EXITING CALIFORNIA: AVOIDING COMMON MISCONCEPTIONS

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Given the high stakes in claiming an individual or business is no longer subject to California tax, a review of the basic rules governing California taxation will help your clients avoid some common mistakes in planning a California exit. Unfortunately, there are some misconceptions about avoiding California taxation and how to properly do so.

At the outset, the California Franchise Tax Board (FTB) devotes a great deal of effort in auditing taxpayers who improperly believe they are no longer subject to California tax. Understanding the rules and how the FTB finds its audit targets will help you to properly advise your clients. There are three primary areas to focus on in planning.

The first area is the California source-of-income rules. If income is determined to be from a California source, it is subject to California tax no matter where your client lives. A simple example is ownership of California income property, which will be subject to California tax no matter where the owner lives. California's source rules can be very complicated, and in the case of business income, California made changes to how business income is sourced to avoid the loss of tax revenue by businesses attempting to move their property and payroll out of California. No California exit planning should occur without a separate analysis of how the California source rules will be applied to your client.

The next area to focus on are the rules defining when someone is a California resident. Many times, people believe they are not residents if they avoid being in California for "six months and a day." This is a common misconception. The FTB will look to that state with which the taxpayer has the "closest connection." As an example, assume a taxpayer spends five months in California, four months in Florida, and three months traveling on cruises and visiting vacation homes. Even though they spend only five months in California, the FTB will argue that the taxpayer is a California resident because they have a "closer connection" to California than any other state.

The last area to focus on is "domicile"—a subjective test that can make someone subject to California tax even if they never set foot in California for the entire year. Even if someone is not a California resident under the residency rules, California can still apply the concept of "domicile" to tax someone. This is where things get tricky—while the residency rules focus on objective factors, discussed in more detail below—the "domicile" test focuses on a taxpayer's subjective intent. Domicile is defined as the place where an individual has their true, fixed, permanent home and principal establishment, and to which place they have, whenever they are absent from California, the intent to return. It is the place where the taxpayer has a present intent of making a permanent home without the "permanent" intent of moving elsewhere. While objective factors, like changing their driver's licenses and voter registration, may seem determinative, one's "domicile" depends primarily on one's subjective intent.

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How does the FTB determine what a taxpayer's subjective intent is? A simple example is social media. Assume a client is planning on selling stock in their business. If a buyer is willing to buy stock, as income from an intangible asset, the stock sale income is sourced to your client's state of residence or domicile. So they move out of California and buy a home in Texas before the sale. So far, so good. But let's suppose (i) your client keeps their California beach house, and (ii) their social media posts contain entries such as "we're here in Texas for a while, but can't wait to move back to California." Those facts would clearly let the FTB claim that even though your client was a Texas resident, their intent was to maintain their permanent home in California.

One common domicile issue is taxpayers who want to leave California, but still wish to maintain their existing California home. There is no legal prohibition on keeping an existing California residence as a vacation home. However, the retention of a California home, especially if it is an expensive residence, lends itself to the FTB argument that someone "intended to" eventually return to California. If someone wishes to keep an expensive California home, it would be advisable for them to at least consider renting it out to a third party so that the home is not available for their use during the time they are maintaining their non-California residence and domicile. The maintenance of a family home in California is especially problematic when married couples take the position that one spouse is a California resident, while the other is not.

Subjective factors aside, there is a fairly well-developed list of residency factors set out in *Corbett v. Franchise Tax Board*, in which the California appeals court listed a number of individual residency facts to be evaluated with respect to a taxpayer who had homes in both California and Illinois. 213 Cal. Rptr. 893 (ordered not published (1985), previously published at 167 Cal. App. 3d 808). Regardless of whether you are arguing residency or domicile, having as many of the factors in your client's favor as possible is important. Note that some of the factors, such as where your client was born or raised their family, can't be changed, but most can. The "controllable" *Corbett* factors include where tax returns are prepared, the ownership and occupancy of a custom built (or expensive) home, holding of licenses for the conduct of a profession, church attendance, location of family doctors, dentists, and veterinarians, driver's licenses, voter registration, and actual voting. Remember it is important not to focus only on these factors, without paying attention to whether there are California sources of income and where clients actually spend their time.

How does the FTB determine where one actually spends their time? The simplest way is to review charge card statements that reflect the locations where one spends money. All the objective *Corbett* factors in the world won't help if the FTB sees that a taxpayer is physically present and spending money in California seven or eight months a year. The FTB can access cell phone records and determine someone's location, but because most people are tied to their credit cards, charge card statements are frequently all the FTB will review.

