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Domicile Planning for Individuals, Estates and Trusts: Key State Tax Issues and Shifting Residency to Maximize Tax Benefits

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Domicile Planning for Individuals, Estates, and Trusts

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February 20, 2020

Holland & Knight

Program Outline

- What is “domicile” and why may a change of domicile be desirable?
- Changing and maintaining domicile
- How is the “situs” of a trust determined, and how does situs impact the trust grantor and beneficiaries?
- Should the trust(s) move too?

Residency v. Domicile

- One or many
- Can be temporary
- Intent not required
- May still be subject to tax

- One at a time only
- True, fixed, and permanent home
- Intent to return required
- Continues until abandoned and new domicile acquired
- Subject to tax
- Determined by looking at a number of factors, based on facts and circumstances at that time

Why change domicile?

- Taxes
  - Most states impose an income tax (exceptions: Alaska, Florida, Nevada, South Dakota, Texas, Washington, Wyoming)
  - Estate tax
    - Connecticut
    - District of Columbia
    - Hawaii
    - Illinois
    - Maine
    - Maryland
    - Massachusetts
    - Minnesota
    - New York
    - Oregon
    - Rhode Island
    - Vermont
    - Washington
  - Gift tax
    - Connecticut
  - Other taxes
    - Property tax, sales tax, “sin” tax

Why change domicile? (ctd.)

- State-specific laws/benefits
  - Rights of publicity (lifetime and post-mortem)
  - State specific exemptions (example: Florida’s homestead exemption)
  - Who may (or may not) serve as a fiduciary
  - Asset protection
- Cost of living
- Family
- Retirement
- Schools
- Health care
- Weather

Domicile - Factors

- Place of birth
- Current residence
- Time spent in each state
- Ownership of real estate (real property or shares in a cooperative corporation)
- Business activities/employment
- Family ties
- Place where individual leaves from/returns for trips
- Location of personal effects, including pets
- Membership in houses of worship, social clubs, charitable boards and groups

Domicile – Factors (ctd.)

- Locations of safe deposit boxes and bank accounts
- Voter registration
- Car registration
- Driver's license
- Address for bills, bank statements
- Resident status and address listed on federal and state tax returns
- Local newspaper subscriptions
- Descriptions in legal documents, including estate planning documents and declaration of domicile

The Specifics: State by State
Florida

For purposes of the homestead exemption, Section 222.17, Florida statutes, provides as follows:

- Single home: “Any person who shall have established a domicile in this state may manifest and evidence the same by filing in the office of the clerk of the circuit court for the county in which the said person shall reside, a sworn statement showing that he or she resides in and maintains a place of abode in that country which he or she recognizes and intends to maintain as his or her permanent home.”
- Multiple homes: “Any person who shall have established a domicile in the State of Florida, but who shall maintain another place or places of abode in some other state or states, may manifest and evidence his or her domicile in this state by filing in the office of the clerk of the circuit court for the county in which he or she resides, a sworn statement that his or her place of abode in Florida constitutes his or her predominant and principal home, and that he or she intends to continue it permanently as such.”

The Specifics: State by State
Florida (ctd.)

For purposes of the Florida estate tax, Section 198.015, Florida Statutes, provides with respect to the domicile of a decedent as follows:

- (1) For the purposes of this chapter, every person shall be presumed to have died a resident and not a nonresident of the state:
  - (a) If such person has dwelt or lodged in the state during and for the greater part of any period of 12 consecutive months in the 24 months next preceding death, notwithstanding the fact that from time to time during such 24 months such person may have sojourned outside of this state, and without regard to whether or not such person may have voted, may have been entitled to vote, or may have been assessed for taxes in this state; or
  - (b) If such person has been a resident of Florida, sojourning outside of this state.
- (2) The burden of proof in an estate tax proceeding shall be upon any person claiming exemption by reason of alleged nonresidency. Domicile shall be determined exclusively in the proceedings provided in this chapter, and orders relating to domicile previously entered in the probate proceedings shall not be conclusive for the purposes of this chapter.

