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Repository Citation

James C. Smith and Walter Hellerstein, *State Taxation of Federally Deferred Income: The Interstate Dimension* (1989),

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State Taxation of Federally Deferred Income: The Interstate Dimension

JAMES CHARLES SMITH* AND WALTER HELLERSTEIN**

I. INTRODUCTION

Most states that impose income taxes¹ conform their levies to the federal model.² Consequently, when income is realized but not recognized at the federal level—for example, when a taxpayer reinvests the gain from the sale of her former residence in a new residence³ or when a taxpayer realizes gain from the exchange of like-kind property⁴—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,⁵ 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 her 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

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We would like to thank Alan Gunn, Sandra McCray, Robyn Pekala, Richard Pomp, Allan Samansky, and Donald Weidner for their helpful comments on an earlier draft of this article.

¹ Forty states impose broadly based personal income taxes. See [1 All States] State Tax Guide (CCH) ¶ 15-110 (Jan. 1989). Connecticut, New Hampshire, and Tennessee impose taxes on limited types of personal income. See *id.* Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming impose no personal income taxes. See *Id.* Forty-five states impose corporate income taxes (see *id.* at ¶ 10-060 (Mar. 1989)), including all those states imposing personal income taxes as well as Alaska and Florida.

² See [1 All States] State Tax Guide (CCH) ¶¶ 15-110 (Jan. 1989), 10-060 (Mar. 1989). Although a few states have embraced conformity in its purest form by piggybacking their income taxes directly onto the federal income tax (R.I. Gen. Laws § 44-30-2 (1988) (state personal income tax 22.96% of federal income tax); Vt. Stat. Ann. tit. 32, § 5822 (Supp. 1989) (state personal income tax 25% of federal income tax)), the overwhelming majority of states take the more moderate course of employing federal adjusted gross income or federal taxable income as the computational starting point for determining state taxable income.

³ IRC § 1034.

⁴ IRC § 1031.

⁵ For a brief discussion of these policies, see notes 14 and 16 and accompanying text.

address not only the question of *when* income is recognized, but also the question of *where* it is recognized.⁶

This article considers the appropriate state tax treatment of nonrecognition transactions that cross state lines. We examine issues of tax policy and constitutional law raised by such transactions by focusing on two discrete nonrecognition transactions: (1) nonrecognition of gain from the sale of a personal 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.⁷ Despite the differences between these two transactions, the nonrecognition issues they raise share common themes: whether a state should respect federal nonrecognition rules for transactions with which it has a more limited jurisdictional relationship than does the federal government, and whether the Constitution imposes limitations on a state's power to fashion its own rules in this domain.⁸

⁶ The analogous issue can arise in the context of federal income taxation when, for example, a United States citizen sells her residence and purchases a new residence abroad. This is, however, a relatively rare occurrence compared to the number of such interstate transactions. Moreover, in the international context one of the taxing jurisdictions involved is not subject to the constraints of the United States Constitution, and its income tax regime, if any, is not likely to share with the United States the common features that the states' income tax regimes share with one another. Hence the unifying constraints upon and characteristics of the states' taxing schemes, which permit a structured analysis of interjurisdictional dimension of the nonrecognition issue, are simply absent in the international context.

For federal tax purposes, the purchase of a new principal residence in a foreign country fully qualifies for nonrecognition of gain. Rev. Rul. 71-495, 1971-2 C.B. 311 (resident alien sold United States residence at gain, returning permanently to Norway, country of citizenship); Rev. Rul. 54-611, 1954-2 C.B. 159 (United States citizen bought new residence in foreign country). The 1971 revenue ruling is silent on the question whether the United States might ever tax the Norwegian citizen's deferred gain. There also are no territorial restrictions for like-kind exchanges under § 1031. Rev. Rul. 68-363, 1968-2 C.B. 336 (exchange of ranch for ranch in foreign country eligible for nonrecognition of gain). However, if the taxpayer is a nonresident alien individual or a foreign corporation, gain will be unrecognized "only in the case of an exchange of a United States real property interest for an interest the sale of which would be subject to [United States income] taxation." IRC § 897(e). Moreover, a provision of the Tax Reform Act of 1986 applies to United States citizens who renounce their United States citizenship, if tax avoidance is one of the principal purposes for expatriation. For a ten-year period, the gain on the sale or exchange of foreign replacement property is treated as income from sources within the United States, and is generally taxed at the rates applicable to United States citizens. IRC § 877, as amended by Pub. L. No. 99-514, § 1243(a), 100 Stat. 2085, 2580-81.

⁷ The involuntary conversion of property, the proceeds from which are invested in similar property in another state, raises issues similar to the like-kind exchange. See text accompanying notes 112-117.

