FINANCIAL PLANNING UPDATE

Should you Change Your State of Domicile?

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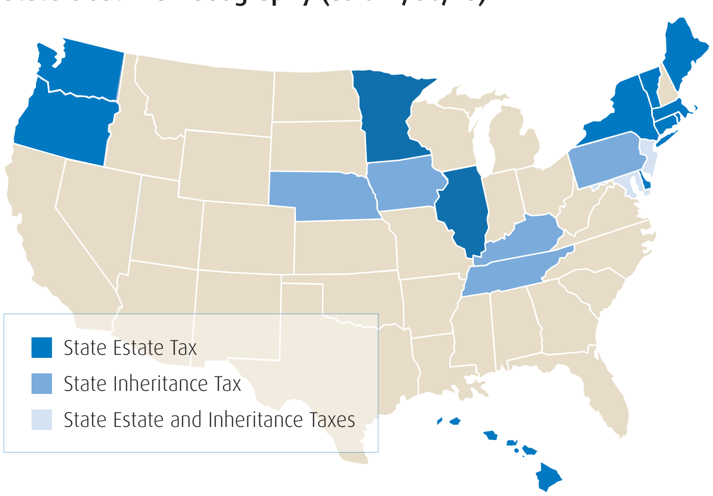
Traveling to warmer climates for the winter is a tradition for many families, as is taking advantage of southern tourism states with lower income taxes. Increasing interest in changing domicile — the location of a person's fixed, principal and permanent home — to select the best state for tax purposes is becoming more common. This trend began to accelerate about 10 years ago with the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") and the real estate bubble that occurred during that time.

When EGTRRA increased the estate tax exemption amount to $1,000,000 and scheduled subsequent increases in estate tax exemption through 2010, the state death tax credit was replaced with a state tax deduction to help pay for that change. As a result, some states saw their estate tax phased out, while other states saw death taxes continue. This left the US with some states with no state death taxes and others which impose a state estate or inheritance tax.

State Death Tax Geography (as of 7/30/13)



Note: Tennessee is in the process of phasing out its estate tax and the tax will be repealed effective 1/1/2016.

> "While a person can have multiple residences, a person can only have one domicile."

In the early 2000s, Florida took on heightened domicile interest. In addition to the attraction of moving to a warmer state with rapidly appreciating real estate values, effective January 1, 1995, Florida amended its laws to impose a cap on increases in the assessed value of property that was used as a primary residence. The Florida Save Our Homes property tax amendment imposed a 3% cap on property appreciation assessments. When the real estate bubble caused an annual increase in home property values ranging from 8% to 27%, Florida real estate tax bills for similar properties varied significantly based on whether the 3% cap applied.

Florida Real Estate Tax Case Study

Larry, an Illinois resident, and Jason, a Minnesota resident, each paid $200,000 in 1999 to purchase identical condo units in the same condo complex in Sarasota, Florida. After buying his condo, Larry changed his domicile to Florida. Jason retained his Minnesota domicile. When the real estate bubble peaked in 2007, each condo unit was worth $500,000. However, due to the 3% cap on property appreciation, Larry's home was assessed at $253,000, while Jason's home was assessed at $500,000. As a result, Jason paid about $6,500 in property tax and Larry paid about $3,300.

Let's take a closer look at domicile, the tax and estate planning consequences of a change in domicile, and recommended steps for making a change following consultation with one's tax, financial and legal advisors.

What is Domicile?

Domicile is the location of a person's fixed, principal and permanent home and is the place to which that person intends to return and remain even though currently residing elsewhere. Domicile is different than residency. **While a person can have multiple residences, a person can only have one domicile.** A person can reside in one state, but still be considered domiciled in another state to which the person intends to return. Once domicile is established in a particular state, it is presumed to continue until a person can show that a change in domicile has occurred.

States, especially the taxing authority of each state, will look at a number of factors to determine domicile. The factors considered will differ state to state and no one factor is determinative.

Relevant Factors to Determine Domicile Include:
Physical presence (amount of time spent in the state)
Residence (whether a person owns or rents a home in the state)
Employment
Family location
Real property ownership
Voting registration and actual voting
Driver's license
Automobile registration and location of most valuable cars
Bank accounts
Tax return filings
Memberships and licenses
Professional services (doctor, dentist, lawyer, accountant)
Location of valuables
Cemetery plots (yes, even those)

Termination of domicile may involve documenting and communicating the change in domicile to the appropriate taxing authorities. This can sometimes be more difficult to prove than establishment of domicile.

Why is Domicile Important?

Property ownership rules are governed by domicile. Laws of the state in which you are domiciled will determine a person's right to retain property and the rights of others to make a claim on your property. States may also impose taxes on a person domiciled in their state. From a planning perspective, taxes are probably the most important factor when considering the selection of your domicile. Asset protection and the rights of a spouse in the event of divorce may also be important considerations.

How Does Domicile Impact Your Taxes?

The chart at right shows how tax laws can differ in certain states. The laws apply depending on your place of domicile. The impact of the law will change depending on a person's amount of income, type of income, size of estate and value of the person's home. The following tax planning points are important to consider when selecting your domicile.

Income taxes

Selecting domicile in a state that imposes no income tax can be an effective tax reduction technique. However, a state can tax a nonresident on income that is earned in that state. This includes compensation earned in that particular state (wages, salary, deferred income, Subchapter S income and income from a partnership or LLC) and income earned from a state source (such as rental income or capital gains on real estate located in a particular state). If you continue to work in a particular state, but change your domicile to another state with no state income tax, you will not necessarily save income tax on your earned income.

