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State Taxation of Nonresidents' Pension Income

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STATE TAXATION OF NONRESIDENTS' PENSION INCOME

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In this article, Hellerstein and Smith examine the issues raised by the efforts of some states to tax the pension income of their former residents and of proposed congressional legislation to forbid such taxation. They contend that there is no sound theoretical basis for depriving states in which deferred income is earned of the right to tax such income. In their judgment, the critical issues raised by state taxation of nonresident pension income are practical, not theoretical. Because states lack the constitutional power to tax the portion of a nonresident's pension income that reflects accumulations during the time the taxpayer was not a resident of the taxing state, states must limit their taxation of nonresident pension income to the income that was earned by the retiree in the state or that was accumulated while the retiree was a resident of the taxing state. In addition, states must have a mechanism for tracing the precise amount of a retiree's pension income that is properly attributable to the taxing state when the income is attributable to the retiree's earnings in several states. Hellerstein and Smith conclude that these difficulties may justify the proposed congressional restriction, although they observe that states may react to such legislation by seeking to tax departing residents on their accrued pension income.

Were there an award for tax controversies that generate more heat than light, the debate over state taxation of nonresidents' pension income would be well deserving of the honor. Marching under the banner of "taxation without representation," organizations such as RESIST (Retirees to Eliminate State Income Source Tax) rail against states whose "Gestapo tactics" are forcing retired workers into "financial slavery" by taxing the pensions of former residents.[1] A U.S. Senator, reminding us that the unfair tax policies of a distant monarch ignited the Revolutionary War, declares that "[t]oday it is not a distant monarch, but nearby State governments that expect something for nothing" by taxing nonresidents.[2] In response to these anguished pleas, bills introduced into Congress seek to bar states from taxing the pension income of their former residents.[3] Indeed, a recent report declares that "Congress this year is likely to pass legislation that would prohibit states from taxing the pension income of former residents now living in other states."[4]

While there may be sound policy reasons for forbidding state taxation of nonresident pension income, they have yet to emerge clearly from the rhetoric that has thus far dominated the debate over the pension tax issue. Our purpose here is to examine the questions raised by the controversy over state taxation of nonresident pensions in the hope that dispassionate analysis of the problem may contribute to a fair solution of it.

I. STATE TAXATION OF PERSONAL INCOME: GENERAL PRINCIPLES

There are two fundamental, but alternative, predicates for state power to tax income: residence and source. In articulating the residence-based theory, the Supreme Court has declared:

> That the receipt of income by a resident of the territory of a taxing sovereignty is a taxable event is universally recognized. Domicile, itself, affords a basis for such taxation. Enjoyment of the privileges of residence in the state and the attendant right to invoke the protection of its laws are inseparable from the responsibility for sharing the costs of government.[5]

[1] *The Thin Blue Line* 21 (July 1989) (reprinted from *Retirement Life* (May 1989)).

[2] *Cong. Rec.* S1189 (daily ed. Jan. 24, 1991) (remarks of Sen. Reid (D-Nev.)).

[3] *See*, e.g., S. 267, 102d Cong., 1st Sess. (1991); H.R. 1531, 102d Cong., 1st Sess. (1991). The proposed legislation provides that "[n]o State may impose an income tax . . . on the pension or retirement income of any individual who is not a resident or domiciliary of such State."

[4] Bureau of National Affairs, *Daily Tax Report*, G-1 (May 11, 1992); *cf. Highlights & Documents*, May 11, 1992, p. 1695.

[5] *New York ex rel. Cohn v. Graves*, 300 U.S. 308, 312 (1937); *see also Lawrence v. State Tax Comm'n*, 286 U.S. 276 (1932).

In articulating the source-based theory, the Court has observed:

> In our system of government the States have general dominion, and, saving as restricted by particular provisions of the Federal Constitution, complete dominion over all persons, property, and business transactions within their borders; they assume and perform the duty of preserving and protecting all such persons, property, and business, and, in consequence, have the power normally pertaining to governments to resort to all reasonable forms of taxation in order to defray the governmental expenses. . . . That the State, from whose laws property and business and industry derive the protection and security without which production and gainful occupation would be impossible, is debarred from exacting a share of those gains in the form of income taxes for the support of government, is a proposition so wholly inconsistent with fundamental principles as to be refuted by its mere statement.[6]

From these two theories of taxing jurisdiction emerge the settled constitutional principles that a state may tax residents on their income from all sources[7] and nonresidents on their income from sources within the state.[8] These constitutional principles are reflected in the state statutes that generally tax residents on all of their income wherever earned[9] while taxing nonresidents on their income derived from sources within the state.[10]

II. STATE TAXATION OF FEDERALLY DEFERRED INCOME: GENERAL PRINCIPLES[11]

Most states that impose income taxes conform their levies to the federal model.[12] Consequently, when income is realized but not recognized at the federal level — for example, when a taxpayer reinvests the gain from the sale of his former residence in a new residence,[13] or when a taxpayer realizes gain from the exchange of like-kind property[14] — states typically follow the federal rule in deferring recognition of that income. On the assumption that state conformity to the federal nonrecognition rules reflects an implicit endorsement of the policies underlying those rules, state deferral ordinarily raises no issue independent of those raised by federal deferral.

When nonrecognition transactions have an interstate dimension, however, issues are raised at the state level that are not usually encountered at the federal level. For example, when a taxpayer reinvests the gain from the sale of his former residence in a new residence in a different state or when a taxpayer realizes gain from the exchange of like-kind property through the acquisition of property in another state, one must address not only the question of *when* income is recognized, but also the question of *where* it is recognized.

The federal Constitution does not necessitate the de facto policy of ignoring the federally deferred income of former residents.

