

Leaving California? Be Sure To Mind Your Taxes

By Robert W. Wood

We live in a mobile society, where brick and mortar locations are not as important as they used to be. For some, where they sleep at night may not be as important either. Whatever the reason, many businesses and individuals toy with the idea of avoiding California taxes by moving.

If you are a California resident, California taxes you on your worldwide income, wherever it may be generated. If you are a non-resident, you pay California tax only on your California source income. What is California sourced can be a complex question, but for many people who leave the state, the figure may be small.

Not coincidentally, many moves seem to occur shortly before a major income-producing event. The fleeing taxpayers might be selling a company or settling a lawsuit. A big spike in income can make one think about federal taxes, and California taxes too. It can be especially true given that, unlike the IRS, California does not give you a lower tax rate for long term capital gain.

That can give one wanderlust. Done carefully, timely, and with the right kind of income, a move can cut the sting of California's high 13.3 percent state tax. Yet, *moving* to avoid California taxes can be tough. If you are dealing with the state's notoriously aggressive Franchise Tax Board, you can still have problems.

Even moving out of state before settling a lawsuit or selling assets does not necessarily obviate California's claim. California may have a claim on some of the proceeds even if the move is well-timed, bona fide, and permanent. In addition, California can dispute the move. California can argue that your move is only temporary and not effective to make you not a California resident.

California can also argue about your timing, arguing that a move in March really was not a move until July. A related and emerging approach involves setting up a new type of trust in Nevada or Delaware. A "NING" is a Nevada Incomplete Gift Non-Grantor Trust. A "DING" is its Delaware sibling. There is even a "WING," from Wyoming.

Let's say you can't move quite yet, so you wonder if a trust in another state might work? The usual grantor trust you form for estate planning doesn't help, since the grantor must include the income on his return. A potential answer for the adventurous is a Nevada or Delaware Incomplete Gift Non-Grantor Trust. The donor makes an incomplete gift — with strings attached — to the trust, and the trust has an independent trustee.

The idea is to keep the grantor involved but not technically as the owner. Not everyone likes this idea and what it could do to state tax revenues. New York State has already changed its state tax law to make the grantor taxable no matter what. California's FTB says it is studying the issue. To be careful, one should assume that the FTB will audit and disapprove of these trusts.

Thus, some marketers of NING and DING trusts offer it as an alternative or adjunct to the physical move. The idea is for the income and gain in the NING or DING trust not to be taxed until it is distributed. At that point, the distributees will hopefully no longer be in California. The chosen trustee must not be a resident of California.

If the NING or DING trust is formed to facilitate a business sale and the proceeds will be capital gain, there is the federal tax of up to 20 percent. Then, there is also the 3.8 percent Obamacare tax on net investment income. It makes the current federal tax burden on capital gain up to 23.8 percent. California taxes all income at up to 13.3 percent, and there is no lower rate for long term capital gain. It is one reason nearby Nevada has always loomed large for California sellers.

Tax-deferred compounding can yield impressive results, even if it is only state income tax that is being sidestepped. If the NING or DING trust is being used to fund benefits for children and will grow for years, it may make even more sense. Parents frequently fund irrevocable trusts for children, and may not want the trust to make distributions for many years. The parents might also remove future appreciation of the trust assets from their estates.

For tax purposes, most trusts are considered taxable where the trustee is situated. For NING and DING trusts, one common answer is an institutional trust company in Delaware or South Dakota. For trust investment and distribution committees, the committee members should also not be residents of California.

Even if you jump through all the requisite hoops, the NING or DING trust may *still* pay some California tax. For example, if the trust has any California source income, it will still be taxable by California. Interest, dividend and gains from stock sales are intangibles, typically not California sourced. But gain from California rental properties or the sale of California real estate is sourced to California no matter what.

Outside of New York residents, the jury is out on NING and DING trusts. Yet California tax lawyers know that the state rarely takes moves that short the state lying down. The facts, documents, timing, and details matter a great deal. Based on the past, California seems more likely to attack these trusts in audits rather than through the legislature.

California has income taxes, franchise taxes, sales and use taxes, and property taxes, to name the most common. Tax disputes in California can be protracted and expensive. But if one is careful, willing to bear some risk, and there is sufficient money at stake, the calculated risks can make sense.



Robert W. Wood is a tax lawyer with www.WoodLLP.com, and the author of "Taxation of Damage Awards & Settlement Payments" (www.TaxInstitute.com). This is not legal advice.