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California's 13.3% Tax On Capital Gains Inspires Move Then Sell Tactics

Living in California has many perks, but the state's 13.3% rate is the highest marginal tax rate in the nation. When you add up to 39.6% federal taxes, it can hurt, especially for those who cannot deduct their state taxes against their federal. California's taxes were always high, but Proposition 55 extended the 13.3% tax rate 'temporarily.' How temporarily? Only until 2030! Personal income tax hikes on incomes over $250,000 started in 2012. It impacts Californians with a single income of $263,000, or a joint income of $526,000. When people talk of moving away, in many cases, the absence of a capital gain rate that can be the straw that breaks the proverbial camel's back.

At the federal level, the capital gain rate is 20% for higher income taxpayers. Add the 3.8% net investment tax under Obamacare, and you have 23.8%. California does not tax long term capital gain at any lower rate, so Californian's pay up to 13.3% too. By paying 23.8% plus 13.3%, Californians are paying more on capital gain than virtually anyone else in the *world*. As talk turns to possible reductions in federal taxes, disproportionately high California taxes are an increasingly large share of the tax burden. Some Californians weigh the benefits and burdens of tax-free Nevada just across the border. Other no-tax states including Texas, Washington, and Florida may also beckon.

Yet California's tough Franchise Tax Board (FTB) polices the line between residents and non-residents, and does so rigorously. As with other high tax states, California is likely to probe how and when you stopped being a resident. For that reason, even if you think your facts are not controversial, be careful. A California resident is anyone in the state for other than a temporary or transitory purpose. It also includes anyone domiciled in California who is outside the state for a temporary or transitory purpose. The burden is on *you* to show that you are *not* a Californian.

If you're in California for more than 9 months, you are *presumed* to be a resident. Check out FTB Publication 1031. Yet if your job requires you to be outside the state, it usually takes 18 months to be presumed no *longer* a resident. Your domicile is your true, fixed permanent home, the place where you intend to return even when you're gone. Many innocent facts might not look so innocent to California's tax agency. For example, do you maintain a California base in a state of constant readiness for your return?

It should be no surprise that former Californians often become residents of no-tax states like Texas. The IRS reports that between 2013 and 2014, over 250,000 California residents moved away. More than 10% went to Texas alone. Some Californians flee the state before selling real estate or a business. Warning: California real estate is taxed here even if you are a non-resident. But settling a lawsuit, or selling stock and other assets after a move can make sense. Some people get the travel itch right before cashing in shares, a public offering, or settling litigation. Some carefully orchestrated deals and moves can work just fine.

However, some people have unrealistic expectations about establishing residency in a new state. They may have a hard time distancing themselves from California, and may not plan on California tax authorities chasing them. When fighting California tax bills, procedure counts. You can have only one domicile, and objective facts can bear on your intent. Start with where you own a home. Where your spouse and children reside counts, as does the location where your children attend school. Your days inside and outside the state are important, as is the purpose of your travels. Where you have bank accounts and belong to social, religious, professional and other organizations is also relevant.

Voter registration, vehicle registration and driver's licenses count. Where you are employed is key. You may be a California resident even if you travel extensively and are rarely in the state. Where you own or operate businesses is relevant, as is the relative income and time you devote to them. Taxpayers with unrealistic expectations can end up with big bills for taxes, interest and penalties. And the state can have a long memory. California's main statute of limitations is four years after you file your return. But if you don't file, that clock never starts ticking. California, like the IRS, gets unlimited time to audit if you never file an income tax return. You might claim that you are no longer a resident and claim that you have no California filing obligation. But the FTB may disagree and can audit you forever *unless* you file a return. That can make filing a non-resident tax return—just reporting your California-source income as a non-resident—a smart move.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.