⁸ A number of other transactions that involve federal income tax deferral have interstate dimensions. Prime examples are: (1) installment sales of property by taxpayers not residing in the state where the property is located; (2) depreciation of property, and the subsequent recapture thereof, by taxpayers not residing in the state where the property is located; and (3) deferred compensation arrangements involving taxpayers who do not reside in the state of their former employment. The analysis of the issues addressed in this article is relevant to the analysis of similar issues that may be raised by state taxation of these types of federally deferred income. However, each of these issues raises its own set of problems, many of which involve

II. THE FEDERAL NONRECOGNITION PROVISIONS

As a general rule, a taxpayer's sale or exchange of property constitutes a taxable event for federal tax purposes. The sales proceeds are compared to the taxpayer's adjusted basis in the property, yielding either a gain or a loss. If the proceeds exceed the basis, the difference is gain, which is both realized and recognized in the year of sale.⁹ The Internal Revenue Code departs from this approach, however, with respect to certain types of property transactions for which it permits deferral of gain or, in some cases, even forgives the gain altogether.¹⁰ The most important deferral transactions are like-kind exchanges,¹¹ involuntary conversions,¹² and replacements of principal residences.¹³ The tax benefit of these transactions often proves to be substantial, and many transactions are structured with deferral as a primary goal.

While each of the deferral provisions has its own set of rules and limitations, they share underlying policy rationales. The justifications typically offered for deferral are a continuity of the taxpayer's investment¹⁴ and the taxpayer's lack of liquid assets.¹⁵ In like-kind exchanges, involuntary conversions, and principal residence replacements, the taxpayer disposes of property and acquires new property that is viewed as performing the same basic function as the old property. The taxpayer has essentially chosen to continue or maintain his investment in a particular type of asset; he has not intended to make a real change in the character of his assets. This continuity of investment is closely linked to the taxpayer's liquidity, since if gain is recognized, the taxpayer will not have proceeds from the disposition or sale with which to pay a tax.¹⁶ The

the technical complexities of the precise deferral mechanism involved. In the interest of keeping this article to manageable proportions, we have therefore limited our focus to the provisions of the Code that explicitly provide for nonrecognition treatment for the sale or disposition of property.

⁹ IRC § 1001(a), (c).

¹⁰ The prime examples of total forgiveness are a sale of a principal residence by a taxpayer over the age of 55 (IRC § 121 permits a one-time exclusion of up to \$125,000 of gain), and transfers at death (IRC § 1014(a)(1) provides that heirs take property with basis equal to its fair market value at date of decedent's death).

¹¹ IRC § 1031. Like-kind exchanges also defer losses.

¹² IRC § 1033.

¹³ IRC § 1034.

¹⁴ See Reg. § 1.1002-1(c). Other rationales sometimes offered for the nonrecognition provisions are that they encourage mobility of capital and that, in the case of § 1031 transactions, they avoid difficult valuation issues. See, e.g., W. Klein, B. Bittker & L. Stone, *Federal Income Taxation* 309-10 (7th ed. 1987). Of course, the latter rationale has force only in the rare two-party exchange in which no other money or property ("boot") changes hands so that there is no need to value the property for federal tax purposes.

¹⁵ That is, gain should not be recognized if the transaction does not generate cash with which to pay the tax.

¹⁶ Cogent arguments can be made that the federal nonrecognition provisions are not in fact justifiable on the basis of continuity of investment or liquidity, or on the basis of any other

proceeds were reinvested in the replacement property, so the taxpayer would have to borrow or resort to other assets to fund the tax payment.

III. REPLACEMENT OF PRINCIPAL RESIDENCE

A. *Federal Rollover Rules*

One valuable tax advantage provided for homeowners by the Internal Revenue Code is the nonrecognition of gain that is "rolled over" into the purchase price of a new residence. This rule of nonrecognition is an exception to the general rule that gain from the sale of property is both realized and recognized at the time of sale. Under § 1034, recognition of gain on a sale of a principal residence is deferred if another residence of equal or greater value is purchased within two years from the date of the sale.¹⁷ There is no limit to the number of times a homeowner can use this provision during her lifetime, although generally there must be a two-year waiting period between rollovers.¹⁸ Upon the taxpayer's purchase of a replacement residence, recognition of gain and payment of tax is postponed rather than forgiven. When a taxable disposition of the replacement residence occurs, the gain must be recognized. To effectuate the deferral and eventual recognition of gain, the basis of the new residence is computed by subtracting the deferred gain from its cost.¹⁹

While § 1034, on its face, confers only tax deferral, for many homeowners the deferred gain is ultimately forgiven, in whole or in part, due to the application of other sections of the Code. Up to \$125,000 of the deferred gain may be forgiven if the owner sells the new residence after reaching the age of 55.²⁰ Alternatively, complete forgiveness of the gain

rationale. See, e.g., Kornhauser, Section 1031: We Don't Need Another Hero, 60 S. Cal. L. Rev. 397 (1987) (recommending abolition of like-kind exchanges after describing flaws in rationales advanced to support § 1031).

While it is beyond the scope of this article to assess the merits and weaknesses of the federal nonrecognition provisions, such an assessment is not unrelated to our topic. If one concludes that the federal policies lack coherence, then, to the extent that this article indicates that states encounter theoretical and practical problems with interstate nonrecognition transactions that are not present at the federal level, the state legislatures should have an even greater incentive than Congress to modify or repeal nonrecognition treatment for residence replacements, like-kind exchanges, and involuntary conversions.