In an article published several years ago in the *Tax Law Review*,[15] we explored the issues of tax policy and constitutional law raised by state taxation of nonrecognition transactions that cross state lines. We focused on two discrete nonrecognition transactions: (1) nonrecognition of gain from the sale of a principal residence by a taxpayer who moves to another state and (2) nonrecognition of gain from the exchange of like-kind property located in different states. Although we did not concentrate on the precise subject of this article — deferred compensation arrangements involving taxpayers who do not reside in the state of their former employment — many of the principles discussed and conclusions reached in our earlier article are equally germane here. We therefore summarize briefly these principles and conclusions insofar as they are relevant to the matter at hand.

First, most states' existing income tax statutes implicitly provide for taxation of federally deferred income earned from sources within the state when that income is federally recognized. This is true even if the taxpayer no longer has any continuing contact with the state in the year of recognition. For example, Georgia's statute, which is typical of most states, imposes a tax "upon every nonresident with respect to his Georgia taxable net income . . . from services performed, property owned, or from business carried on in this state."[16] "Georgia taxable net income" is defined as the taxpayer's federal adjusted gross income, with state adjustments not relevant here.[17] In light of the fact that (1) a taxpayer's federal adjusted gross income includes all income that is recognized for federal tax purposes, including income that was realized in prior years, but whose recognition was deferred to the current year, and (2) the Georgia statute does not exclude from its federally based definition of taxable income Georgia-source income that is recognized in a subsequent year by someone who no longer lives or works in Georgia, it follows that when Georgia-source income is recognized for federal tax purposes it is taxable under the

[6] *Shaffer v. Carter*, 252 U.S. 37, 50-51 (1920).
[7] *Id.* at 57.
[8] *Id.*
[9] 2 Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* para. 20.04[2] (1992).
[10] *Id.* para. 20.05[2].
[11] The following discussion draws freely from James C. Smith & Walter Hellerstein, "State Taxation of Federally Deferred Income: The Interstate Dimension," 44 *Tax L. Rev.* 349 (1989).
[12] Typically, states adopt federal adjusted gross income as their computational starting point for determining state personal income tax liability. *See* Hellerstein & Hellerstein, note 9 *supra*, para. 20.02.
[13] I.R.C. section 1034.
[14] I.R.C. section 1031.
[15] *See* note 11 *supra*.
[16] Ga. Code Ann. section 48-7-20 (Supp. 1991).
[17] *Id.* 48-7-27(a).

Georgia statute. The same analysis would obtain in the overwhelming majority of states.[18]

Second, state taxing authorities generally make no effort to tax the federally deferred gain of taxpayers who are former residents at the time of federal recognition.[19] This amounts to a *de facto* policy of tax forgiveness, explainable as the interaction of two factors: (1) the state's lack of statutory authority to tax the deferred income when it is realized because it is not recognized for federal (and hence for state) purposes and (2) the practical difficulties of taxing the income when it is recognized for federal (and hence for state) tax purposes at a time when most former residents will have few continuing ties to the taxing state.

There is no sound theoretical basis for depriving states where deferred pension income is earned of the right to tax such income when it is recognized for federal income tax purposes. . . .

Third, the federal Constitution does not necessitate the *de facto* policy of ignoring the federally deferred income of former residents. States plainly possess the power, under the Due Process Clause, to tax income derived from sources within the state, even if the income is recognized years later when the taxpayer no longer has any connection with the state. Whatever may be the practical problems in collecting a tax on such income — problems we consider below — the constitutionally sufficient nexus that the state has with the income when it was earned does not evaporate merely because the income earner has severed his ties with the state and the state has chosen to postpone taxation of the income for policy reasons.

Fourth, apart from considerations of administrative feasibility, there are no compelling policy reasons why a state in which income was earned, but which has chosen to follow the federal deferred recognition rules, should not tax such income when it is recognized for federal tax purposes. The factors that ordinarily justify the state's exercise of its taxing power over income that has its source in the state apply with no less force merely because the state has decided to defer recognition of such income.[20]

Indeed, from the standpoint of equity and efficiency, a state's failure to recognize the deferred income when it is federally recognized is generally undesirable. Equity dictates that taxpayers who are similarly situated should bear equivalent tax burdens. Taxpayers who do not change their state of residence will pay state income tax on their federally deferred income when it is federally recognized. But if a taxpayer changes his state of residence between the time of income realization and the time of income recognition, there is a risk that the taxpayer's state of new residence will not tax the federally recognized income. When this happens, the relocating taxpayer in essence achieves tax forgiveness at the state level, even though his circumstances are identical with those of the remaining resident taxpayers in all relevant respects.

Efficiency in this context means tax neutrality, i.e., whether a state income tax system, in its treatment of deferred income, is economically neutral *vis-a-vis* a person's decision to remain a resident or to move to another state. A taxing regime is efficient in this respect if a taxpayer is neither penalized nor advantaged by reason of his decision to change his state of residence. On the other hand, a taxing regime is inefficient if, for example, a taxpayer who relocates out-of-state escapes taxation because neither the old state nor the new state taxes the deferred income when it is federally recognized.

III. STATE TAXATION OF FEDERALLY DEFERRED INCOME: NONRESIDENT PENSION INCOME

On the basis of the foregoing discussion, we believe that there is no sound theoretical basis for depriving states where deferred pension income is earned of the right to tax such income when it is recognized for federal income tax purposes merely because the retiree no longer resides in the taxing state. In fact, as a matter of theory, the opposite policy is desirable. If states tax the deferred pension income of their continuing residents when it is federally recognized, in principle they should likewise tax the pension income of former residents to the extent it represents income earned while the taxpayer resided in the taxing jurisdiction.

