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How Should Upcoming Tax Developments Influence Your Decision-Making?

Have you ever mused about moving to a different state because:

- The weather is better there,
- Taxes in the state you live in are high,
- Your city and state governments are fiscally irresponsible,
- Taxes are likely to increase even more, and
- Even essential public services might need to be cut.

Living in Chicago, Illinois, it is hard not to think about these things. Of course, Illinois does not have a monopoly on mismanagement, but it does have more than its fair share.

As the year 2020 approaches a close, there is much going on in terms of taxes and related matters that it is worthwhile for investors to pay attention and make conscious decisions. In this letter, we first present some data that shed some light on why people move from one state to another. We then describe some tax-related developments that deserve investors' attention. Lastly, we provide a framework of sorts to think about the highly complex decision of moving to another state. *(The discussion herein is intended to raise awareness of some important topics rather than to provide any specific investment or tax advice. The nuances of taxes state-by-state are too complex and too varied to be captured by the overview type of analysis presented here.)*

Why People Migrate

The U.S. Census Bureau provides extensive data on migration among states. The last year for which such data are available is 2018. We take the 2018 data and test whether people move for **career prospects, weather, cost of living, or taxes**. While not a scientific study, this analysis does provide some interesting insights. In the table below, we show which states gained the most from migration and which ones lost the most.

Change in Population (2018)

Top 5 Gainers		Top 5 Losers	
State	**% Change**	**State**	**% Change**
Idaho	+1.4%	New York	-1.1%
Arizona	+1.3%	Alaska	-1.0%
Nevada	+1.3%	Hawaii	-0.9%
South Carolina	+0.9%	Connecticut	-0.8%
Vermont	+0.9%	New Jersey	-0.8%

Source: https://www.census.gov/data/tables/2018/demo/geographic-mobility/cps-2018.html

To get data for career prospects, weather, cost of living, and taxes, we use the following proxies.

- Career Prospects – Median Income by State
- Cost of Living – Cost of Living Index
- Weather – Average Temperature for the Year
- Tax Rate – Marginal Income Tax Rate

Below we show the best and worst five states for each of these factors.

Median Income

Best (Highest)		**Worst (Lowest)**	
State	**Income**	**State**	**Income**
Massachusetts	$86,345	Mississippi	$42,781
Maryland	$86,223	Arkansas	$48,283
New Hampshire	$81,346	Arkansas	$49,781
Washington	$79,726	Alabama	$49,936
Virginia	$77,151	Louisiana	$49,97

Source: https://www2.census.gov/programs-surveys/cps/tables/time-series/historical-income-households/h08.xls

Weather

Best (Warmest)		**Worst (Coldest)**	
State	**Temp**	**State**	**Temp**
Florida	71°	Alaska	27°
Hawaii	70°	N. Dakota	40°
Louisiana	66°	Maine	41°
Texas	65°	Minnesota	42°
Georgia	64°	Montana	43°

Source: https://worldpopulationreview.com/state-rankings/average-temperatures-by-state

Cost of Living Index

Best (Lowest)		**Worst (Highest)**	
State	**Value**	**State**	**Value**
Mississippi	84.7	Hawaii	197.6
Kansas	86.5	New York	155.9
Oklahoma	86.7	California	142.7
New Mexico	87.2	Oregon	134.3
Arkansas	88.2	Massachusetts	129.7

Source: https://meric.mo.gov/data/cost-living-data-series

Marginal Income Tax Rate

Best (Lowest)		**Worst (Highest)**	
State	**Tax**	**State**	**Tax**
Texas	0%	California	12.3%
Florida	0%	Hawaii	11%
Nevada	0%	New Jersey	10.75%
Washington	0%	Oregon	9.9%
Alaska	0%	Minnesota	9.85%

Note: Wyoming and South Dakota also have 0% tax rate.
Source: https://taxfoundation.org/state-individual-income-tax-rates-and-brackets-for-2020/

We performed a statistical analysis by running a regression of Change in Population against each of these four variables. Our conjecture was that median income and weather would have a positive correlation with migration gain and cost of living and taxes would have a negative correlation with migration gain. In other words, we expected the data to show that people are attracted to states with better career prospects and warmer weather, and they want to avoid states with high cost of living and higher tax rates.

The table below shows the correlations we observed.

Correlations of Migration with Explanatory Factors

Career Prospects	-0.10
Weather	+0.06
Cost of Living	-0.38
Taxes	-0.23

Three of the factors – Weather, Cost of Living and Tax Rates – have the direction of correlation that we expected. However, Median Income is unexpectedly negatively correlated to population migration implying that people are leaving high income states. Quite likely, what is happening is that the positive impact of higher income in states like Massachusetts is more than offset by the negative impact of higher cost of living, bad weather and higher tax rates.