¹⁷ IRC § 1034(a). If the cost of the new residence is less than the adjusted sales price of the old residence, some deferral of gain is still possible. Gain is recognized in the year of sale up to the extent of the difference between that cost and the adjusted sales price. Any realized gain in excess of this amount is deferred. *Id.*; Reg. § 1.1034-1(a).

¹⁸ For successive rollovers of gain, each sale must occur more than two years after the date of the preceding sale. IRC § 1034(d)(1). An exception to the two-year waiting period is provided for employment related moves. IRC § 1034(d)(2).

¹⁹ IRC § 1034(e). For example, a taxpayer who sells a residence costing \$100,000 for \$140,000 (realizing a \$40,000 gain) and replaces it with a \$200,000 residence will have a new basis in the replacement residence of \$160,000.

²⁰ IRC § 121.

occurs if the owner still owns a replacement residence at death and has previously rolled over gain.²¹

B. The Problem of the Interstate Move

By adopting federal adjusted gross income as the computational starting point for determining state personal income tax liability, most states have implicitly adopted the federal rules permitting rollover of gain on the sale of a principal residence. These states, therefore, generally tax the deferred gain only when the residence is sold in a transaction that does not qualify for deferral under federal law.

When a homeowner sells her principal residence in connection with an interstate move, however, the interaction of the federal rollover provisions with state income tax regimes raises a number of related questions that do not arise in a wholly intrastate transaction. Should the state from which the taxpayer is departing or the state to which the taxpayer is moving tax the deferred gain, and when should that gain be taxed? Should the old state tax the gain immediately upon the former resident's departure despite the fact that the gain is not then recognized at the federal level? Can the new state tax the gain from the sale of the former residence upon subsequent disposition of the new residence and recognition of the gain on the old residence for federal tax purposes?

These questions raise two sets of issues. The first set of issues involves tax policy concerns, 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.²² The second set of issues involves constitutional concerns. Whatever may be the dictates of sound tax policy, the states operate within the constraints imposed by the federal Constitution. These constitutional restraints require, among other things, that the states refrain from extending their taxes to income with which they have no minimum connection²³ and that they not discriminate against nonresidents²⁴ or interstate commerce.²⁵ Examination of the nonrecognition issues raised by the taxpayer who moves interstate must

²¹ IRC § 1014(a)(1). The basis of the residence in the hands of the devisee will be stepped up to fair market value.

²² See, e.g., R. Musgrave & P. Musgrave, *Public Finance in Theory and Practice* 225 (4th ed. 1984).

²³ E.g., *Miller Bros. v. Maryland*, 347 U.S. 340, 344-45 (1954) ("due process requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax").

²⁴ See, e.g., *Toomer v. Witsell*, 334 U.S. 385 (1948) (striking down license fee discriminating against nonresidents under the privileges and immunities clause, U.S. Const. art. IV, § 2).

²⁵ See, e.g., *Bacchus Imports v. Dias*, 468 U.S. 263 (1984) (striking down tax discriminating against out-of-state liquor under commerce clause, U.S. Const. art. I, § 8, cl. 3).

therefore take into account constitutional, as well as tax policy, considerations.

1. Tax Policy Considerations

a. Taxation by State of Former Residency²⁶

Assume a homeowner who resides in state *A* moves to state *B*, selling her home in state *A* at a gain and reinvesting the proceeds in a home in state *B*, thereby deferring recognition of the gain for federal tax purposes.²⁷ The question for state tax purposes is when, if ever, state *A* should require the taxpayer to recognize and pay tax to state *A* on the federally-deferred gain from the sale of her former state *A* residence? There are four possible approaches state *A* could adopt with respect to the deferred gain of such a taxpayer.

i. Forgiveness of Tax on Deferred Gain

The simplest approach would be for state *A* to ignore the deferred income of the taxpayer who moves to state *B*. The principal justification for this approach is administrative convenience. After the taxpayer moves to state *B*, state *A* tax administrators will tend to lose contact with the taxpayer who has become a nonresident. To keep tabs on this nonresident in an effort to collect an income tax from her at some future point will be difficult at best.²⁸ State *A*'s adoption of a *laissez faire* policy with respect to the federally deferred gain the taxpayer realized upon the sale of her state *A* home offers an easy solution to the problems that seeking to tax such gain could raise.

Laissez faire is apparently the prevailing policy in most states.²⁹ This may be somewhat surprising since the policy results in complete forgiveness of tax on the deferred gain by the state of the taxpayer's former residency, with a consequent revenue loss.³⁰ It may be even more sur-

²⁶ In order to avoid confusion between the use of the term "residence" to denote a taxpayer's principal residence (that is, her home) and use of the term "residence" to denote the status of being a resident of a particular state, we use the term "residency" to denote the latter concept throughout this article.

²⁷ If the homeowner is entitled to only partial deferral of the gain because the cost of the new home is less than the adjusted sales price of the old home (see note 17), the discussion throughout this part of this article is only applicable to the portion of the gain that is deferred.

²⁸ See *Taylor v. Conta*, 106 Wis. 2d 321, 316 N.W.2d 814 (1982); and text accompanying notes 37-43.