A. Reasons Advanced for Congressional Intervention

The objections that have generally been raised to state taxation of former residents' pension income on the basis of principle strike us as ludicrous. The essential argument, as articulated by Senator Harry Reid

[18]Hellerstein & Hellerstein, note 9 *supra*, para. 20.02.

[19]One exception to this generalization is Michigan:

> If an individual changes his or her domicile from Michigan to another state, the aggregate amount contributed to a deferred compensation plan together with interest that has accrued through the date of the domicile change is subject to Michigan income tax when the taxpayer begins to receive distributions from the plan.

Mich. Rev. Admin. Bull. 1988-15, [2 Mich.] *St. Tax Rtpr.* (CCH) para. 319-044. While Michigan has a $10,000 exclusion for certain pension and retirement benefits, other deferred compensation arrangements do not qualify for exclusion. *Id.* The Michigan Court of Appeals recently sustained the application of this policy to a former Michigan resident who retired to Florida. *Molter v. Department of Treasury*, No. 125786, 1992 Mich. App. Lexis 131 (Ct. App. April 6, 1992).

[20]To reiterate the underlying rationale for source-based taxation, the proposition "[t]hat the State, from whose laws property and business and industry derive the protection and security without which production and gainful occupation would be impossible, is debarred from exacting a share of those gains in the form of income taxes for the support of government, is . . . so wholly inconsistent with fundamental principles as to be refuted by its mere statement." *New York ex rel. Cohn v. Graves*, 300 U.S. 308, 312 (1937).

(D-Nev.), who has introduced legislation to bar states from taxing nonresidents' pensions,[21] goes as follows:

> [T]he issue of taxation without representation was supposedly resolved by the Revolutionary War. . . .
>
> Today . . . unfair taxation has another name: State source income tax. Regardless of euphemism, it is the same injustice our ancestors fought. . . . Taxation without representation.

Indeed, no principle is more firmly established, both internationally and domestically, than the power of a taxing sovereign to tax income on the basis of source . . . .

In the late 18th century, American colonists dumped tea into Boston Harbor because the King of England was unfairly taxing them. Living an ocean away from England, the colonists did not benefit from British roads, bridges, or services, nor were they invited to participate in British elections. In short, the colonists paid for goods they did not receive.

Today it is not a distant monarch, but nearby State governments that expect something for nothing. Governments that cross State lines, collect taxes and retreat, offering their nonresident taxpayers nothing in return.[22]

This argument rests on two premises. First, only those persons who have the right to vote ought to be subject to tax; and second, those who are taxed ought to receive some benefits from the government's expenditures of tax revenues. As to the first premise, whatever principles the Revolutionary War may have established, an inviolate link between the right to vote and the duty to pay tax is not one of them. Persons who lack the right to vote due to nonresidence are nonetheless properly taxable on the basis of source.[23] Indeed, no principle is more firmly established, both internationally and domestically, than the power of a taxing sovereign to tax income on the basis of source, regardless of the political relationship of the income earner to the taxing jurisdiction. The well-recognized power that the United States and the states assert over nonresidents and foreign corporations[24] reflects this deeply rooted rule of international and domestic law and practice.

The second line of attack — that the state of former residence does not provide benefits for the taxpayer — is also unpersuasive. It is true, of course, that a retiree who has completely severed his ties with his state of former employment may in fact receive no benefits from his tax payments *after his retirement*. But this misses the mark because it looks to the wrong point on the time continuum. Instead, the time period during which income was earned is the key. The state provided the nonresident with ample benefits — in the form of roads, police and fire protection, and other governmental services — while the income was being earned in the state. The fact that the income is taxed at a time when the nonresident is no longer receiving benefits from a state does not mean that such benefits were never received. Thus, when states tax the pension income that nonresidents have earned in the state, there is no denial of the "benefit" principle on which source taxation ultimately rests.

Moreover, it is a strange conception of "fairness" in taxation that would prevent a state from taxing income earned within its borders, and with respect to which the state has presumably accorded substantial benefits, merely because the state has permitted the taxpayer to defer recognition of such income. After all, deferral of recognition is a matter of legislative grace. The state could have taxed the pension rights prior to retirement, when they were earned.[25] Had it done so, thereby recouping a fair share of the costs of government while

[21] S. 267, 102d Cong., 1st Sess. (1991).

[22] *Cong. Rec.* S1189 (daily ed. May 24, 1991) (remarks of Sen. Reid (D-Nev.)).

[23] A firm link between the right to representation and the state's power to tax, rigorously applied, would lead to preposterous results. Not only would nonresidents avoid taxation by the state in which the income was earned, but residents who were barred from voting would receive windfalls. Income earned by or paid to children would escape taxation. Those states that strip felons of voting privileges would confer tax immunity for all future income.

[24] *See* Boris I. Bittker & Lawrence Lokken, *Fundamentals of International Taxation* Ch. 66 (1991); Walter Hellerstein, "State Taxation of Interstate Business: Perspectives on Two Centuries of Constitutional Adjudication," 41 *Tax Law.* 37 (1987).

[25] Difficulties can arise in determining the precise time at which a state may tax deferred compensation arrangements, in part because of the wide diversity among such arrangements. Cash-basis taxpayers generally report income in the year of actual or constructive receipt. Reg. section 1.446-1(c)(i). Under some types of plans, the taxpayer clearly does receive cash and then elect to contribute to a tax-deferred plan (e.g., individual retirement accounts, Keogh plan accounts, and simplified employee pension accounts). On the other hand, insofar as the deferred income represents a "mere promise to pay," then it would not be income to a cash-basis taxpayer. *See, e.g., Amend v. Commissioner*, 13 T.C. 178 (1949) (*acq.*, 1950-1 C.B. 1). For some types of plans, proper treatment under the cash receipt and disbursements method of accounting is murky. For example, employees who purchase tax-deferred annuities through salary reduction agreements may be said not to have received income, or such an arrangement may be characterized as constructive receipt, given the taxpayer's control over the process and ability to terminate the arrangement.

