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Leave California Taxes, Don't Worry, Be Happy?

By Robert W. Wood

Living and working in California is taxing, and that's not likely to change. Businesses and individuals both pay a lot. California's top 13.3% individual tax rate is the same on ordinary income and capital gain, and that fact can be especially frustrating if you eye no-tax states, or even other states that give capital gains a lower marginal tax rate like the IRS does. As I consider how many clients I've seen bolt for the exits, the lack of a capital gain rate in California accounts for some of them, particularly since moves before sales of assets are common.

Can you dream that California will see the light and reduce its tax rates, at least on capital gain? You can dream, but you should assume that California will not be reducing its rates anytime soon. In fact, if anything, it might go the other way. There have been several proposals over the last few years to increase the top 13.3% rate as high as 16.8%. And for many in the Golden State, that can make talk of crossing the Nevada border or hopping on a flight to Austin sound alluring.

It sounds pretty good all the time, but cutting out state taxes can be especially intoxicating right before you sell that horde of appreciated stock or bitcoin. But would that work? Moving sounds easy, but if you aren't careful how you do it, you could end up saying goodbye California taxes, and hello to a residency audit. California's tough Franchise Tax Board (FTB) monitors the line between residents and non-residents, and can probe how and when you left.

It pays to know what you are up against, and the burden is on you to show you are not a Californian. Some of it, of course, is about timing. If you are in California for more than nine months, you are presumed to be a resident, and more than six months can often cause problems too. If high income tax rates are not scary enough, California also proposed a wealth tax, although so far, that has not passed.

But even without any of these proposed tax hikes, paying 13.3% in non-deductible state taxes (after the IRS $10,000 cap) is painful. You can leave for Nevada, Texas, Washington or other no-tax states, but if you aren't careful, you could end up being asked to keep paying California taxes. In some cases, such as where you work outside of California but have California-based customers or clients, California can assess taxes no matter where you live.

Any time you are thinking about California tax exposure, it pays to think about the statute of limitations too. Most people know the usual IRS statute of limitations, which is generally 3 years after you file a tax return. But less well known is the IRS rule that if you omit 25% of your gross income—and that can include overstating your basis in an asset—the IRS gets 6 years to audit you.

In California, the FTB gets a minimum of four years to audit no matter what, but the really scary audit period in California is if you never file a return for a particular tax year. Let's say you leave California and stop filing in the golden state altogether. Suppose that 5 or 10 years later, the Franchise Tax Board comes along and says you are still a California resident, or that at least you have some California source income that you failed to report. In either case, the FTB can try to collect, with no statute of limitations. The reason is that California, like the IRS, gets unlimited time if you never file an income tax return. That can make filing a non-resident tax return—just reporting your California-source income as a non-resident—a smart move.

How about fighting over the most fundamental issue of all, whether you are or are not a resident? California looks to objective factors to determine residency. Your time in California versus time outside counts. California uses a comparative analysis to see if you have closer connections to another state. Many people who leave have unrealistic expectations and have a hard time distancing themselves from California. And be careful, because in California tax disputes, procedure counts.

If you are gauging your exposure, time in and out of the state is obviously important. Also consider the size and value of your residences, and the location of the property on which you claimed the homeowner's property tax exemption. Where your driver's license was issued, where cars are registered, your professional licenses, and registration to vote all counts. So does the location of your banks, doctors, dentists, accountants, church, temple or mosque, and more.

What clubs are you a member of, and where? Where do you work, and have business and social contacts? Where do you have all your mail sent? Not all of these are equally important, and almost no one has everything all lined up perfectly. As you might expect, physical presence is probably the biggest issue. If you spend more than 9 months in California, you are *presumed* to be a resident. If you spend 6 months or less in California, you *may* qualify as a seasonal visitor, but only if you don't work while you are in the state and meet other tests.

If you are a California resident but are heading for the exits, consider this checklist:

1. Get a new other state driver's license, and turn in your California one.
2. Move and register your car(s) in your new state.
3. Notify California DMV, move vehicles and re-registration.
4. Insure cars and real estate with insurance in the new state
5. Register to vote in the new state.
6. Cancel California voter registration for old residence.
7. Terminate California club memberships.
8. Join clubs and social groups in the new state.
9. Relocate family to the new state.
10. Move cherished family heirlooms (photos, keepsakes, etc.) to home in the new state.
11. Sell, list for sale, or lease (preferably a long-term lease) any California property—selling is best.
12. Terminate lease of any California property.
13. Lease (long-term) or buy residence in the new state. Buying is best.
14. Notify friends and family of permanent move out of California.
15. Notify banks, credit card companies, etc. of move and provide new state address for statements. Have

correspondence including bank statements, credit card statements, etc., sent to new state address.

16. Use healthcare providers and other advisors (except with regards to advice concerning California taxation) in the new state.
17. File change of address forms with US Postal Service and IRS.
18. Notify all contacts of change of address and permanent move.
19. Obtain new state phone numbers.
20. Send holiday cards, birthday cards, and other correspondence from home in the new state.
21. Change professional affiliations and licenses as needed to the new state
22. Establish office or workplace in the new state.
23. Limit physical presence in California as much as possible.

Finally, if you are a lawyer, does moving out of state make your practice income free of California tax? In many cases the answer will be no, perhaps not at all, and especially not completely. However, some of how you might fare is likely to depend on how your office or firm is set up, whether you are a member of other state bars, where your cases and clients are, and more. And like anything to do with California taxes and tax audits, it is nuanced and downright tricky.

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