*Note: does not apply to decedents dying on or after 1/1/2005

The Specifics: State by State
California

- Section 17014(a) of the California Revenue and Taxation Code defines "resident" to include:
  - (1) Every individual who is in this state for other than a temporary or transitory purpose
  - (2) Every individual domiciled in this state who is outside the state for a temporary or transitory purpose
- Any individual who is not a California resident is a "nonresident"
- Rebuttable presumption of California residency when an individual is present within California for more than 9 months of a taxable year

The Specifics: State by State
California (ctd.)

- California recognizes that “residence” and “domicile” are separate and distinct concepts for California income tax purposes
- To change domicile, the California State Board of Equalization has required a showing that a taxpayer:
  - (1) left the state without any intention of returning
  - (2) was located elsewhere with the intention of remaining there indefinitely

  →Reality: Simply “intending” to move from California is not sufficient by itself to establish a change of domicile

The Specifics: State by State California (ctd.)

- Analysis includes
  - "Closest connections" – compares the taxpayer's contacts with the new place of abode to the contacts with the former place of abode
    - "Bragg factors" include, but are not limited to: location of real estate, state where spouse and children reside, state where children attend school, state where taxpayer claims homeowner's property tax exemption on residence, taxpayer's phone records, number of days the taxpayer spends in California v. other states (and purpose of those days), location where tax returns are filed and state of residence claimed by the taxpayer on the returns, location of the taxpayer's bank and savings accounts, origination point of the taxpayer's checking account and credit card transactions, the state where the taxpayer maintains memberships in social, religious, and professional organizations, the state where the taxpayer registers his automobiles and maintains a driver's license . . .

The Specifics: State by State
New York

- Under 605(b) of Article 22 of the New York Tax Law, a resident of New York State ("NYS") is one who:

  - Is **domiciled** in NYS (for more than 30 days/year)
    - "the place which an individual intends to be such individual's permanent home – the place to which such individual intends to return whenever such individual may be absent."

  or

  - Is a **statutory resident**
    - someone who is NOT domiciled in NYS but who maintains a permanent place of abode in this state and
    - spends more than 183 calendar days of the taxable year in this state
      - Exceptions: active service in the armed forces, in New York only to travel outside of New York, or for emergency medical care

The Specifics: State by State
New York

NYS 2014 Nonresident Audit Guidelines

- Burden is on the party asserting the change of domicile, i.e., the taxpayer, to demonstrate with <u>clear and convincing evidence</u> that he has effected a genuine change of domicile (or was never domiciled in NYS)

- NYS examines 3 separate and distinct areas during the audit of a nonresident individual:
  - Domicile
  - Statutory residency
  - Income allocation

The Specifics: State by State New York (ctd.)

- Primary Factors
  - Home
    - Use and maintenance of a residence in NYS, compared to the nature and use patterns of a non-NYS residence
    - Auditor may evaluate attempts to sell, ownership, size and value of residence, nature of use, number and type of domestic employees
  - Active business involvement
    - Auditor looks to the individual's pattern of employment
    - Actual location one element, but NYS considers degree of involvement by the individual in day-to-day operations
  - Time
    - Auditor will compare the time spent in NYS in relationship to the time spent in other locations
    - NYS is a "day-counting" state

The Specifics: State by State
New York (ctd.)

Primary Factors (ctd.)

- Items “near and dear”
  - Location of personal effects, including family heirlooms, art, collections of books, stamps, and coins, even pets
- Family connections
  - Generally limited to individual’s immediate family when necessary (individual, spouse/partner, minor children)
  - Location where minor children attend school
  - Focus on living patterns established by taxpayer
  - Spouses can have different domiciles
- Other factors which are subordinate to the “Primary Factors”, including:
  - Address for bank statements, bills, correspondence
  - Physical location of safety deposit box
  - Vehicle registrations and corresponding license’s
  - Voter registration
  - Possession of Manhattan Parking Tax exemption
  - References in legal documents
  - Analysis of telephone services at each references

The Specifics: State by State New York (ctd.)

