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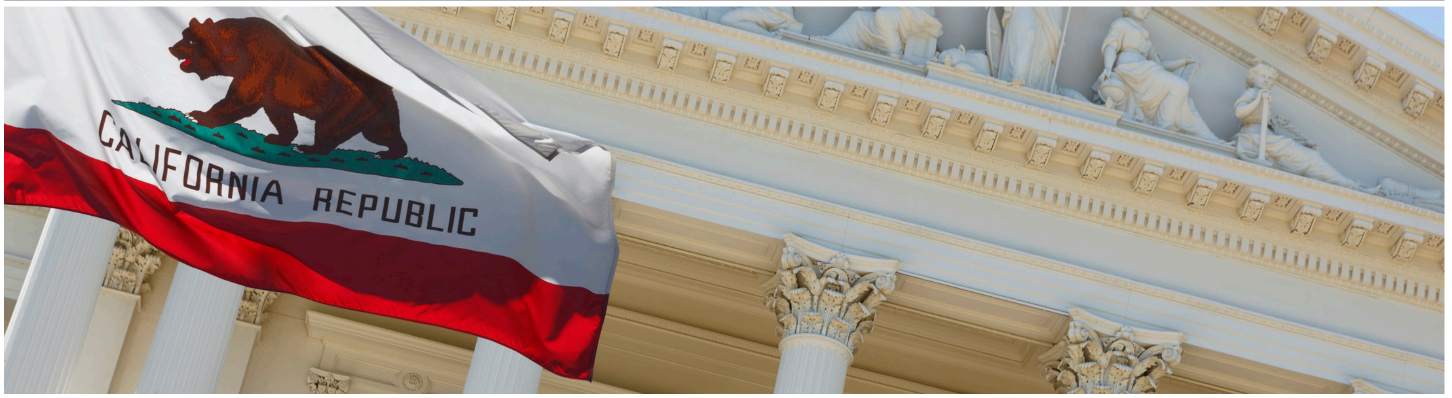

Pre-Liquidity California Personal Income Tax Planning for Owners of Closely Held Businesses

California's top marginal personal income tax rate of 13.3% is the highest in the country, and can make a serious dent in a California resident's after-tax proceeds from a liquidity event. As a result, many California residents may consider moving to a low or no tax state prior to selling their business. *We have the expertise to advise clients as to getting out of California prior to a liquidity event, and have successfully defended numerous residency audits*.

California Taxation of Residents and Nonresidents

California residents are subject to tax on their worldwide income. Thus, regardless of deal structure, a California resident will pay California personal income tax on 100% of his/her gain. California does not have favorable tax rates for capital gains—all income is subject to tax at the same rate.

In contrast, nonresidents are only subject to tax on their income from California sources. In an asset sale (including a deemed asset sale, such as an F Reorg or stock sale with a 338(h)(10) election) the gain will be apportioned at the entity level. As a result, a nonresident would typically owe California personal income tax on some, but not all, of the gain. However, gain from the sale of an intangible (such as ownership interests in a corporation, LLC, or partnership) by an individual is generally sourced to the individual's state of residence at the time of the sale. Thus, in a "pure" sale of stock or membership interests, a nonresident may avoid California personal income tax entirely.

California Taxation of Residents and Nonresidents

There is no "checklist" of items which, if completed, will establish non-residency. Nor does spending less than 6 months in California establish non-residency. The determination of whether or not someone is a California resident is a fact-specific analysis. What is sufficient for one individual may not be enough for another. We can assist clients with understanding how to best position themselves to successfully defend a residency audit, and the extent to which maintaining certain connections with California would impact the residency analysis.

A change in filing status from resident to non-resident in the year of, or prior to, a large gain event is highly likely to trigger a residency audit by the Franchise Tax Board. Residency audits can be incredibly intrusive, drag on for years, and request extensive documentation. The best defense in a residency audit is advance planning. It is critical to create and maintain documentation to support that the move out of California was real. It is also important to have an advocate "telling the story" behind the paper, and guiding the auditor to the proper conclusion. Both of these will materially increase the likelihood of a quick and successful resolution.

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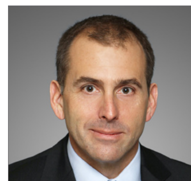

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