The Mass Exodus - Can You Save Taxes by Moving Out of California?

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Overview

It is no secret that California has high taxes. Its individual income tax rate is the highest in the nation, and its corporate income tax and sales tax rates make the top ten. On top of this is a growing list of onerous local gross receipts and payroll taxes. There have even been hints of a first-of-its-kind state wealth tax.

Individuals and businesses feeling the California tax pinch are looking for options to reduce their growing state and local tax burden. Many think a California exit is the best option. Intuitively that makes sense. But tax laws are anything but intuitive. Before committing to a relocation, taxpayers must investigate whether it will actually reduce taxes. This article explores these considerations.

The Problem: Does Relocation Really Save Taxes?

Many believe moving from California will save significant taxes for both the individual and their business. But will it? For many, the scenery may change, but the tax bill will remain the same. This is due to how California determines taxable income and its aggressive auditing of residency. Each of these issues is discussed below.

Nonresident income sourcing: A trap for the unwary

Often individuals move from California only to discover that they continue to pay California individual income tax! How can this be? The answer lies in two bedrock principles of individual income tax. First, a state may tax 100% of a resident's worldwide income (subject to credits for taxes paid to other states). But that is only half the puzzle—states may also tax a nonresident on income from sources in the state. This is what trips up many well-intentioned tax refugees.

For example, an individual may move from California and continue to receive income from California real estate investments or a closely-held business that operates in California. We have even seen instances where one high earner in a married couple moves, leaving their spouse behind only to learn that community property rules frustrate the plan. Although the individual is no longer a California resident, California may still tax the individual on these types of California-source income. Therefore, if most of a taxpayer's income is California sourced, the anticipated tax savings may not materialize.

Business operations control taxes

Businesses run into a similar difficulty. Taxpayers often think that reincorporating or establishing a token office in a low-tax jurisdiction will allow them to escape California corporate income taxes. Commercial domicile may be a relevant consideration—typically when selling certain intangibles (e.g., stock)—but for the most part, actual business activity drives where a corporation pays tax. If a relocating business does not fundamentally change its business operations or customer base (which can be hard to do), it is unlikely to realize meaningful tax savings.

This is due to constitutionally-based laws that determine how much of a business's income a state may tax. If the business operates across state lines, each state may tax only its fair slice of the pie. Rules for determining the size of the slice are called allocation and apportionment and are meant to roughly approximate the amount of business conducted in the state.

States have leeway to establish their own rules for determining the percentage of business done in their borders. California, like many other states, uses a single sales factor apportionment formula. This means that California multiplies a business's federal taxable income (after some adjustments) by a fraction: sales sourced to California divided by all sales. The resulting amount is subject to California tax.

What does this mean for the relocating business? If the business moves its facilities and employees outside California without changing the relative mix of California v. non-California sales, its California tax bill may remain static. For example, if a California company has $5 million of income and has 20% of its sales sourced to California, California will tax $1 million of its income. If that company relocates its facilities and workforce to another state and continues to have 20% of its sales sourced to California, California will likewise continue to tax $1 million of its income. What's more, if a company relocates to a jurisdiction that uses property or payroll to determine how much business is done in the state, a move could potentially increase the company's overall state tax burden!

This of course, assumes that the business retains sufficient connection (nexus) with California to remain subject to its taxing jurisdiction—in this day and age, it takes precious little. For example, sending traveling salespeople into the state, having a remote worker in the state (subject to some grace for COVID situations), or even making certain amounts of sales into the state may establish that nexus. But with careful planning and the right business model, it may be possible to escape California's taxing jurisdiction altogether.

Of course, there are exceptions on the margins where relocating may cause California taxes to shrink. Each case will be different. That is why it is vital for business leaders to sit down with their accountants to model how a move may affect their California tax liability before committing to a move.

What about wealth taxes?

In 2020, the California legislature entertained a bill (AB 2088) that would have enacted the nation's first wealth tax—a 0.4% annual tax on wealth over $30 million. Recognizing its potential to cause California flight, the bill would have continued to impose the tax for ten years after a resident left the state. The constitutionality of this 10-year provision is dubious. Fortunately, the tax did not pass.

Although the tax did not pass, the concept is not dead and will be up for debate in future legislatures. Those individuals who may already be eying an exit from California would be wise to monitor these developments. It may be to their advantage to exit the state before such a tax passes, especially if the tax does not apply to those who depart before it passes.

The Solution: What Should You Know About Changing Tax Residence?

Taxpayers who decide to leave California for tax purposes should avoid two cardinal mistakes: (1) misunderstanding residency laws and (2) not genuinely moving. The internet is replete with misinformation (i.e., being outside California for six months changes residency). And aggressive residency auditors will ferret out half-baked attempts to establish residency outside California.

Residency determinations involve personal questions of family and social connections; it should be no surprise that these audits can be extraordinarily invasive. But they can be straightforward for taxpayers who thoughtfully prepare a plan for exiting the state, establishing a new residence, and retaining key documentation. The latter is quite important; the types of documentation that auditors request years down the road tend to evaporate quickly.

Each plan for changing residency will be unique. That said, a few examples of steps that one should consider in changing residency include: disposing of a California home (or converting to a rental), acquiring a new home, changing drivers licenses and vehicle registrations, registering to vote, forming relationships with new medical, financial, and other professionals, and joining social and civic organizations. Small details matter: some cases have turned on where the family pet lived or where cell phone calls originated.

Taxpayers anticipating large liquidity events, such as selling a business or stock holdings, often intend to change their residence before that event. In addition to verifying that a changing residency will save California taxes, these individuals also should take great care to follow through with their residency change well in advance of the liquidity event to ensure that the timing is clear.

Key Takeaways

- California residents and businesses may significantly reduce state and local taxes by migrating to a more favorable jurisdiction.
- Tax migration is not a panacea—each taxpayer should carefully evaluate whether a relocation actually reduces California taxes.
- Individuals with California sourced income may remain subject to California tax even as a nonresident.
- Due to California's single sales factor apportionment, many businesses may not experience a California tax reduction from relocating operations.
- Changing residency requires careful planning, execution, and documentation.
- Residency changes should be considered well in advance of income-generating liquidity events.

If you are considering a move out of California, contact your HCVT tax professional or the tax professionals listed below. Our team can provide guidance and insights about the tax implications and key considerations individuals and businesses should address as they contemplate a change in residency.

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