Accrual-method accounting provides an alternative for states that desire to tax pension rights when earned. As a matter of constitutional law, the state could clearly require that taxpayers report deferred compensation on an accrual basis. This would eliminate the need to deal with questions of receipt or constructive receipt of cash. Under the accrual method, deferred compensation would be reported as income "when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Reg. section 1.446-1(c)(1)(ii). For plans in which employer contributions are not vested initially, an accrual method would apparently call for taking the contributions into income at the time of vesting.

There is precedent at the federal level for requiring that certain taxpayers use an accrual method. *See* I.R.C. 448(a) (barring cash receipts and disbursements method for tax shelters, C corporations, and partnerships with C corporations as partners); Boris I. Bittker & Martin J. McMahon, Jr., *Federal Taxation of Individuals* 36-7 (1988) (merchants and manufacturers are ordinarily required to use accrual method for federal income tax purposes).

the taxpayer was still a resident and still employed, no objection on the basis of lack of benefit or fairness could conceivably have arisen. Instead, following the federal model of pension taxation, the state deferred the tax obligation to the future, when the retiree receives pension payments. To strip the state of its power to tax such income because it has accorded the taxpayer the additional benefit of deferral cannot be supported as a matter of tax equity.

B. Tax Policy Considerations

Proponents of a congressional ban on state taxation of nonresidents' pension income have failed to address meaningfully the real issue; i.e., what is the appropriate treatment of the taxpayer who moves interstate from the standpoint of sound tax policy? Tax policy analysis requires an inquiry into the equity, efficiency, and administrability of the tax system.[26]

To strip the state of its power to tax such income because it has accorded the taxpayer the additional benefit of deferral cannot be supported as a matter of tax equity.

In terms of equity, the key question is whether a retiree who moves out of state after retirement and a retiree who continues to reside in his state of employment after retirement are similarly situated. Is this a distinction that justifies differential tax treatment for these two retirees' deferred employment income? The answer is "no." Both taxpayers earned income while residents of the same state, both enjoyed the same access to benefits provided by that state, and both profited by the same deferred recognition rules for retirement income. The personal choice each taxpayer makes about where to retire should not have state tax consequences with respect to the pension income already earned. The issue is *not* about income that either or both taxpayers will earn after retirement or after a change of residence.[27]

But, unless the former state of residence seeks to tax the pension income of former residents, there is great risk that the in-state retiree and the out-of-state retiree will be taxed differently. Taxpayers who remain residents of their state of employment after retirement will pay state income tax on their pension income when and as it is federally recognized. The pension income of taxpayers who relocate, however, often will not be not subjected to an equivalent tax by their state of retirement.[28]

Likewise, efficiency is offended if the pension income of retirees who move interstate escapes the tax imposed on retirees who chose continuing residence. The concern, an issue of tax neutrality, is whether the state income tax system causes retirees to alter their behavior with respect to their decision where to live.[29] Here, efficiency analysis dovetails with equity. If the state of retirement fully taxes the retirement income of the new resident, there is no efficiency problem. But often this will not be the case, and for reasons of efficiency as well as equity the tax system should not influence a retired employee's decision as to where to retire. It should not penalize retirees who elect to stay resident, nor should it create a tax windfall for those who load the moving van.

C. Practical Difficulties

Our conclusion that there is no theoretical justification for prohibiting states from taxing nonresidents' pension income earned within their borders does not mean that we necessarily oppose the legislation barring states from so doing. In our judgment, there are practical problems raised by state taxation of nonresident pension income that may nevertheless justify the proposed congressional restraint.

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[26]*See*, e.g., R. Musgrave & P. Musgrave, *Public Finance in Theory and Practice* 225 (4th ed. 1984).

[27]Obviously, when a retiree changes his state of residence, the old state cannot tax his income that is earned or accrued after the date of change of residence, except to the extent that such income derives from sources within the old state. *Cf. Mich. Rev. Admin.* Bull. 1988-15, [2 Mich.] *St. Tax Rtpr.* (CCH) para. 319-044, quoted in note 19 *supra* (implicitly recognizing this proposition by taxing former residents only on interest accrued on deferred compensation plans through the date of domicile change). For this reason, part of the pension income paid to relocating residents often is not properly taxable by the state of former residence. To the extent pension payments include investment income earned since the change of residence, it should be exempt from income tax by the state of former residence.

[28]There are two reasons why the state in which the taxpayer retires may fail to tax pension income earned or accrued prior to the taxpayer's change in residence. First, some states, like Florida and Texas, have no personal income tax. Second, there is a plausible constitutional argument, based on due process, that the state of retirement cannot tax the retirement income to the extent it was both earned and actually received before the taxpayer became a resident; for example, an individual retirement account (IRA) or similar account. *See*, e.g., *Kennedy v. Commissioner of Corps. & Tax'n*, 256 Mass. 426, 152 N.E. 747 (1926) (state may not tax income of new residents received from sources outside state during taxable year but prior to time they became residents); *Murnane v. Commissioner of Revenue*, [Mass.] St. & Loc. Tax Serv. (P-H) para. 58,336, at 58,283 (Feb. 23, 1987) (state cannot constitutionally tax gain recognized by new resident from sale of out-of-state residence when gain was realized while taxpayer was nonresident); FTB Ltr. Rul. No. 329, [1 Cal.] St. Tax Rep. (CCH) para. 16-557.40 (July 25, 1968) (nonresident who sells principal residence and purchases new residence in California, deferring gain for federal tax purposes, is not required to reduce basis of new California residence by amount of deferred gain for California tax purposes).