Recent Developments on the Tax Front

The financial shortfalls facing many states have been well documented. These shortfalls are being made significantly worse by the Covid crisis. It is hard to see a way out of this predicament without raising taxes. At the state level, tax increases can take the form of an increases in income tax, property tax, sales tax or estate tax. At the federal level also, our government has taken on extraordinary debt in recent years and it is reasonable to expect higher tax rates at some point to pay for this debt. The higher tax rates at the federal level may happen relatively quickly if Joe Biden becomes president and Democrats gain control of both houses of Congress.

Below, we discuss some of the measures that are likely to be considered seriously by a unified Democratic administration and congress.

Income Tax: Raise the highest marginal tax rate from 37% to 39.6% on income above $400,000.

Tax on capital gains and qualified dividends: Raise the tax rate from 20% maximum to 39.6% for those earning over $1 million.

Estate tax: Lower the tax-free transfer limit from about $23 million per couple to, possibly as low as about $7 million.

The timing of these changes is uncertain. January 1, 2022 is a good guess but the possibility of retroactive application to January 1, 2021 cannot be ruled out.

Strategies to Deal with High or Rising Taxes

Investors have limited ability to counter high or rising federal income taxes. Of course, they can invest in tax-exempt municipal securities but there is a limit to how far one can let taxes influence investment strategy. Moreover, the deteriorating financial condition of municipalities implies higher risks than in the past. A strategy that might be worth considering is conversion of a Regular IRA to a Roth IRA. This would lock in today's lower tax rate and also provide other benefits of Roth such as less onerous mandatory distribution requirements and a lower impact on the size of the estate.

The possibility of capital gains tax rate almost doubling for certain taxpayers is important and requires urgent attention by those likely to be impacted. Typically, investors defer capital gains and accelerate harvesting of capital losses. This year, the opposite strategy seems to make sense for high income investors. Harvesting long-term capital gains would enable investors to lock in lower taxes and postponing harvesting of losses would make them more valuable when taxes rise.

Estate taxes also require an urgent discussion for those with large estates. It would be advantageous for many to take advantage of the liberal limits now in place so before they are gone.

Investors have the option of waiting until election results are known to decide whether any of these actions are warranted. However, please note that tax and estate planning attorneys will be very busy in November and December if Biden wins, and some preparation ahead of time makes sense.

Should Taxes Influence Where You Live?
In addition to state income tax, estate tax levied by certain states can have some influence of one's decision regarding where to live in later years. Such estate (and inheritance) taxes levied at the state level are in addition to the 40% federal tax on estates. These taxes can be as high as 20% of the estate. So, moving from a state like New York to Florida not only reduces tax on income by 8.8%, it also reduces estate taxes by 16%.

In addition to taxes, of course, other factors come into play in making a decision as to where to live. A few of these are listed below but this list, of course, is neither comprehensive nor customized.

- Family, friends and the social network
- Business ties and income opportunities
- Healthcare provider relationships
- Concerns, if any, about safety and rule of law
- Environment and surroundings

At first glance, it would appear to be difficult to navigate such a diverse set of important factors. Although the decision is highly personalized, we believe writing down all the factors and separating them into three categories can provide a framework for decision making. The categories are:

- Deal breakers
- Important factors
- Less important factors

Deal breakers, as the name implies, are one or two fundamental requirements that must be met in order for one to be convinced to move. Less important factors on the other hand should be completely ignored in decision making. Once deal breaker criteria are met then a tradeoff among the important factors would be necessary. It may be obvious, but it is worth noting that the benefit of intricate estate planning does not accrue to the generation doing the planning, but to the next generation. That factor is worth keeping in mind while evaluating the trade-offs among important factors.

Given the highly personal nature of this decision, it is possible for two smart, logical persons to make the opposite decisions. For example, one couple might decide that their social and healthcare network is too critical for them to give up just to enable the next generation to have some extra money. On the other hand, another couple might give more importance to that fact that moving to another state not only provides them financial benefits but it also allows them to take advantage of better weather and a safer environment.

Based on the experience of some of the people we know, it is important to note that obtaining residency in another state is not simply a matter of staying in that state a certain member of days. It is much more complicated. No high-tax state wants to easily give up its high earners and the taxes that they pay. Their tax authorities are highly vigilant and willing to do thorough audits of those who claim to now be living in a different state.

Elvis Presley once sang *Home is Where the Heart Is*. If only it were that simple for the individuals wanting to reside in a different state. For them, *Home is Where the Taxman Determines It to Be*!

We will be monitoring the developments post-election and will help our clients take any investment action that would be beneficial. If you would like to discuss the issues mentioned in this letter or any other investment issues, please do not hesitate to call us.

Thank you for your trust and confidence!

Gautam Dhingra and Chris Olson
October 20, 2020

Important Note: Each client situation is different and, therefore, it is important that the thoughts shared above not be construed as client-specific advice. Moreover, High Pointe is neither a legal advisor nor a tax advisor. Please consult your legal and tax advisors to address your specific situation.