²⁹ We base this statement on the fact that no state (except North Dakota, see note 40) has legislation which explicitly authorizes the taxation of the federally deferred gain and on our informal inquiries to a number of state tax authorities that indicate that they make no effort to tax the deferred federal gain of former residents when the gain is recognized for federal tax purposes.

³⁰ This is tantamount to giving the taxpayer a basis step up when he moves out of state.

prising considering that the policy is also inconsistent with the states' taxing statutes that provide for taxation of nonresidents upon income from sources in the state, including income from the disposition of real property located in that state.³¹ The state statutes, insofar as they rely on federal adjusted gross income as their computational starting point, appear to include within the state tax base income recognized from the sale of real property in the state—even though the income may have been realized (and deferred) years ago.

From the standpoint of equity and efficiency, the soundness of the forgiveness policy depends on the treatment of the taxpayer upon subsequent disposition of the property in a transaction that is taxable under federal law. If such a transaction is taxed in full by the state of new residency, there is nothing unfair or inefficient³² about the *laissez faire* policy of the state from which the taxpayer departed. Under this assumption, the taxpayer moving interstate will be treated exactly like the taxpayer moving intrastate, and there will be no tax induced incentive either to make or refrain from making an interstate move. If, however, such a transaction is not taxed in full,³³ then both equity and efficiency considerations suggest that the *laissez faire* policy is undesirable.³⁴

What, then, is the explanation for the prevalence of the *laissez faire* policy, which seems contrary to the states' fiscal interests and is questionable from the perspective of equity and efficiency? The answer lies prin-

³¹ E.g., Cal. Rev. & Tax Code § 17041(b) (West 1989); Cal. Personal Income Tax Reg. § 17951-3, reported in [Cal.] St. Tax Rep. (CCH) ¶ 18-903 (Jan. 1989); N.J. Stat. Ann. § 54A:5-8(1) (West 1986); N.Y. Tax Law § 631(b)(1) (McKinney 1987).

³² An efficient tax system is one that is economically neutral, that is, one that does not bring about economic distortions by causing people to alter their behavior solely on account of the tax consequences of their actions. While there is an enormous literature on the impact of particular taxes on taxpayer behavior generally, this article is concerned exclusively with the relationship of state tax policy to interstate transactions. Hence we are concerned with efficiency or neutrality only insofar as a particular state tax policy induces non-neutral behavior with respect to the tax consequences of engaging in an intrastate vis-a-vis an interstate transaction. Cf. *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 331 (1977) (transfer tax that imposes a greater tax liability on out-of-state brokerage sales than on in-state sales "forecloses tax-neutral decisions" between the two, thereby discriminating against interstate commerce in violation of the commerce clause).

³³ As we point out below, there are strong constitutional arguments supporting the proposition that, upon a subsequent disposition of the property, the state to which the taxpayer moves may not tax the deferred gain from the sale of the taxpayer's former residence, at least if she sold the property while still a resident of the original state. See text accompanying notes 87-95. Moreover, if a taxpayer moves to a state like Florida or Texas, which has no personal income tax, the subsequent disposition of the taxpayer's residence will have no state consequences there.

³⁴ The taxpayer who moves intrastate has a heavier tax burden than one who moves interstate and thus taxpayers might be induced into tax-motivated moves, resulting in inefficiency. Although in a pure sense, "full" taxation by the state of new residence would mean not only inclusion in income but taxation at an equivalent rate, realistically equity and efficiency should be considered satisfied by inclusion.

cipally in the fact that the policy is not the result of considered decision making. It is rather a *de facto* policy reflecting the interaction of two factors: (1) the state's lack of statutory authority to tax the federally deferred income when it is realized because it is not recognized for federal (and hence for state) tax 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 connections with the taxing state.

The taxpayer who sells her residence in state *A* and replaces it with a residence in state *B* therefore falls through the cracks of the state *A*'s taxing regime. When the former residence is sold and it would be relatively easy for state *A* to tax the gain, state tax officials may have no statutory authority to tax it because the state law follows federal nonrecognition. When they have authority to tax it on the subsequent sale, state *A* officials may fail to realize that they have such authority or, if they do consider the issue, they may decide informally not to take enforcement action given their perception of the administrative burdens.

ii. Federal Piggybacking

There is ample justification for a state to decide, for reasons of fiscal policy, fairness, and efficiency,³⁵ that it is improper to forgive completely the deferred gain on a sale of a principal residence when a seller moves interstate and utilizes the federal rollover rules. Once this decision is made, it is necessary to select an administratively feasible mechanism for the collection and enforcement of the tax that is or will become due.

One possible approach available to state *A* is to follow precisely the federal nonrecognition rules. Under this approach, which can be referred to as "federal piggybacking," deferral of gain continues until the taxpayer sells or disposes of her new residence in state *B* in a transaction generating federal taxable income. The statutory pattern presently in force in most states calls for federal piggybacking, but as indicated above,³⁶ most states fail to enforce their statutes, adopting a *laissez faire* policy of forgiving the deferred gain.

Under the federal piggybacking approach, state *A* cannot predict when a taxable disposition will occur, or indeed, whether one will ever occur.³⁷ If a taxable sale of the state *B* residence (or its replacement) does occur,

³⁵ The fairness and efficiency justifications depend on the assumption that the deferred gain will not be taxed by the state to which the taxpayer moves—an assumption that is reasonable and, perhaps, constitutionally mandated. See text accompanying notes 88-95.