[29]An inefficient outcome results if a retiree has the following utility schedule. He would prefer to remain in his state of employment after retirement, were it the case that his retirement income would bear the same tax burden wherever he lives. In other words, apart from the tax system, he likes living where he now is. However, he in fact prefers to move to some out-of-state location because he perceives that his already-earned retirement income will thereby escape state income taxation.

1. Distinguishing taxable deferred compensation from nontaxable deferred investment income. States plainly possess the power and, in our judgment, a sound theoretical basis for taxing the deferred pension income that a nonresident receives with respect to personal services previously performed in the state. Thus far in our analysis, however, we have largely ignored the fact that pension income reflects more than deferred compensation. Retirement accounts start with initial or periodic employer and/or taxpayer contributions, which amount entirely to deferred compensation, but over time investment income, consisting of interest, dividends, and the like, accumulates on the taxpayer's deferred compensation. For many retirees, the accumulated investment income is larger than the sum of the contributions reflecting deferred compensation due to the time value of money and the long period over which accumulations accrue for retirement plans that are funded for decades prior to retirement. Accumulated investment income in tax-qualified retirement plans is tax deferred, both at the federal and state tax level, just as is the deferred compensation itself.

The fact that pension payments include deferred compensation components and investment income components creates a serious practical complication in state taxation of nonresident pension income. For while states clearly possess the power to tax income from personal services performed by nonresidents in the state[30] as well as investment income earned by residents,[31] they clearly lack the power to tax investment income earned by nonresidents unless it has an in-state source. The source-based theory, as applied in this context, has typically required that the income stem from intangible property having a business situs in the state.[32] A few courts, however, have sustained state tax power over nonresidents' income from intangibles in situations clearly not warranted by the traditional business situs doctrine.[33] Despite such cases extending the source rationale, states generally limit their taxes on nonresidents' income from intangibles to cases in which the intangible property is used for business in the state or has acquired a business situs there.[34]

Often, however, more than two states will have plausible claims to a taxpayer's pension income due to the fact that the taxpayer has worked in more than one state.

Because states generally lack the constitutional power to tax the portion of a former resident's pension income that reflects accumulations after the taxpayer's change of residence, states must limit their taxation of nonresident pension income to the deferred employment income and the income accumulated prior to the retiree's change of residence. As a practical matter, it may be difficult, if not impossible, for a state (or for an employer with state withholding tax obligations[35]) to determine, on a pension-check-by-pension-check basis, what proportion of the payment reflects deferred payment for services rendered in the state and what proportion represents investment income

[30] *See* text at note 7 *supra*.

[31] *See* text at note 8 *supra*.

[32] The Supreme Court has defined "business situs" as the state in which "intangibles . . . are used in the business or are incidental to it, and have thus become 'integral parts of some local business.'" *First Bank Stock Corp. v. Minnesota*, 301 U.S. 234, 237 (1937). In a thoughtful opinion, a New Jersey court held a nonresident taxable on the payout from a profit-sharing plan from his former New Jersey employer over the objection that New Jersey was taxing dividends, interest, and appreciation in the value of a nonresident's intangible assets. *McDonald v. Director, Division of Taxation*, 10 N.J. Tax 556 (1989). The court held that all of the income was attributable to the taxpayer's former employment in New Jersey. In 1989, the New Jersey legislature explicitly exempted nonresidents' pension income from New Jersey sources. 1989 N.J. Laws ch. 219, codified at N.J. Rev. Stat. section 54A:5-5 (Supp. 1992). *Cf. Gow v. Director of Revenue*, 556 A.2d 190 (Del. 1989) (voluntary termination incentive payment received by nonresident taxpayer was not subject to personal income tax in Delaware, since the payments did not constitute payment for services rendered in the state).

[33] For example, in *International Harvester Co. v. Wisconsin Department of Revenue*, 322 U.S. 435 (1944), the Supreme Court sustained a tax on dividends received by nonresident shareholders from a corporation engaged in business in the state. The levy was imposed on "the privilege of declaring and receiving dividends," which were deducted by the corporation from dividends payable to shareholders, and there was no assertion that the nonresidents employed their stock in any business they conducted in the taxing state. In sustaining the tax, the Court accepted the state court's construction of the statute as laying a tax on the nonresident shareholders rather than on the corporation. In rejecting due process objections to imposition of the levy, the Court declared:

> Personal presence within the state of the stockholder-taxpayers is not essential to the constitutional levy of a tax taken out of so much of the corporation's Wisconsin earnings as is distributed to them. A state may tax such part of the income of a non-resident as is fairly attributable either to property located in the state or to events or transactions which, occurring there, are subject to state regulation and which are within the protection of the state and entitled to numerous other benefits which it confers. . . . And the privilege of receiving dividends derived from corporate activities within the state can have no greater immunity than the privilege of receiving any other income from sources located there.

Id. at 442. *See also Anderson v. Lambert*, 494 So. 2d 370 (Miss. 1986) (nonresidents taxable on gain from complete liquidation of corporation doing business in the state); *cf. Johnson v. Collector of Revenue*, 246 La. 540, 165 So. 2d 466 (1964) (nonresidents taxable on gain from complete liquidation of corporation owning oil-producing lands in state under specific statutory provision deeming taxable situs of stock to be in state to extent property distributed in liquidation is located in state).

[34] *See* Hellerstein & Hellerstein, note 9 *supra*, para. 20.5[6].

[35] *See*, e.g., Ga. Code Ann. section 48-7-101 (Supp. 1991).

that accrued while the taxpayer was a nonresident of the state.[36]

2. Deferred compensation involving more than two states. Americans are very mobile, now more than ever. Up until now, we have considered only the simplest tax problem of pension income having interstate dimensions — that of a person who lives and works in one state until retirement and then moves to another state. Often, however, more than two states will have plausible claims to a taxpayer's pension income due to the fact that the taxpayer has worked in more than one state prior to retirement or has earned income in a state other than his state of residence.

