Multistate Residency: Planning Ahead to Minimize Taxes

Planning Update | November 2018

Prepared by:

Ryan Davis, Wealth Planner, Abbot Downing

Jennifer Drahos, Senior Wealth Planner, Abbot Downing

Summer in Massachusetts. Winter in Florida. Working in New York. Commuting home to New Jersey. Mobility across state lines is a frequent aspect of American life. Although travel between states is seamless, the tax laws between states can trip up unwary individuals. If time is divided between multiple states, individuals can often find themselves in the situation of fending off competing claims for tax dollars. While individuals can have connections to multiple states, they can have only one domicile at a time. An individual's domicile state will usually have the primary claim to income taxes. However, other states with connections to the individual may also have claims to taxing authority. Individuals can mitigate the risk of double taxation by understanding and documenting domicile, preparing for audits by state taxing authorities, and taking advantage of credits when possible.

Common Income Tax Scenarios

An individual's domicile is the state where the individual intends to have a primary residence and where the individual behaves accordingly. Domicile is important because that state will have a claim to the individual's worldwide income regardless of where that income originates. However, the existence of 50 states and the District of Columbia means there are many jurisdictions that could levy income taxes when an individual has connections to multiple states. States other than a domicile state may attempt to lay claim to parts of an individual's income. The overlap between the worldwide claim of the domicile state and the particular claims of other states raises the prospect of double taxation. In practice, a few states do not have income taxes at all, and the states that do have income taxes adhere to a set of rules based around common definitions. Knowing these definitions is the first step in planning. Since multistate income tax issues arise in a few predictable scenarios, the following examples illustrate how the rules apply:

- **Domiciled in Two States During One Year.** If an individual moves their domicile from one state that has an income tax to another state that has an income tax, the individual will inevitably owe an income tax liability to each. Each state may consider the individual a part-year resident for the time spent in that state; therefore, a part-year income tax return may be required to be filed in each state. For states that do not have part-year income tax returns, the individual may be required to file a nonresident income tax return for the state from which they moved. Income earned while domiciled in the previous state will be taxed to that state. Going forward, the state to which the individual has moved is the new domicile, and resident income tax returns will be filed under that state each year.
- **Living in One State and Commuting for Work to Another.** For an individual living near state lines, this will be a familiar scenario. In this scenario, an individual is domiciled in one state, but receives income sourced from the other state where they work. The individual is likely considered a "statutory resident" of the state in which they work. Statutory residency is a legal status where an individual becomes a deemed resident of a state even if that individual's domicile is another state. Many states consider anyone spending 183 days in the state during the year to be a deemed resident. Therefore, the individual owes taxes to the domicile state and the other state that claims the individual as a resident. Income tax returns will be filed in both states and a credit will be claimed on the

income tax return for the state in which the individual is domiciled, as available, to prevent double taxation. When an individual has a domicile in one state and deemed residency in another state, this is typically referred to as "dual residency."

- **Working or Living in Multiple States.** For many professionals who travel regularly for work, this scenario may subject them to the taxing authority of several states. If an individual is mobile and spends enough time working in other states, that individual can then become subject to the income tax of those states. Note that for extremely mobile professionals who spend a great deal of time in a number of places, these taxing rules might mean their income is taxed by three or even more states.

  A common variation of this scenario is an individual who lives a "snowbird" lifestyle and spends large blocks of time in different states based on the season. Such individuals should be especially cognizant of which state is truly their domicile state and which state might try to classify them as a deemed resident. Depending on the particulars, an individual may be considered a resident or a nonresident. The individual will still owe income tax liability to states other than the state of domicile. When an individual does not fall into the definition of a statutory resident but still owes taxes to another state, a nonresident income tax return will need to be filed.