- Nonfactors
  - Location where the Will is probated
  - Passive interest in partnerships or small corporations
  - Mere location of bank accounts
  - Contributions made to political candidates or causes
  - Location where taxpayer's individual income tax returns are prepared and filed
  - Charitable contributions
  - Volunteering for nonprofit organizations

Pre-domicile planning

- Leaving the original state
  - Former primary residence
    - Consider the sale of real property or cooperative corporations located in the original state
    - If not going to sell, then consider the transfer of the former primary residence to a LLC or similar entity so it looks less like a personal residence
  - Taking objective steps to inform the original state of new domicile
    - For example, file a Massachusetts License Cancellation Request Form

Pre-domicile planning (ctd.)

- Leaving the original state (ctd.)
  - Update address to the address of residence in the new state
    - Credit card statements
    - Address on checks
    - Stationary
  - Inform social organizations, charitable entities, houses of worship, etc...in the original state of the move to the new state
  - Relinquish non-professional state licenses
    - Hunting licenses
  - Remove any resident discounts
    - Residential parking
    - Toll passes

Pre-domicile planning (ctd.)

- Arriving in the new state (ctd.)
  - Find medical providers in new state
  - Supplement or replace existing advisors with advisors in the new state
    - Legal
    - Financial
    - Accountants
  - Register minor children in schools in the new state
  - Register automobiles, boats, airplanes, etc… in new state
    - Physically move the items as soon as possible
    - Comply with sales and use tax laws in the new state
  - File tax returns using address of the residence in the new state

Pre-domicile planning (ctd.)

- Arriving in the new state (ctd.)
  - Purchase real property or sign a long term lease for a residence that is comparable (or better) than the residence in the original state
    - Move “near and dear”/tangible personal property to new location
  - Engage local attorneys located in the new state to advise on the residency laws of the new state
    - Update estate planning instruments to comply with new state laws
    - Review nuptial agreements to determine whether a state specific amendment is necessary
    - Analyze elective share and divorce laws of the new state
    - Analyze community property versus common law jurisdictions

Pre-domicile planning (ctd.)

- Arriving in the new state (ctd.)
  - File declarations of domicile or similar publicly recorded documents, if possible, in the new state
    - For example, in Florida, a declaration of domicile may be filed in the new county of residence
  - Determine requirements and deadlines for the following:
    - Voter registration
    - Homestead exemption, if available
  - Consider a new cellphone number in the new state
  - Find a new gym, house of worship and social organizations
  - Open new bank and investment accounts in new state
    - Transfer assets to new state
    - Does the new state offer tenancy by the entireties or any different forms of ownership?

Pre-domicile planning (ctd.)

- Arriving in the new state (ctd.)
  - Safe deposit boxes
    - Open a safe deposit box, if necessary, in new state
    - Close safe deposit box in original state
    - Move any assets and important documents to the new state
  - If employed, seek employment in the new state or see about opening an office in the new state
  - Consider relocating closely held business, or opening a branch of the closely held business in the new state

Making the new domicile stick

- Timely file homestead application in new state, if applicable
  - For example, Florida and Texas
- Become socially, religiously and charitably involved in the new community
- File last resident income tax return/non-resident income tax return in former state
- Stay out of the former state and keep immediate family members out of the former state as much as possible
- Avoid airport layovers in the former state
- Vote in the new state
- Spend meaningful (or required time) in the new state

Making the new domicile stick (ctd.)