State death taxes

Planning to minimize state death tax is simple. Except for real property that is located in another state, you avoid a state estate or inheritance tax if you change your domicile to a state that does not impose a state death tax. States that do impose an estate or inheritance tax will generally impose the tax upon the death of a person domiciled in that state or upon the death of a nonresident who owns real property located within that state.

Real estate taxes

Most states give their residents a small tax break if a home is used as a principal residence. Typically, the relief is in the form of a reduction in the assessed value of the home or a credit against the property tax amount. If you decide to change your domicile, it will be important to notify your current property tax assessor that you have moved and are no longer eligible for any homeowner tax relief.

Florida offers the most significant property tax relief to persons domiciled in that state. The $50,000 homestead exemption and 3% cap on property appreciation are important tax planning benefits.

Tax Laws from Selected States with BMO Private Bank Locations

State	Estate Tax	Estate Exempt	Income Tax Rate	Cap. Gains	Ret. Income	Social Security	Homestead Property Tax Relief	Fiduciary Income Tax
Arizona	No	N/A	2.59%-4.54%	All	Yes	No	School tax credit	2.59%-4.54% based on admin.
Florida	No	N/A	None	None	No	No	$50,000 exclusion plus 3% cap on appreciation	None
Illinois	Yes	$4 M	5%	All	No	No	$6,000–$7000 exclusion	5% based on domicile plus 1.5% replacement tax assessment on trust income
Indiana	Inher. tax repeal 2013	N/A	3.4%	All	Yes	No	Up to $45,000 exclusion plus supp. exclusion	3.4% based on admin.
Kansas	No	N/A	3.5%-6.45%	All	Yes	Yes	$20,000 exclusion	3.5%-6.45% based on admin.
Minnesota	Yes	$1 M	5.35%-9.85%	All	Yes	Yes	Up to $30,400 exclusion for homes <$413,800	5.35%-9.85% based on domicile
Missouri	No	N/A	1.5%-6%	All	Yes	Yes	Credit provided if age 65+ or disabled	1.5%-6% based on domicile
Washington	Yes	$2 M	None	None	No	No	Limited relief	None
Wisconsin	No	N/A	4.4%-7.65%	30% excl.	Yes	No	Lottery credit	4.4%-7.65% based on domicile

Fiduciary income taxes

Fiduciary income taxes — taxes imposed on irrevocable trusts — apply in states that impose a state income tax at rates similar to the individual state income tax rates. Fiduciary income taxes often apply to irrevocable trusts that become irrevocable when the creator of the trust (the "settlor") is domiciled in the state. Frequently, the event that causes the trust to become irrevocable is the death of the settlor. Thus to avoid fiduciary state income taxes, you are advised to change your domicile to a state without fiduciary income taxes before your trust becomes irrevocable. [Note: Some states do impose a fiduciary income tax on irrevocable trusts that are administered in that state.]

Impacts of a Change in Domicile

Common law vs. community property rights

Most states apply common law property ownership, meaning each spouse owns what is titled in the spouse's name. Some states, including Washington, Arizona and Wisconsin, apply community property ownership, meaning each spouse owns a 50% interest in each and every item of property.

Step-up in basis upon death of each spouse

A benefit of community property ownership is that all assets classified as community property will receive a full step-up in basis upon the death of each spouse. This may affect your capital gains tax exposure and is a reason why many people moving from a community property state to a common law property state may want to preserve the community property classification.

Estate planning documents

Your estate planning documents should be reviewed by legal counsel in the state to which you intend to change, or have changed, your domicile. We generally recommend that new financial and health care powers of attorney be prepared in the new state of domicile. You may also want to consider a joint trust and reliance on estate tax portability (with a $5.25 million exemption per spouse as of 2013), especially if you are moving from or to a community property state.

Homestead asset protection rights

As noted in the table above, asset protection on your home will vary from state to state. If you are concerned about asset protection, you will want to verify the impact of a change in domicile on your homestead exemption for creditor purposes.

Family law rights

Discussion of family law rights is beyond the scope of this article, but if you executed a pre-marital or post-marital property agreement, you will want to have that agreement reviewed and updated after you change your domicile.

Trust code rules

Rules that govern trusts vary from state to state. If you created an irrevocable or revocable trust as part of your estate plan, an intended change in domicile warrants a trust review to determine if the change will affect the terms of your trust.

Changing Your Domicile

Depending upon the state from which you are moving, the state department of revenue will likely scrutinize your move to the highest degree. Many states are beefing up their department of revenue staff to monitor changes in domicile.

We recommend working closely with your tax and financial advisors and legal counsel to consider all ramifications of a change in domicile and, if warranted, taking the necessary steps and precautions that will ensure a smooth transition. Remember these considerations:

- *Every state employs its own set of factors to establish new domicile or terminate an existing domicile.*
- *Termination of domicile is often more difficult to prove than establishing a new domicile.*
- *It falls on the taxpayer to "prove" that domicile has, in fact, changed.*

Conclusion

As you can see, changing your domicile is complex, especially if you retain a home in multiple states. There is no magic rule to prove a change in your domicile. However, a change in domicile can significantly benefit your financial and estate plan. We recommend that you consult with your financial adviser, lawyer and tax preparer to determine whether such a move is right for you.

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