Consider, for example, an employee who worked for one corporation for his entire career, but was stationed in Illinois for five years, New York for 15 years, and then California for 10 years, finally retiring in Nevada.[37] If states are to tax the pension income of their former residents at the time of federal recognition, fact patterns such as this present a substantial allocation problem. For this employee's company pension, states (and his employer wherever it has state withholding tax obligations) must have a mechanism for precisely dividing his pension income among the three states where he worked. Each state may properly tax only (1) the deferred income attributable to personal services performed in that state and (2) the investment income that accumulates while the taxpayer was a resident of that state.

Similar tracing problems are raised by an employee who worked in a state other than his state of residence. Consider, for example, a New Jersey resident who commuted throughout his career to a place of employment in Pennsylvania and then retired in Florida. Should New Jersey or Pennsylvania or both states tax his pension income as he receives it in Florida? Pennsylvania's claim, although resting solely on the source theory of income taxation, nonetheless seems unassailable, provided it limits its tax to only the deferred compensation, not sweeping in any accumulated investment income. Pennsylvania could have taxed the Pennsylvania-source income during the year it was earned, but chose to defer recognition, following the federal model. There is no reason for denying its taxing power merely because it stayed its hand, delaying recognition until receipt of pension income.

If Congress . . . were to bar state taxation of nonresident pension income, the states would not necessarily roll over and play dead.

New Jersey's claim to the new Floridian's pension income is tenuous, not for constitutional or theoretical reasons but for statutory reasons. Its argument, which rests solely on the residence theory of state taxation, is that residents are taxable on income from all sources and that, while the retiree was a New Jersey resident, he earned income from working in Pennsylvania, the deferred portion of which he has never returned as income. New Jersey permitted deferral and now the taxpayer, at the time of federal recognition of pension income, is a nonresident, but this issue of timing should not strip the state of power to tax. Residency at the time the income was earned supplies a nexus, sufficient for due process, that does not fade over time. Logically, New Jersey has jurisdiction to tax the full amount of the deferred compensation, together with any accumulations thereto up to the date of the taxpayer's relinquishment of New Jersey residence. The state's problem, however, lies in the structure of most states' tax codes, which require a resident to file an income tax return only for the years in which a person is a resident for all or part of the year. Thus, the filing requirements, unless amended, are inadequate to reach a former resident's pension income where the income was earned in a state other than the state of former residence.

As these multistate fact patterns suggest, jurisdictional tax claims may proliferate when the retiree's pension income has connections with several different states, based on residence and/or place where personal services are performed during various stages of the retiree's career. Each state is obligated to limit its pension tax to deferred compensation from services performed in the taxing state or while the retiree was a resident. And for investment income accumulating in the retirement plan, each state is obligated to exclude from its pension tax any investment income accumulated while the taxpayer was a nonresident of the taxing state. The cumulative burden imposed by these two obligations could make the problems of implementing a constitutionally acceptable nonresident pension tax insuperable.

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[36]While states lack constitutional power to tax accumulations that accrue after the taxpayer becomes a nonresident, they could choose to charge interest on the tax liability imposed on deferred pension income. Such an approach would give the taxpayer the option of reporting the deferred compensation immediately, when earned, or electing deferral with interest to accrue from the year earned to the year of federal (and thus state) recognition. As a practical matter, depending on the interest rate assessed, such a plan could have the same practical tax effect as if the state of former residence had power to tax the investment income directly.

No states now charge interest on deferred recognition of income, and such a policy would depart from the federal income tax model for pensions, which confers interest-free tax deferral. States, however, could amend their state income tax codes to impose an interest charge on the privilege of tax deferral. There is a federal analogue for nonrecognition of income under installment sales. Since the Revenue Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330, the federal government has charged interest on the tax that is deferred by the installment method of reporting gain on the sale of property for certain dealers and for very large installment sales. I.R.C. section 453(*l*)(3) (interest on deferred tax liability for dealer sales of time-share units and dealer sales of unimproved residential lots); I.R.C. section 453A(a)(1), (c) (interest on deferred tax liability when sales price exceeds $150,000 and aggregate outstanding obligations exceed $5,000,000).

[37]Assume that each time the taxpayer moves, his legal state of residence changes accordingly.

D. Possible State Responses to Congressional Intervention

If Congress, motivated by these concerns (and perhaps by others that do *not* justify congressional action[38]) were to bar state taxation of nonresident pension income, the states would not necessarily roll over and play dead. There are several different approaches they could adopt with respect to deferred pension income. Each approach raises tax policy concerns, and some present constitutional issues as well.

1. State repeal of deferred recognition generally. One reaction states may take is simply to uncouple their taxing regimes from the federal model and end deferral of income paid into qualified pension plans and the like to preserve their revenue bases. The states are constitutionally free to take such action[39] and, were they to do so, congressional action will have produced a Pyrrhic victory for nonresident retirees. In terms of tax policy, however, state repeal of deferral would not necessarily be undesirable. With continuing residents and former residents treated identically, equity and efficiency concerns would be fully satisfied.[40] On the other hand, decoupling the state's tax code from the federal model would impose additional administrative burdens on state taxing authorities and additional compliance burdens on state taxpayers.

