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Generations Winter 2023 - Business Owners Face Unique Challenges With Domicile Planning

It is no secret that over the past few years, there has been a surge of high-income taxpayers relocating from states in the [Northeast](#) to low- or no-income-tax states like Florida. Many of these taxpayers include business owners with active operations and employees in the state they have left. Often these owners are looking to make the move in anticipation of a future sale of that business. As these [relocations](#) continue to impact state and city tax revenue, state tax audit rates will increase. Once a taxpayer establishes a domicile in a particular state, that domicile stays with the taxpayer until he or she can demonstrate by clear and convincing evidence that he or she has both (i) severed domicile in the former state *and* (ii) established domicile in the new state. The burden of proof lies with the party claiming that domicile has changed. Taxpayers looking to relocate their domicile in anticipation of a future sale of a business need to plan especially carefully.

The existence of a business in the former state of residence can impact a taxpayer's change of domicile in several ways. States will examine a variety of factors when looking to determine whether a taxpayer has actually changed domicile. The five primary factors that states most often scrutinize when a taxpayer changes domicile are (i) home, (ii) residence of family, (iii) time spent in each state, (iv) business activity and (v) the presence of personal items (objects that are "near and dear"). States focus a lot of attention on business activity in the state the taxpayer has left, looking at ownership, substantial investment, and active and consistent management of the business. If the state can argue successfully that a taxpayer's ties to business activity in that state mean that the taxpayer has failed to achieve a change in domicile, the taxpayer remains taxable in that state on all his or her income, not just the income from the business operating in the former state.

Taxpayers seeking to maintain ownership and control of a business operating in their former state while looking to change domicile will need to show changes in their operations that indicate that their activity in the new state is stronger than their activity in the former state. For example, a taxpayer might shift the management of their operations by renting or buying local office space, hiring local employees, and developing local business connections in the new state. The new office address should be used in communications (email and letterhead), marketing materials (websites and business cards) and transaction documents. For many businesses, this has become much easier with post-COVID-19 [remote work arrangements](#), where [businesses](#) can be headquartered anywhere and employees may be scattered around the globe.

Shifting ownership of interests in the business to other family members or trusts as part of the taxpayer's estate planning may also serve to establish that connections with the former state have been severed. Many states have authorized the creation of "directed trusts," which can assign investment, administration and distribution decisions among different parties. These trusts can make it easier for a taxpayer funding a trust with business interests to maintain control of the business while still giving his or her family the financial benefit of the gifted portion of the business. A change in business structure can also be helpful in proving a change of domicile. By shifting equity or relinquishing control of a business or, conversely, by expanding the business and moving the business into a new market, a taxpayer can demonstrate intent to abandon a former domicile and establish a new one.

When changing domicile as a business owner, it is also important to consider the sourcing of the operating income of the business (i.e., where the business income is generated) and from the potential sale of the business itself. Different types of operating income, such as sales of tangible property, income from services or rental income, may be sourced differently. The business owner must understand the sourcing rules, particularly in their former state of domicile, to ensure compliance with state tax laws.

The sale of a business also raises important considerations when changing domicile. When it comes to a sale of a business, sourcing rules vary by state and type of income generated by the business. Some states may source the income from the sale of a business based on the market in which the sale was made, while others may look to the location where the business operates. In general, the sale of intangible property, like stock in a corporation, is sourced to the state in which the owner of the stock resides at the time of sale. The opposite would be true for the sale of tangible property, like inventory, buildings or land, where gains are typically sourced to the place the property is located. The sale of partnership interests can vary depending on the percentage of the business sold, the state where the business is located and the domicile of the owner at the time of the sale.

In conclusion, when the owner of a business wishes to change domicile, it is important that he or she considers the impact that business activities will have on the overall domicile analysis. It is also important to understand the sourcing of income from sales and the potential sale of the business itself. As states continue to address revenue shortfalls with [aggressive tax proposals](#) and audits, it will become increasingly important for business owners looking to move to a new state to plan carefully and purposefully structure their exit.

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