- Carefully review all legal documents and applications
  - Addresses or declarations of domicile or residence on notes and mortgages, estate planning documents, etc…
  - Social security and Medicare/Medicaid forms
- Lawsuits in the new state
- Pre-mortem planning
  - Seek medical treatment in the new state
  - Pass away in the new state
  - Ensure death certificate has the new state's address for residence of the decedent
  - File for probate in the new state
  - Bury (or cremate) decedent in the new state
  - Hold memorial service in the new state

Domicile Audits

- Income tax audit
  - Maintaining records during audit window
    - Flight records
    - Credit/card ATM records
    - Car transponder/toll records
    - Calendar of location
    - Cellphone records
  - Burden will be on the taxpayer to prove he or she was not in the former state
- Gift tax audit
- Estate tax audit
  - May span a period of years
    - For example, nonresident affidavit for Massachusetts asks about a five year period before death

Federal Income Taxation of Non-Grantor Trusts

- Taxable income = gross income on worldwide income, less certain deductions
- Income is taxed
  - Trust level
    - Assessed against taxable income that the trust recognizes but is not distributed to the beneficiaries in a tax year
  - Beneficiary level
    - Assessed against taxable income that the trust recognizes and distributes in the same tax year
    - Trust gets "income distribution deduction"
    - Beneficiaries who receive income will be issued a "Schedule K-1" to report the income on the individual income tax returns in the same year that the trust claims the distribution deduction

Basis for Imposition of State Fiduciary Income Tax

- "Resident Trust" – 43 states + DC rely on one or more of the following criteria:
  - Residence of the grantor at creation of irrevocable trust/domicile of testator at death (testamentary trust)
  - Residence of the trustee
  - Governing law set forth in the trust instrument
  - Beneficiary's residence

- The definition of a "resident trust" is state-specific, so trusts are not taxed consistently from state to state

- Steady stream of constitutional challenges to the state income taxation of trusts when it appears that a trust has no "nexus" to the state, including a recent challenge before the US Supreme Court

The Specifics: State by State
New York

- Resident Trusts
  - A trust created by a New York testator or trustor as follows:
    - (B) a trust, or a portion of a trust, consisting of property transferred by Will of a decedent who at his death was domiciled in this state, or
    - (C) a trust, or portion of a trust, consisting of the property of:
      - (i) a person domiciled in this state at the time such property was transferred to the trust, if such trust or portion of a trust was then irrevocable, or if it was then revocable and has not subsequently become irrevocable; or
      - (ii) a person domiciled in this state at the time such trust, or portion of a trust, became irrevocable, if it was revocable when such property was transferred to the trust but has subsequently become irrevocable

      NY Tax Law §605(b)(3)(B)-(C)
  - NYS taxes all NY taxable income of Resident Trusts
- Nonresident Trusts
  - A trust that is not a resident trust
  - NYS taxes only NY-source income of Nonresident Trusts

  NY Tax Law § 618

*Reminder: Trustees must make estimated tax payments for trusts!

The Specifics: State by State
New York

- Nonresident Resident Trust Exemption
  - A Resident Trust is not subject to tax if there are no NYS trustees, assets, or source income as follows:
    - (I) all the trustees are domiciled in a state other than New York;
    - (II) the entire corpus of the trusts, including real and tangible property, is located outside the state of New York; and
    - (III) all income and gains of the trust are derived from or connected with sources outside of the state of New York, determined as if the trust were a non-resident trust.
      - NY Tax Law § 605(b)(3)(D)(i)
  - Example: a trust that has nonresident trustees and intangible assets (stocks and bonds)
  - Practice tip: A Trustee could consider transferring tangible personal property or real property held by the trust into a LLC, converting it into intangible personal property

*Practice tip: Consider dividing trust to segregate NY source income!

The Specifics: State by State
Delaware

300 DE Code § 1601 (8)

(8) "Resident Trust" means a trust:

a. Created by the will of a decedent who at death was domiciled in this State;
b. Created by, or consisting of property of, a person domiciled in this State;
c. With respect to the conditions of 1 of the following paragraphs are met during more than ½ of any taxable year:

1. The trust only has 1 trustee who or which is:
   A. A resident individual of this State, or
   B. A corporation, partnership or other entity having an office for the conduct of trust business in this State;
2. The trust has more than 1 trustee, and 1 of such trustees is a corporation, partnership or other entity having an office for the conduct of trust business in this State; or
3. The trust has more than 1 trustee, all of whom are individuals and ½ or more of whom are resident individuals of this State.