2. State repeal of deferred recognition for nonresidents. Alternatively, states might seek to preserve tax deferral for continuing residents, but deny it to those departing retirees before they can claim congressional immunity. States may try to tax deferred personal service income of departing residents, making the change of residence an event that triggers recognition of income. Such an approach could also extend to nonresidents who work within the state, with cessation of in-state employment serving as the tax trigger. At least one state's tax code already appears to call for such treatment for departing residents. California's personal income tax statutes currently provide:

> When the status of a taxpayer changes from resident to nonresident, or from nonresident to resident, there shall be included in determining income from sources within or without the state, as the case may be, income and deductions accrued prior to the change of status even though not otherwise includable in respect of the period prior to that change. . . .[41]

Such a policy, however, creates thorny federal constitutional problems. The essential claim is that the statutory denial of nonrecognition treatment discriminates against nonresidents in violation of the Privileges and Immunities Clause.[42] During the 1980s, two Wisconsin courts considered a similar issue involving state taxation of federally deferred gain — specifically, discrimination against nonresidents in the rules applicable to the recognition of gain from the sale of a principal residence. These decisions merit close scrutiny as the courts' analysis is relevant to the pension income issue.

A Wisconsin statute[43] denied deferral of gain on the sale of Wisconsin residence where the replacement residence purchased by the taxpayer was located outside the state. In *Taylor v. Conta*,[44] former Wisconsin residents asserted that the denial of nonrecognition treatment on the sale of their Wisconsin residences violated the Privileges and Immunities Clause. The gravamen of their claim was that a continuing Wisconsin resident, who was permitted to defer recognition on the sale of a Wisconsin residence, was treated more favorably than a former resident, who was required to recognize gain immediately.[45]

Despite the disparity in the treatment of continuing residents and former residents, the Wisconsin Supreme Court sustained the statute.

Despite the disparity in the treatment of continuing residents and former residents, the Wisconsin Supreme Court sustained the statute. The court found that the legislature was justified in treating residents and nonresidents differently for two reasons. First, it had a reasonable concern that, unless the gain were taxed immediately, the state would lose jurisdiction to tax the gain realized on the sale of the Wisconsin residence after the taxpayer left the state.[46] Second, unless the gain were taxed immediately, the state could confront administrative problems in keeping track of former residents until the deferred gain was recognized.[47] Because there was a "substantial relationship between the problems caused by former residents for the state in achieving the state's tax objectives and the burden

[38] *See* text accompanying notes 20-24 *supra*.

[39] There is precedent for state divergence from the federal rules for tax-deferred compensation income. For example, for years Georgia taxed the income of taxpayers paid into individual retirement accounts and certain other retirement arrangements by requiring additions to federal adjusted gross income to arrive at state taxable income. Ga. Code Ann. section 48-7-27(b) (repealed 1990).

[40] Such state action might represent a tax hike, but not necessarily. Since it expands the income tax base, the state legislature could lower its personal income tax rates if it wanted its repeal to be revenue neutral.

[41] Cal. Rev. & Tax. Code section 17554 (Supp. 1992).

[42] U.S. Const. art. IV., section 2.

[43] Former Wis. Stat. section 71.05(1)(a)5 (repealed 1981), quoted in *Taylor v. Conta*, 106 Wis. 2d 321, 316 N.W.2d 814 (1982). Although the statute was repealed in 1981, it is similar to statutes presently in force in other states. *See*, e.g., Ala. Code section 40-18-8(e) (Supp. 1991); Ark. Stat. Ann. section 26-51-404(b)(2) (1987); Ga. Code Ann. section 48-7-27(b)(6) (Supp. 1991).

[44] 106 Wis. 2d 321, 316 N.W.2d 814 (1982).

[45] They further argued that the theoretical equality that the statute arguably produces, because all Wisconsin taxpayers are eventually taxed on the gain from the sale of their principal residences, was unsubstantiated in fact because exclusions provided to elderly taxpayers in connection with the sale of their residences resulted in many Wisconsin residents paying no income tax on their deferred gains.

[46] 106 Wis. 2d at 343, 316 N.W.2d at 825.

[47] *Id.*

placed on non-residents,"[48] the court held that the denial of nonrecognition treatment to nonresidents did not violate the Privileges and Immunities Clause.

In 1988, six years after the Wisconsin Supreme Court's decision in *Taylor*, an intermediate Wisconsin appellate court revisited this question in *Kuhnen v. Musolf*.[49] While professing to be bound by the *Taylor* court's opinion, the appellate court nevertheless invalidated the statute under the Privileges and Immunities Clause on the ground that the records in the two cases were different. The court found that few if any Wisconsin taxpayers ever paid a tax on the deferred gain from sale of their residences,[50] so that the denial of nonrecognition treatment amounted to "a migration or exit tax."[51] The court also found that the administrative convenience concern was not justified because "the state routinely imposes and collects income taxes against nonresidents."[52]

As the conflicting results in the Wisconsin cases suggest, the constitutional issue raised by a state's attempt to deny nonrecognition of gain to departing residents is not an easy one. To be sure, the cases are technically reconcilable. There is a difference between denying departing residents tax deferral enjoyed by similarly situated residents and imposing a tax on departing residents that similarly situated residents do not pay at all. It is questionable, however, whether that distinction has any real substance. The economic benefit of tax deferral can be substantial, so denying it to departing residents cannot be dismissed as a *de minimis* burden. Moreover, the distinction between tax deferral and tax forgiveness vanishes over time.[53] For most homeowners, deferral has virtually the same present economic value as forgiveness.[54]

The question remains as to which Wisconsin court correctly resolves the deferral issue for principal residences. In our judgment, the *Kuhnen* court's analysis is more persuasive than the *Taylor* court's. We are not persuaded that there is a constitutionally sound distinction between deferral and forgiveness. Furthermore, the denial of nonrecognition treatment to departing residents imposes a substantial burden on them.[55] Due to the burden's substantiality, the tax amounts to the imposition of a levy on departing residents, which can withstand scrutiny under the Privileges and Immunities Clause only if there are compelling "independent" reasons for the discrimination.[56]

We are not persuaded that there is a constitutionally sound distinction between deferral and forgiveness.

