or the individual's immediate family attend classes, and whether resident or nonresident tuition was charged;

(Z) statements made to any insurance company concerning the individual's residence, on which the insurance is based;

(AA) location of most professional contacts of the individual and his or her immediate family (e.g., physicians, attorneys); and

(BB) location where pets are licensed.

Many Factors Will be Irrelevant or Out of a Taxpayer's Control

- As is clear from a review of the factors, many will simply not apply to certain taxpayers
- Other factors are difficult to control or plan for
- Therefore those factors that can be controlled must be controlled

Factors That Many Taxpayers Let Slide

- All mail and registrations should be directed to the new place of domicile
- This includes having tax bills and forms for property and cars located in a non-domicile state sent to the state of domicile
- New doctors and other professionals should be found in a new state of domicile
- A new will should be executed in the new place of domicile
- End relationships with local banks in former home state and start relationships with banks in new states
- If a national bank is used, also begin using a local bank in new state
- Consider using financial advisors in new state of residence

Day Count Matters for Domicile

- While one has to spend more than 183 days in Connecticut to be a statutory resident, large day counts are bad evidence in domicile audits
- Taxpayers should aim to spend more time in new state of residence than any other place and substantially more time than is spent in a former home state
- Time spent in a former home state should be seasonally appropriate and exclude major holidays outside of the appropriate season
- And remember, a day can be any part of a day for day count purposes (yes, day counts can exceed 365 days for a single year)

Day Count Matters for Domicile (Cont.)

- An ideal fact pattern during a year is:
  - Fewer than 100 days per year in a former home state
  - Time in former home state seasonably appropriate, e.g., Connecticut during the summer only, new home in Florida for the rest of the year
  - More than 200 days in new home state

Day Count Matters for Domicile (Cont.)

- Examples of patterns tax departments may challenge:
  - Fewer than 183 days in former home state, but….
    - More time in former home state than new home state
    - E.g., 140 in former home state, 100 days in new home state, balance of days travelling
  - Using former home state as “home base”
    - One month in spring and fall in former home state
    - Summer traveling
    - Winter in new home state

The International Side of Things

- Many individuals who move abroad stop filing state and federal income tax returns
- It may sometimes be appropriate to stop filing a state income tax return when living abroad permanently
- It is rarely appropriate to stop filing a federal income tax return when living abroad
- This is because in order to claim the foreign earned income exclusion or the foreign tax credit a US return must be filed

The International Side of Things

- Consider you clients needs
- Is your client concerned with
  - Federal income tax
  - State income tax
  - Both
- Some states have formula driven rules to determine when someone spending time overseas is no longer taxed as a resident

Is there a sure bet?

- The surest way to change place of domicile is to sell your home and to leave place A for place B
- Don't return to place A and don't leave place B
- Establish the hallmarks of a life in place B, e.g…
  - Buy a home
  - Make friends
  - Bank
  - Shop
  - Be part of the community
  - And review the factors above….

Keep filing!

- If a sophisticated taxpayer plans to change his or her place of domicile and retain access to a home in the original state of domicile then:
- KEEP FILING RETURNS IN THE ORIGINAL STATE OF DOMICILE
- These will be the state's non-resident return
- The returns should likely include income sourced to that state
- Do what it takes to have that income, invest in a business, etc.
- In most states this will limit the number of years a state can go back to challenge place of domicile

What if my clients won't…

- I have given change of domicile advise to dozen of individuals over the years
- I can only remember one individual that took everything I said to heart
- He delayed his planned change of domicile for a year to sell him homes in the northeast
- Most clients do as much as they're comfortable with and accept some risk

What if my clients won't…(Cont.)

- Barring meeting the definition of a statutory resident (e.g., spending more than 183 days in Connecticut in a calendar year), it is up to taxpayer to prove domicile based on evidence
- As long as someone wishing to move to another state understands that the better the evidence, the better their chances of success, advocates can defend any reasonable position
- The harder the fight to prove domicile, generally, the more expensive

What clients should do before an audit

- Track day count!
- See day count goals, days started in one state an ended in another can count as two days (see state specific guidance)
- Keep moving records, including manifests of goods moved
- If clients cannot move furniture, art, etc. make sure they move heirlooms
  - Photo albums
  - Other items of sentimental value

What clients should do before an audit (Cont.)

- Meet with you clients at least annually to discuss all of this
- Big life events will be fresh on a client's mind but may not be recalled if trying to piece together information years later
- I have seen auditors try to go back more than ten years
- Even with good electronic records, piecing together day to day activities a decade on is challenging and time consuming
- Spending a little time now can save a lot of time later

Do they have to do this forever?

- Once established a place of domicile is generally “sticky” in that it is not easy to change
- As such, the first several years after moving are most important
- This is not to say anyone should ever return to things like hosting holidays in a former primary residence
- While unpleasant to consider, the years before death also tend to be important when dealing with estate tax matters

Questions