³⁶ See text accompanying notes 28-29.

³⁷ Forgiveness of the gain will result if the taxpayer continues to own the state *B* residence until her death, or if she sells after reaching age 55 and the gain is less than \$125,000. See note 10. Alternatively, she may move elsewhere, selling her state *B* residence and using a § 1034 rollover a second time. See note 18 and accompanying text. Other nontaxable dispositions of

the taxpayer would be legally obligated to report to state *A* the gain realized on the sale of her state *A* residence.³⁸ It is true that she has become a nonresident, and a number of years may have passed since the change in her residency status. Nonetheless, states plainly possess the power, which they generally exercise, to tax nonresidents upon income derived from sources within the state.³⁹ Here, the taxpayer realized income from the sale of her state *A* residence. Although the income was recognized in a taxable year when she was a nonresident, this should not affect the ability of state *A* to tax that portion of the taxpayer's federal adjusted gross income that has its source in state *A*.⁴⁰

Is it practical for state *A* to collect a tax when the deferred gain is recognized? State *A* may encounter substantial problems of administration and collection if the tax on the deferred gain is due at some indefinite time in the future, when the nonresident makes a taxable transfer of her replacement residence in state *B*. In an income tax system that relies on

the state *B* residence are also possible: for example, an involuntary conversion, or, if converted to rental property, a like-kind exchange. See text accompanying notes 107-17.

³⁸ For purposes of state *A*'s taxation of the deferred gain, the amount realized from the taxable sale or disposition of the state *B* residence should be immaterial. The federally recognized gain, of course, will be equal to the deferred gain from the sale of the state *A* residence, adjusted by the difference between the amount realized and the cost of the state *B* residence. If the difference is a positive number (reflecting appreciation of the state *B* home), state *A* obviously cannot tax it.

Alternatively, if the amount realized is less than the cost of the state *B* residence (reflecting depreciation or selling expenses), state *A* should be able to tax all of the federally deferred gain on the state *A* residence, even though a lesser sum will be reported at the federal level. For example, assume the taxpayer realizes a gain of \$30,000 on the sale of her state *A* home, purchases a replacement in state *B* for \$100,000, and later sells the replacement home for \$90,000 (after expenses). Although she will report a \$20,000 gain for federal purposes, state *A* should be able to tax the entire \$30,000 of deferred gain. Effectively, the taxpayer incurred a loss of \$10,000 on the purchase and sale of her state *B* home, while a nonresident of state *A*. As such loss is completely unconnected to her prior residency or to her state *A* activities, state *A* should not give her the benefit of the federal rule that nets the deferred gain with a subsequent loss.

³⁹ *New York ex rel. Cohn v. Graves*, 300 U.S. 308, 312-13 (1937); *Lawrence v. State Tax Comm'n*, 286 U.S. 276 (1932). See also note 31 and accompanying text.

⁴⁰ Conceptually, this sequence is closely analogous to a nonresident who, having never resided in state *A*, sells real estate situated in state *A* at a profit. The gain on a nonresident's sale of real estate is treated as income by the state where the real estate is located, under the source rationale. See notes 31 and 39. The two fact patterns are functionally identical if our taxpayer who moved from state *A* to state *B* entered state *B*, as a new resident, before she was able to sell her state *A* residence. In that case, she was a nonresident at the time of both the realization and recognition of the gain on the sale of the state *A* residence.

While the general language of most state income tax statutes appears to authorize the federal piggyback approach, one state has explicit legislation pointing in this direction. A North Dakota provision, enacted in 1979, states:

Any gain or loss resulting from the sale or exchange of a principal residence in this state by a taxpayer who reinvests in another principal residence outside of this state shall be treated in the same way for state income tax purposes as it is treated for federal income tax purposes.

N.D. Cent. Code § 57-38-01.13 (1983).

voluntary reporting, will the taxpayer realize that she should file a nonresident return in a state from which she may have departed long ago? If she does not report the sale of her state *B* residence on her own initiative, will state *A* tax administrators be able to discover the omission and remind her? During the years that the taxpayer has lived in state *B*, she will not have filed a state *A* nonresident return, unless she has continued to work periodically in state *A*⁴¹ or has other income from sources within state *A* requiring her to file a nonresident return on a continuing basis. Unless the former resident continues to file returns in state *A*—and the vast majority will not—it is unlikely that she will file a nonresident return reporting the deferred income to state *A* upon a taxable transfer of the replacement residence.

