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Tax Residency Rules

The best way not to pay income tax in the mobile world is to make sure that you are not considered to be a resident in a particular tax jurisdiction. And this is within your control.

For this reason, many people leave California, which is one of the highest taxed states in the country, to a non-income tax state such as Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming. However nothing is free. These non-income tax states make up their treasury with other form of levies such as property tax, sales tax, utilities or others, such as oil revenue for Alaska, Wyoming and Texas, hotel occupancy tax for Nevada and Florida.

Once you establish residency in these non-income tax states, you will not have to pay for state income tax but you will still have to pay federal income tax. This tax saving could be as high as 10% to 12% of your taxable income depending on which state income tax you are saving.

So how do you establish residency in these non-income tax states. You need to have closer tie to these states than anywhere else. If you have closer tie to states that have income tax, these states will try to assert their tax authority on your income.
Closer tie includes, but not limited to, following factors:

1. Where your family lives,
2. Where driver license is registered with,
3. Where you are registered to vote,
4. Where you spend most of your time,
5. Where your work is, and
6. Where your assets are.

Even if you live in Nevada, if your business is in California, then your business will still be taxed in California on your business income. The term Nexus is used in tax law to describe a situation in which a business has a "Nexus" or presence in a state and is thus subject to state income taxes and to sales taxes for sales within that state. Nexus describes the amount and degree of business activity that must be present before a state can tax an entity's income. As the determination of Nexus is a factual finding, you should discuss with your tax advisor to determine how it affects you.

So what happens if you live in Nevada (closer tie) but have a business in California (Nexus). Since Nevada is a non-income tax state, you will not have any state income tax at your individual level. However, you will be taxed as non-resident by California on the California business income.

All states with income tax system tax non-residents on income generated from their state. As such, if you conduct a business in an income tax state that you are a non-resident, you will be taxed as a non-resident. However, you will only be taxed on the business or investment income from that state. You will need to file non-resident income tax return in the state that you have business or investment.

For highly paid individuals, such as athletes and performers, these states will tax non-residents on income generated from their state, even if the athletes and performers are not resident of their state. For the rest of us, we do not have to worry about the state income tax, on states that we are not residents, unless we have a business or investment in that state.

If you live in California and you conduct a business in Arizona, both states with income tax system, you will be able to get credit for state income paid in Arizona on your California income tax return. This credit mechanism ensures that you will not be taxed by both California and Arizona on same income.

For mobile business people, such as athletes and performers, establishing a corporation in a particular state to protect themselves from legal liabilities and from state income taxes may be beneficiary. You should discuss with your tax advisors to see whether you would benefit from setting a corporation in that state. Please note that you never put a real estate in a corporation, even S corporation, due to double taxation. You should consider using an LLC for real estate investment.

The way state income tax works is much like how international income tax works. Each state has an income tax mechanism, which is much like how different countries tax their residents and non-residents. As in state income tax system, the international tax system is based on residency, source of income and location of assets. In international tax setting, residency is also determined by closer tie but income tax treaty between two countries must also be considered. As in business, tax authorities compete to attract residents and businesses, much like accumulating customers. In such scenario, one can be pulled by both countries to be taxed. The tax treaty resolves many questions, when pulled by both countries. As discussed earlier, determining residency is within one’s control as such, a care should be made in determining which country would result in lowest level of taxation.

In state and international taxation, residency, Nexus (for state tax purposes), permanent establishment (for international tax purposes) and source of income determines your tax liabilities. However, these factors are all within your control. You should discuss with your tax advisors to make sure that you keep more of what you make.