We conclude that denying departing residents nonrecognition treatment of the sale of a principal residence should not survive constitutional scrutiny when continuing residents enjoy that treatment.[57] Even the *Taylor* court conceded that, at least for tax years beginning after 1979, no tax would ever be imposed on the deferred gain enjoyed by homeowners who relocate within Wisconsin except in "rare" cases.[58] On this assumption, the essential rationale for taxing departing residents upon their departure collapses, for the denial of deferral ceases to be a rough but administratively feasible way of achieving equality between residents and nonresidents. Rather, it imposes a burden on nonresidents that will be borne, if at all, only by a small percentage of residents, and at a fraction, in present value terms, of the burden imposed on departing residents. Properly interpreted, the Privileges and Im-

[48]106 Wis. 2d at 350, 316 N.W.2d at 829.

[49]143 Wis. 2d 134, 420 N.W.2d 401 (App. 1988), petition for review denied, No. 86-0372 (Mar. 22, 1988).

[50]Most resident owners eventually qualified for the increased exclusion of gain by owners over the age of 55 (*see* discussion in *Taylor v. Conta*, 106 Wis. 2d 321, 333, 316 N.W.2d 814, 821 (1982)) available under a 1979 state statute that incorporated I.R.C. section 121 into Wisconsin law. The court failed to mention an additional avenue of forgiveness: If the residence is not sold, the step-up in basis upon the owner's death. *See* I.R.C. section 1001(a),(c).

[51]143 Wis. 2d at 149, 420 N.W.2d at 407.

[52]143 Wis. 2d at 150, 420 N.W.2d at 408.

[53]The present value of one dollar in 20, 30, or 40 years, assuming a 10-percent discount rate, amounts to about $.15, $.06, and $.02, respectively.

[54]Consider a taxpayer in his late twenties or early thirties who purchases a "starter" home and follows the typical pattern of "trading up" to successively more expensive homes, using the appreciation in the prior residence to finance the downpayment on the new residence. He enjoys virtual forgiveness of the tax on the sales of the first or second home. In addition, if the taxpayer remains in the last home he purchases for an extended period, as many homeowners do, he will enjoy significant deferral while living there, even if he eventually sells that home, wholly apart from the benefit of the exclusion for taxpayers over age 55. In short, the distinction between deferral and forgiveness has limited economic substance for most homeowners, and it does not recommend itself as a basis for drawing constitutional lines between permissible and impermissible discrimination against nonresidents.

[55]It is worth noting that even the *Taylor* court assumed that "the statute in practical effect unequally burdens non-residents." *Taylor*, 106 Wis. 2d at 334, 316 N.W.2d at 821.

[56]*Hicklin v. Orbeck*, 437 U.S. 518, 525-26 (1978); *Toomer v. Witsell*, 334 U.S. 385, 395-96 (1948).

[57]We recognize, however, that the state from which the homeowner departs has legitimate administrative concerns in enforcing its right to collect the tax from its former residents when the gain is recognized. Although *Taylor* is wrong in implying that a state would actually lose jurisdiction to tax the deferred gain merely because the home seller leaves the state, it is true that a state would be likely to face daunting hurdles in implementing its right to tax the departing resident's deferred gain.

[58]*Taylor*, 106 Wis. 2d at 333, 316 N.W.2d at 821. Because the $100,000 exclusion for homeowners over the age of 55 was not adopted until 1979 — three years after the tax years at issue in *Taylor* — the court characterized the taxpayers' proof of significant disadvantage as "weak in light of the limited avoidance of gain available to residents in 1976." 106 Wis. 2d at 333, 316 N.W.2d at 820-21. The court recognized, however, that the subsequent changes in federal law after 1976 "made it more likely that Wisconsin residents who had deferred gain in 1976 and still owned a home in 1979 could totally avoid taxation on the deferred gain." 106 Wis. 2d at 333, 316 N.W.2d at 821. Hence, even the *Taylor* court might share our view if presented with a post-1979 transaction.

munities Clause precludes such unjustifiably disparate treatment of residents and nonresidents.

How all this would play out in the context of taxation of nonresident pensions is unclear. The disparate treatment of residents and nonresidents with respect to the availability of deferral is the same in the pension context as it is in the homeowner context. On the other hand, in the pension context, there is no forgiveness of the resident's tax liability, so one can argue more persuasively that the denial of deferral to departing residents is a rough but administratively feasible means of achieving equality between residents and nonresidents. Moreover, if Congress bars states from taxing nonresidents' pension income, the states' position as to the administrative need for differential treatment of departing residents certainly becomes more compelling. Then, the states would face a statutory bar on their jurisdiction, rather than substantial administrative problems that might in fact be capable of solution.[59]

IV. CONCLUSION

We remain agnostic over the question whether proposed federal legislation barring states from taxing nonresident pension income should be enacted. Although we believe that most of the reasons thus far advanced for adopting such legislation are specious, there nevertheless are powerful practical considerations that may justify such a congressional bar. The response of the states to such legislation could well render the nonresident retirees' victory a hollow one, but the states may face constitutional difficulties if they were to seek to deny deferral to departing residents only. In any event, our purpose here was not to provide easy answers to difficult questions, but rather to assure that the right questions were being asked. Only through a rational analysis of the tax policy and constitutional questions raised by the interaction of federal and state tax rules can we hope to find sensible answers to these questions.

[59]This presents the unusual prospect of federal legislation having an impact on how the privilege and immunities clause, a part of the federal Constitution, applies to the states. Nonetheless, under the standard that a tax levy discriminating against nonresidents (which would presumably include departing residents) is justified if there are compelling reasons for the discrimination, there is no reason why avoiding the repercussions of a congressional statute cannot furnish the compelling reason.