Cost-effective and efficient administration thus depends on state *A*'s ability to discover when the taxpayer has made a taxable transfer of the state *B* residence. It is, of course, exceedingly unlikely that state *A* tax administrators will discover first hand evidence of the actual sale of out-of-state real property. Were the residence located within state *A*, a monitoring system could be implemented, although it could prove to be expensive. Sales and other transfers of property by deed would generally be a part of the real property recording system, maintained by the local governments of state *A*. A feasible system probably could be devised to forward information about the recorded transfer to state income tax officials. For out-of-state property, however, cross-checking of deeds and state income tax returns is not practical. Other alternatives state *A* could consider to facilitate enforcement of the tax at the time of the nonresident's sale of out-of-state property include monitoring the former resident's federal income tax returns,⁴² requiring the departing resident to post a bond with state *A* to cover the potential tax liability on the nonrecognized gain, or filing a state tax lien on the out-of-state replacement property.⁴³

⁴¹ In this situation, the taxpayer's employer already has withheld estimated income tax from the nonresident's compensation. Due to the withholding, the nonresident should be aware of the obligation to file a return, and the state will expect to receive a return from each nonresident who has paid withholding tax.

⁴² Assuming that the former resident properly reports the taxable sale or disposition of the replacement residence, it will appear on federal Form 2119 (Sale of Your Home). If she is no longer using the replacement residence as her principal residence at the time of sale or she does not engage in another § 1034 rollover, it should be reported as a capital gain on federal Schedule D. This check would have to be done on an annual basis, beginning during the tax year after the former resident's sale of the old residence in state *A*. The state could also monitor federal informational returns reporting real estate transactions. See IRC § 6045(e) requiring an attorney, title company employee, mortgage lender, or broker to file a return with the Service for each real estate transaction with which she is involved.

⁴³ See also notes 84 and 102-03 and text accompanying notes 101-03. Another possibility is suggested by a recent statute enacted in Vermont, which requires, in the case of any sale or exchange by a nonresident of real property located in Vermont, that the transferee withhold

Taxation by state *A* of the deferred gain if and only if the taxpayer subsequently makes a taxable transfer of the new out-of-state residence is equitable. The tax treatment of income from property transactions should neither favor nor penalize a taxpayer who moves interstate. The rule is also economically neutral with respect to the interstate nature of the taxpayer's move. The taxpayer who relocates to state *B* is treated in exactly the same manner as the taxpayer who moves within state *A* in terms of eligibility for nonrecognition and the eventual imposition of income tax liability by state *A*.

iii. Nonrecognition Only for In-State Replacement

Another possible solution for state *A* is to conform to the federal rollover rules generally, but with one major modification: It could require that, for purposes of state income tax, the replacement residence be located within state *A*.⁴⁴ Four states presently take this approach.⁴⁵ Under this rule, when there is no replacement within state *A*, gain on the sale of a principal residence is both realized and recognized at the time of sale. Such denial of rollover of gain directly advances the state's interest in effective monitoring of tax liabilities and collection of tax revenues. In most circumstances, administration will be far simpler than in the typical case of a nonresident who sells in-state realty at a gain. If the relocating taxpayer sells during the tax year in which the move occurs (whether before or after the move), the taxpayer will already be required to file a return for the partial year of residency.⁴⁶ Such an approach, however,

and transmit to the tax commissioner as payment against the income tax imposed on income received by the seller 2.5% of the consideration paid for the transfer. Vt. Stat. Ann. tit. 32, § 5847(a) (1989).

⁴⁴ Such a locational requirement would need to be set forth in the state tax code as a deviation from the otherwise applicable federal tax rules.

⁴⁵ Ala. Code § 40-18-8(e) (1975); Ark. Stat. Ann. § 26-51-404(b)(2) (1987); Ga. Code Ann. § 48-7-27(b)(6) (Supp. 1989); Haw. Rev. Stat. § 235-2.4(f) (Supp. 1988). Oregon and Wisconsin applied similar statutes requiring in-state replacement for a number of years. See notes 72 and 138 and accompanying text.

A provision of Georgia's income tax law is illustrative:

When, on the sale or exchange of real or tangible personal property located in this state, gain or loss is not recognized because the taxpayer receives or purchases similar property, the nonrecognition shall be allowed only when the property is replaced with property located in this state.

Ga. Code Ann. § 48-7-27(b)(6) (Supp. 1989) (enacted 1971).

The Arkansas statute is unusual in that it conditions nonrecognition on both the old and the new residences being located within the state. This seemingly taxes an incoming resident who sells an out-of-state home and replaces with an Arkansas home. Apparently, however, no such tax on newcomers is actually imposed due to another unusual rule that generally excludes from the gross income of resident individuals income derived from the use, production, or sale of out-of-state real property. Ark. Reg. § 7.84-2018.1 (1969).

⁴⁶ This assumes, of course, that the departing resident has other income, earned or otherwise, for the taxable year of the move in excess of the state income threshold for resident filing.

creates equity and efficiency concerns by imposing tax burdens on interstate moves not imposed on intrastate moves, and it raises constitutional problems as well.⁴⁷

iv. Tax Upon Change in Residency Status

The most aggressive position state *A* could adopt with respect to out-of-state residence replacements would be to make change in residency status a taxable event. Gain on the in-state residence would be recognized when the taxpayer, in moving to state *B*, ceased to use the in-state residence as her principal residence on the theory that change in residency coincides with change in use of the property. Alternatively, this approach could be supported by arguing that realization is a concept rooted in administrative convenience and that administrative considerations justify a special rule of realization for one who changes residency. Administratively, this approach has the advantage of not requiring the taxpayer to file a nonresident return during some year after the move. Any tax would be due when the taxpayer files a tax return for the last partial year as a resident. Whether such a policy is justified from a fairness and efficiency standpoint would depend largely on whether the deferred gain would be taxed by some other state. If both state *A* and the state of new residency were to tax the deferred gain, unfairness and inefficiency would result because the taxpayer would be penalized due solely to the interstate nature of her move. If, on the other hand, the state of new residency either exempted the deferred gain or extended a credit to the taxpayer for the tax previously paid to state *A*, both the fairness and efficiency criteria would be satisfied.⁴⁸