In addition, the FTB is able to gather information—including from private parties—as good evidence of a taxpayer's presence in California. In one case, a "Nevada resident" with a Nevada address and vehicle registrations had the FTB pull their vehicle service records, all of which indicated the Nevada-registered vehicles were routinely serviced in California.

Another important point is how an exiting California taxpayer reports their income to California. Assume the same client who was planning a stock sale of a valuable business left California to establish Texas residency and they rented out their California home. Even if the stock sale takes place in the year following the move, California will know all about it because a taxpayer who lives in another state must file a non-resident return on all California source income. So, even if your client is a Texas resident, they will have to file a California non-resident return after their move reflecting their California source income. That reporting will reflect their *total* taxable income and their California source income (from the home rental). The large capital gain from the stock sale and the timing of the taxpayer's move in the year prior to sale will be very obvious to the FTB. This does not mean that, with the proper facts and intent, your client can't win an audit, but they certainly will have to justify their position.

The FTB has made residency audits one of their primary targets. They have a separate audit level unit for residency matters. The auditors in this function tend to be more highly trained and knowledgeable than most FTB auditors, and the audits are very detailed and document intensive. The FTB uses automated audit models that identify potential audit adjustments in various categories. A good example are individuals with significant income levels that have filed California resident returns in the past, but no longer file as residents.

Special considerations apply when married spouses take the position that one spouse is a California resident while another is a non-resident. As noted above, the maintenance of a family home in California is one indication that the "non-resident" spouse maintains strong ties with California. *See FTB Publication 1031, example 4,* www.ftb.gov/forms/2021/2021-1031publication.pdf at 6. Apart from that, the California source rules also have an impact on California's ability to tax the non-resident spouse. Assume the non-resident spouse is a bona fide resident of Nevada with a permanent job and domicile in Nevada. Even so, the tax results may heavily favor California. As to the resident spouse, all of their income will be subject to tax in California because they are a California resident. In addition, because both California and Nevada are community property states, the non-resident spouse's income will be split between both spouses, meaning half of the Nevada income earned by the Nevada resident spouse will still be subject to California tax.

California's source rules are not static. For example, in the recent case, *2009 Metropoulos Family Trust*, 79 Cal. App. 5th 245 (2022), the California Court of Appeal held that business goodwill arising from the sale of assets of a multi-state business was business income that had to be apportioned, meaning that non-resident taxpayers were taxed on a portion of it as opposed to being entitled to exclude all of such income from California. In addition, California has adopted the single sales factor rule for many multi-state businesses. That method taxes a multi-state business based upon where its sales occur, disregarding older methods that also considered where the business had its property and payroll. This means that a business that relocates to a low-tax state by moving its plant and entire workforce there will still pay California tax to the extent it derives sales from California.

The sourcing rules pose similar barriers to professionals who maintain California clients. For example, if I decide I want to move to Montana and conduct my law practice remotely, I am still taxed on all revenue derived from my California clients, even if I never set foot in the state. The tax impact of someone's move from California can't be determined without consideration of the type of income they will realize and how it is treated under California's sourcing rules.

California law does provide some individual residency presumptions, but these presumptions are typically not focused on in FTB audits. The first presumption is that a taxpayer who, in the aggregate, spends more than nine months of a tax year in California is presumed to be a California resident. On the other hand, periods of even less than six months in California can still result in California residency.

The second presumption is that an individual whose presence in California does not exceed six months within a tax year and who maintains a permanent home outside of California is considered to be in California for temporary or transitory purposes—i.e., a nonresident—*provided the taxpayer does not engage in any activity or conduct business within the state other than as a seasonal visitor, tourist, or guest.* This presumption is the source of the infamous "six months and a day" rule, and it can easily be overcome by the FTB. For example, as noted above, the FTB can still find California residency by showing that, even though someone was in California for less than six months, the time they spent in California exceeded the time they spent in any other state.

Taxpayers typically bear the burden of proof in tax matters, including California residency issues. The one major advantage for your clients is that they have the ability to control every factor they can and document it ahead of time. The FTB won't know about a change in residence until after it is reported, and it is relatively easy for your clients to document things like the date they actually moved (moving van documentation is very persuasive) and joining charities, country clubs, and participating in religious organizations in their new state of residence.

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