- **Income from Business Interests in a State Other Than the Domicile State.** While the above scenarios describe ways that earned income can become subject to the taxing authority of multiple states, receiving income from business interests may also trigger the income tax of additional states. Owning rental real estate, a farm, or any business interests that are pass-through entities (partnerships and S-corporations) may all require income taxes be paid to a state other than the state in which an individual is domiciled. In this scenario, the individual's income has the contact with another state, not the individual themselves. The individual will usually file a nonresident tax return in the state where the income is sourced and a resident return in the domicile state.

Leaving a State and Establishing a New Domicile

Individuals who divide their time between multiple states should have a clearly established domicile. Multiple states may still lay claim to the income of the individual, but having a clearly established domicile will help bolster the individual's ability to argue their case. Determining where an individual is domiciled is a test based on facts and circumstances that show an individual's intent. An individual must demonstrate intent to establish domicile in a particular state. The reverse concept is equally as important. Changing domicile involves more than leaving one state: the individual must also "land" in another by showing changes in lifestyle. Action must be taken consistent with the intent to move from one place to another. Doing so does not require a complete severing of ties with the old state but does require material changes.

The following actions indicate an intent to establish domicile:

1. Registering a car in the state of domicile
2. Registering to vote in the domicile state (and actually voting there)
3. Possessing a driver's license issued by the domicile state
4. Receiving mail in the domicile state
5. Executing estate planning documents under the laws of the domicile state
6. Seeing doctors and dentists in the domicile state
7. Filing a declaration of domicile, if available
8. Spending at least 183 days in the domicile state
9. Filing all federal and state tax returns using the domicile state address and claiming the domicile state as the state of residency

When determining if domicile has successfully changed, the inquiry will focus on whether the individual's actions belie where they truly consider their domicile:

1. Home – Where does the individual consider their one true home?
2. Time – Where does the individual spend most of their time?
3. Business – Where does the individual conduct most of their business?
4. Family – Where is the individual's spouse, significant other, minor children?

5. “Near and Dear” – Where are the items located that the individual considers near and dear to them (sometimes considered the “teddy bear” test)? This test considers home furnishings, clothing, etc. as well as special items such as family heirlooms, favorite pieces of artwork, jewelry, etc.
6. Return test – Where does the individual go when they return from vacation, business trips, etc.

Credits

Filing state income taxes may be challenging for an individual who lives and/or works in more than one state. Filing rules vary by state and depend on whether an individual is a nonresident or a part-year resident of states other than the state of domicile. Fortunately, states offer tax credits to provide some fairness to this system.

An individual may receive a credit only for income that is subject to double taxation. If taxes owed to the nonresident state are higher than taxes owed to the state of domicile, a credit is limited to the amount of taxes due to the domicile state. An individual cannot receive a credit higher than the amount owed to the state of domicile.

If an individual earns income in a state as a nonresident, they will be required to pay taxes on that income to the nonresident state. The individual will also be required to pay taxes to the nonresident state on income generated from assets owned in that state. The individual must still pay taxes to the state of domicile on that same income. Some states provide credits to individuals on the domicile state income tax returns for taxes paid to the nonresident states.

If an individual is a part-year resident in two or more states, taxes will be paid to the state on income earned while a resident there as well as income from other sources while a part-time resident. States may separate the income earned in each state and only tax income earned while living in that respective state.

Audits by State Taxing Authorities

Time spent planning how to remove connections with a state and how to establish domicile in a new state will be invaluable if an individual later gets notice of a state-level audit.

Each state has the authority to examine tax returns for accuracy and fraudulent reporting. State taxing authorities face pressure to bring in tax revenue, and high-income taxpayers and individuals with complicated multistate income tax liabilities are much more likely to be audited than the general population.

An audit by a state taxing authority will usually begin like an IRS audit: an individual will receive a letter indicating they are being examined. The state taxing authority may ask for supporting documentation about the information reported on prior year tax returns. Common items of interest for a state audit are the same as those for a federal audit: business deductions, large charitable deductions, and losses. For individuals with multistate income tax liabilities, claimed credits may also be examined. Good recordkeeping and documentation are helpful to be able to respond to any requests. Individuals and their CPAs should keep thorough records of income and expenses that are reported on all tax returns.