A recognition-of-gain rule based on change in residency status could take one of two forms. A broad enactment would mandate the reporting of gain, whether or not the in-state residence is sold, thus necessitating the appraisal of the residence as of the time the owner becomes a nonresident.⁴⁹ Such a provision would represent a radical departure from cur-

Almost all individuals who are affluent enough to own a home, and to sell it at a gain, have annual incomes substantially larger than the relatively low filing thresholds.

⁴⁷ See text accompanying notes 70-85.

⁴⁸ See text accompanying notes 32-34 and text following note 66.

⁴⁹ Hawaii adopts a hybrid of this approach by making change in residency an element that triggers recognition of gain, when coupled with a sale and the lack of an in-state replacement:

Section 1034 (with respect to rollover of gain on sale of principal residence) of the Internal Revenue Code shall be operative for the purpose of this chapter; provided section 1034(a) (with respect to nonrecognition of gain) of the Internal Revenue Code shall apply only to:

- (1) A taxpayer who purchases a replacement residence which is located within the State, or
- (2) A taxpayer who is a resident of the State, taxable upon the taxpayer's entire income, computed without regard to source within the State.

rent principles of income taxation, reflected both by the Internal Revenue Code and by prevailing state tax statutes.⁵⁰ As a general rule, a taxpayer does not realize income when an asset owned by the taxpayer appreciates in value.⁵¹ That appreciation is not taxed until the occurrence of a "realization," such as a sale or other disposition of the asset. Taxing gain upon a change in taxpayer status (or a change in use) requires an exception to the general rules of income realization. To implement such an exception, the change in status from resident to nonresident, coupled with change in use of the residence, could be statutorily defined as the realization of income.

A narrower formulation of a recognition rule tied to change in residency would apply only to those residents who previously used the deferral mechanism.⁵² This would work a less drastic revision of present concepts of income realization. A resident who moved out-of-state would be required to report any gain previously realized but not recognized prior to the move, due to the purchase of an in-state residence to replace an earlier principal residence.⁵³ Under this narrower version, administration would be easier because an appraisal of the value of the residence at the time of the move would not be required since the previously deferred gain was established when the taxpayer purchased the in-state residence. However, imposing a tax upon change in residency status, like permitting nonrecognition only for in-state replacements, creates equity and efficiency concerns by treating those who move interstate less favorably than those who move intrastate, and it raises constitutional problems.⁵⁴

Haw. Rev. Stat. § 235-2.4(1) (Supp. 1988). Subsection (2) may be largely superfluous because purchase of a new principal residence outside the state almost always coincides with a change in residency status. See note 71. Nevertheless, the statute appears to countenance nonrecognition for a taxpayer buying a new out-of-state principal residence if the taxpayer still is domiciled in Hawaii on the date of purchase. Apparently, nonrecognition then continues if the taxpayer subsequently relinquishes Hawaiian residency.

⁵⁰ The Internal Revenue Code and the conforming state income tax codes do, however, provide for recognition of income in some cases in which it otherwise would not be traditionally treated as realized. See IRC § 951 et seq. (special recognition rules for income of controlled foreign corporations); IRC § 1271 et seq. (special recognition rules for original issue discount obligations and certain other debt instruments).

⁵¹ E.g., *Eisner v. Macomber*, 252 U.S. 189 (1920).

⁵² Continual rollovers of gain upon successive sales and reinvestments are permitted, subject to a waiting period. See note 18 and accompanying text.

⁵³ For example, assume that in 1980 *X* sold a state *A* residence at a gain of \$30,000, which she rolled over by purchasing another state *A* residence costing \$100,000. In 1989, when her residence is worth \$140,000, she moves interstate. The narrower version of the change-in-residency recognition rule would require that she now recognize the \$30,000 deferred gain. The broader realization-recognition rule, described in the text, would trigger gain recognition of \$70,000.

⁵⁴ See text accompanying notes 70-85.

b. Taxation by State of New Residency

In the preceding subsection we considered the alternative taxing regimes available to state *A* with respect to the homeowner who realizes a gain on the sale of her home in state *A* at a gain and reinvests the proceeds in a home in state *B*, thereby deferring the gain for federal tax purposes. In this subsection, we shift perspective and consider the alternative taxing regimes available to state *B* when the homeowner sells the replacement residence in state *B* in a transaction in which gain is recognized for federal tax purposes.⁵⁵ Insofar as the federally recognized gain reflects the excess of the sales price of the state *B* residence over the purchase price, it presents no issues with an interstate dimension, and we will not consider them further here.⁵⁶ Rather, we focus on the question of state *B*'s treatment of the portion of the federally recognized gain that was realized, but not recognized, when the taxpayer sold her home in state *A*.

i. Federal Piggybacking

As noted above,⁵⁷ most states employ federal adjusted gross income as the computational starting point for state personal income tax purposes. The states then make specified adjustments to the tax base for items such as income from federal obligations and income from state and local obligations. Rarely do states expressly require an adjustment to federal income for residence replacements.⁵⁸ If state *B* were to follow this approach to measuring income, it would tax fully the gain recognized by the resident taxpayer upon the sale of her state *B* principal residence, including the deferred gain, which was earlier realized, but not recognized, in state *A*.