The Specifics: State by State
States That Do Not Impose Fiduciary Income Tax

- Alaska, Florida, Nevada, South Dakota, Texas, Washington, Wyoming

N.C. Dep't of Revenue v. Kimberley Rice Kaestner 1992 Family Trust

- 1992: NY grantor creates an inter vivos, irrevocable trust for the benefit of 3 children
  - Fully discretionary trust
  - New York law governs
  - No North Carolina ties (no NC beneficiaries, trustee, or property)
- 1997: Kimberley moves to North Carolina
  - Trustee decants (pursuant to NY statute) to eliminate termination provision
- 2005-2008: NC imposes tax under NCGS § 105-160.2 on trust "for the benefit of a resident"
  - No distributions to Kimberley
  - NY trustee
  - MA bank account
- Key take-aways:
  - Narrow holding and limited "to the specific facts presented"
  - The presence of in-state beneficiaries alone did not empower North Carolina to tax income accumulated in a trust

N.C. Dep't of Revenue v. Kimberley Rice Kaestner 1992 Family Trust (ctd.)

- Planning post-Kaestner
  - Structure new trusts to qualify as a "resident" trust of a tax favorable jurisdiction
    - Governing law (including flexibility to change situs and governing law)
    - Trustee
    - Trustee should be "picky" when selecting trust investments
  - For existing trusts in high tax jurisdictions, consider a variety of "fixes"
    - Small changes → big impact
      - Trustee
      - Situs
    - Decant
    - Other alternatives (modification, merger, etc.)

Considerations for Moving a Trust

- Should the trust move too?
  - Move out of state that may impose income taxes based on the location of the fiduciaries
  - Move out of a state that may have residency questions upon the death of the grantor or a beneficiary

- Where should the trust move to?
  - New State
  - Neutral state
    - South Dakota
    - Delaware
    - Nevada
    - Alaska

Considerations for Moving a Trust (ctd.)

- Legal and Administrative Considerations
  - Consider the perpetuity period of the original state versus the new state
  - Fiduciary considerations
    - Ability to direct the fiduciaries?
    - Can the current fiduciaries serve?
    - Liability concerns
  - Generation-skipping transfer ("GST") tax considerations
  - Secret trusts
  - Consent and notice requirements of both states
    - Qualified beneficiaries (or designated representative)
      - Does virtual representation apply?
    - Grantor
    - Fiduciaries

Considerations for Moving a Trust (ctd.)

- What methods are available to decant or modify a trust?
  - Statutory
  - Case law
- Ways to move a trust (if determined to move)
  - Decanting to a new trust created under the laws of the new state (or a tax neutral state)
    - Brand new trust created under the laws of the new state
    - Report seed gift to the new trust to the IRS on a timely filed Form 709 (US Gift Tax Return)
    - Maintain perpetuity period of original trust in the new trust to maintain GST status
  - Consider a sale if limited perpetuity period in original state trust and you have grantor trusts or no material adverse income tax consequences

Considerations for Moving a Trust (ctd.)

- Ways to move a trust (if determined to move) (ctd.)
  - Modifications
    - Judicial or nonjudicial
    - Changing terms of existing trust
      - For example, changing the governing law of the trust to the new state or neutral state
  - Change of Principal Place of Administration (situs)
    - Consent and notice requirements by qualified beneficiaries, grantor and fiduciaries
    - Maintaining the same trust terms
- Reporting the move to the original state
  - Final trust income tax return in prior principal place of administration
- Reporting the move to the qualified beneficiaries to start statutes of limitations in original state

Questions?

Thank you

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