Wealth Planning **Update**

Should you change your state of domicile?

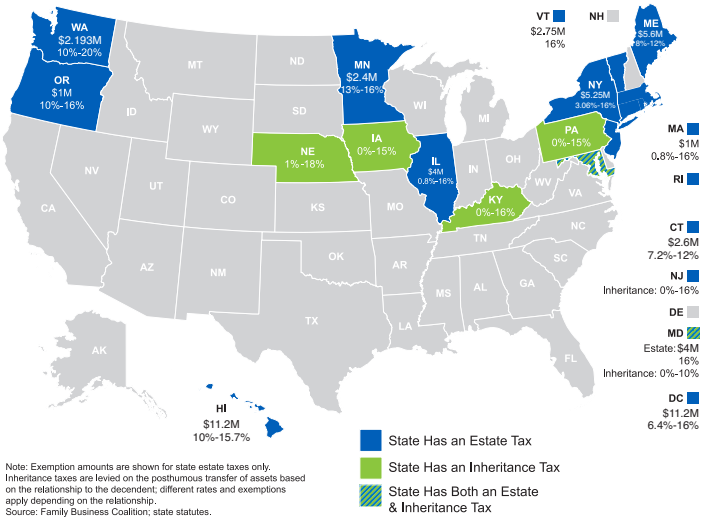
Traveling to warmer climates for the winter is a tradition for many families, as is taking advantage of southern tourism states with lower income taxes. Increasing interest in changing domicile—the location of a person's fixed, principal and permanent home—to select the best state for tax purposes is becoming more common.

This trend began to accelerate about 18 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 the 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 U.S. with some states with no state death taxes and others which impose a state estate or inheritance tax.

Does your State Have an Estate or Inheritance Tax?

State Estate & Inheritance Tax Rates & Exemptions 2018



Note: Exemption amounts are shown for state estate taxes only. Inheritance taxes are levied on the posthumous transfer of assets based on the relationship to the decendent; different rates and exemptions apply depending on the relationship.
Source: Family Business Coalition; state statutes.

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 assessment appreciation. 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 amended its property tax laws again in 2008 to differentiate between residents and nonresidents by increasing the homestead exemption amount from property tax for residents and adding portability of untaxed appreciation between home purchases. Further, Florida changed the nonresident annual increase cap to 10%.

Florida real estate tax case study.

Two neighbors purchased identical condos in 1999. Each condo had an estimated value of $500,000 in 2008 with a roughly 10% increase in value per year. The non-Florida domiciled owner (non-homesteaded) pays about $10,330 (2015) in tax. The Florida domiciled owner (homesteaded) pays about $5,630 (2015) in tax.

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 on the next page shows how tax laws can differ in certain states. The laws apply depending on your place of domicile. The impacts of the laws will change depending on a person's amount of income, type of income, size of estate and home value. 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.

Fiduciary income taxes.
Fiduciary income taxes—taxes imposed on certain estates and 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 consider changing your domicile to a state without fiduciary income taxes before your trust becomes irrevocable. *[Note: Some states impose a fiduciary income tax on irrevocable trusts that are administered in that state.]*

Tax laws from selected states with BMO Private Bank locations[1].

State	Estate Tax	Estate Exempt	Inc. 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	Up to $3,965 exclusion (or freeze) for qualifying persons and up to $502 income tax credit for qualifying seniors	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	4.95%	All	No	No	Generally, $6,000 exclusion and 5% income tax credit	4.95% based on domicile plus 1.5% replacement of grantor tax assessment on trust income
Indiana	No	N/A	3.23%	All	Yes	No	Up to $45,000 exclusion plus supp. exclusion and up to $2,500 income tax deduction	3.23% based on admin.
Minnesota	Yes	$2.4 M	5.35%–9.85%	All	Yes	Yes (Up to $4,500 of benefit may reduce income.)	Up to $30,400 exclusion for homes <$413,800 and up to $2,770 income tax credit for qualifying taxpayers	5.35%–9.85% based on domicile of grantor unless trustees, beneficiaries, and admin. are outside MN
Missouri	No	N/A	1.5%–5.9%	All	Pensions exempt subject to income limits	No (If age 62 and under qualifying income threshold; otherwise, may be eligible for partial exemption if age 62 or disabled.)	Up to $1,100 income tax credit provided if age 65+ or disabled	1.5%–5.9% based on domicile of grantor and income beneficiary
Wisconsin	No	N/A	4%–7.65%	30% exclusion on LT (60% of net LT gain on farm assets exclusion)	Yes (Certain public pensions excl. & $5,000 of private benefits subj. to income/ age limits)	No	Lottery & Gaming prop. tax credit reset each year and up to $300 income tax credit	4%–7.65% based on domicile of grantor

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 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 $11.4 million exemption per spouse as of 2019), especially if you are moving from or to a community property state.

Homestead asset protection rights.
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 possibly 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 may significantly benefit your financial and estate plan. We recommend that you consult with your financial advisor, lawyer and tax preparer to determine whether such a move is right for you.

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[1] Information herein is based on 2019 laws/rates (or 2018 laws/rates if 2019 not available).

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