A state taxing authority may also conduct a residency audit for individuals who have significant connections to a state but do not claim to be domiciled there. For example, a residency audit might result from a change in claimed domicile if an individual is now claiming to be domiciled in another state known for its low or nonexistent income taxes. In some instances, residency audits may require individuals to prove a negative: that they were not in a state.

An analysis of residency can be invasive because domicile is based on many aspects of an individual’s life. An individual living in two states would submit evidence as proof their life is based primarily in another state according to the domicile factors discussed previously. In some instances where an individual has homes in more than one state, they may be asked to demonstrate domicile to the state taxing authority through photographs and documentation of where near and dear personal items are kept. Individuals may also be asked to demonstrate proof of travel and proof they were out of state at various times. In recent years, smartphone applications with location tracking have been used to document out-of-state travel. Auditors may even examine public social media posts for activities that indicate domicile and provide evidence of an individual’s whereabouts. The key to success in any type of audit is the same: good recordkeeping maintained on an ongoing basis.

State Wealth Transfer Taxes

While the above discussion focuses on income tax issues associated with living and working in multiple states, families of substantial wealth should also consider state-imposed wealth transfer taxes. Wealth transfer taxes are taxes imposed on assets held at death or received at someone else's death. Twelve states and the District of Columbia impose their own estate tax. Six states impose an inheritance tax, which is a tax paid by the recipient of an inheritance (as opposed to the person leaving the inheritance). While some states provide a state estate tax exemption that matches the federal estate tax exemption amount, other states are "decoupled" from the federal exemption amount and provide for a much lower exemption amount. Recently, the trend has been for states to abolish wealth transfer taxes, but this trend could reverse if states require more tax revenue in the future or if changes in federal estate tax laws prompt states to re-impose their own wealth transfer taxes.

State-imposed wealth transfer taxes can easily blindside unprepared families. Wealthy families should work with their estate planning attorneys to discuss state wealth transfer taxes and to account for such taxes. As with income taxes, options are available to plan for wealth transfer taxes. For state estate taxes, planning will need to be written directly into will and trust documents to take advantage of exemptions and to create necessary trusts. Individuals that are residents of a state that has wealth transfer taxes may also consider moving to a state with a more favorable wealth transfer tax environment. This can be especially appealing for older individuals with substantial financial assets who may want to move to a state that will neither impose income taxes on distributions from retirement accounts nor impose an estate tax. Even a family that is not resident in a state that imposes wealth transfer taxes may find itself facing a tax bill after the death of a loved one. Owning real estate in another state, such as a vacation home or rental property, can subject the real estate's owner to a nonresident estate tax at death.

Conclusion

Managing the complexities of state-level taxes can be challenging. Changing domicile from one state to another is a process that requires time and thoughtful planning. Navigating credits and state audits can be time consuming. Even death does not guarantee that the challenge is over as an individual's estate may be subject to state wealth transfer taxes. The good news is that with the forethought to be aware of and to plan for such complexities an individual can have connections to multiple states and still minimize taxes. We encourage you to discuss the issues with your Abbot Downing Relationship Manager or Wealth Planner. Additionally, having conversations with tax and legal advisors about state tax issues and residency is an indispensable step in the planning process.

Abbot Downing, a Wells Fargo business, provides products and services through Wells Fargo Bank, N.A., and its various affiliates and subsidiaries. Wells Fargo Bank, N.A. is a bank affiliate of Wells Fargo & Company.

This report was prepared by Abbot Downing. Information and opinions presented have been obtained or derived from sources we consider reliable, but we cannot guarantee their accuracy or completeness.

Wells Fargo and Company and its affiliates do not provide legal advice. Please consult your legal advisors to determine how this information may apply to your own situation. Whether any planned tax result is realized by you will depend on the specific facts of your own situation at the time your taxes are prepared.

© 2018 Wells Fargo Bank, N.A. All rights reserved. Member FDIC. WCR-1118-00221