Strict adherence to the federal model by state *B* would be sound from a tax policy perspective. First, it would be easy to administer. Second, it would promote interstate equity in that all taxpayers, whether they purchased their property in state *B* or in some other state, would be

⁵⁵ The issue is merely postponed if gain is not recognized for federal income tax purposes because the proceeds are reinvested in a new principal residence located within state *B*, and subsequently there is a taxable sale or disposition of the new residence. Alternatively, if gain is not recognized because the taxpayer buys a new principal residence located in a third state, state *B* is in the same position as state *A* for purposes of analysis (see text accompanying notes 26-54), except insofar as state *B* might seek to tax gain that was realized, but not recognized on the sale of the state *A* residence. If gain is not recognized because the owner is over age 55, this reflects state *B*'s adoption of the federal policy of complete forgiveness of tax liability on such gain, and raises no issues with any interstate dimension.

⁵⁶ That gain reflects appreciation on the state *B* residence and is appropriately subject to tax only by state *B*.

⁵⁷ See note 2.

⁵⁸ But see note 45 (statutes requiring additions to federal income for failure to make in-state replacements).

treated alike. And, for the same reason, it satisfies the criterion of tax neutrality because it would not create any tax-induced incentive for homeowners to purchase either in-state or out-of-state replacement homes. Strict adherence to the federal model by state *B*, however, may be unconstitutional, at least if the homeowner sold her state *A* home while still a resident of state *A*.⁵⁹

ii. Exemption of Previously Deferred Gain

Alternatively, state *B* might choose to exempt the deferred gain from the sale of the state *A* residence.⁶⁰ Were state *B* to authorize an exclusion of the deferred gain from an incoming resident, it is likely that it would do so only with respect to a taxpayer who was a nonresident at the time of sale of the state *A* residence. Because states generally exercise their constitutional power to tax residents on their income from all sources,⁶¹ to permit a new resident an exclusion for gain realized from the sale of out-of-state property after she became a resident would accord her a preference not accorded to other residents selling out-of-state property. There does not appear to be a distinction between these two classes of residents justifying different state tax treatment on fairness grounds, unless a state adopted a policy of excluding from its tax base any gain on property reflecting appreciation (realized and unrealized) prior to the time the taxpayer became a resident.⁶² Moreover, the adoption of such differential treatment of residents would create a tax-induced incentive for a homeowner to change residency before selling a home, which would offend neutrality criteria.

Differentiating between state *B* resident taxpayers who sold their former homes while nonresidents and those who sold such homes only after becoming residents, however, may create a difference in tax results based on fortuitous circumstances and therefore raise still other tax policy concerns. Some individuals who move interstate are able to sell their existing residences before they physically move. Many others, however, move first and sell later, often for reasons largely beyond their control. They may have listed their old residence for sale before their move, but they might have encountered a slow real estate market, or their employment in the new state may have necessitated a quick relocation. Creating a tax preference for residents who manage to dispose of their former

⁵⁹ See text accompanying notes 86-95.

⁶⁰ State *B* could accomplish this objective simply by permitting an adjustment to (i.e., a subtraction from) the taxpayer's federal adjusted gross income equal to the amount of the deferred gain.

⁶¹ See [All States] State Tax Guide (P-H) ¶ 1325 (1989), which summarizes the individual states' personal income tax regimes at the cited paragraph number within the discussion of each state's regime and indicates that states generally tax a resident's income from all sources.

⁶² See text accompanying notes 64-69.

homes while nonresidents creates a disparity between similarly situated taxpayers that is unwarranted.

In addition, if residency status at the time of sale is the critical factor, difficult factual questions about the date of sale will arise, particularly in connection with an earnest money contract or contract of sale. The closing of a home sale typically takes place one to two months after the parties have executed the contract. Not infrequently, sellers will execute a contract of sale, physically move to their new state, and shortly thereafter return to their place of former residency to close the sale of their old home. State *B* may contend that the seller was its resident at the time of sale (the closing). The seller, however, will claim nonresidency, arguing that the sale occurred at the time of contract. Under many circumstances, the seller's position may be supported both by the property doctrine of equitable conversion and by authorities indicating that the time legal title passes is not determinative, and that a sale occurs when the benefits and burdens of ownership are transferred.⁶³

iii. Fair Market Value Basis

A third approach that states could adopt with respect to incoming residents who have purchased a replacement residence in a nonrecognition transaction would essentially immunize the new resident's prior out-of-state activities from taxation. On the theory that a new resident should not be subject to taxation for out-of-state activities conducted while a nonresident, the state could treat the fair market value of the property, at the time of change in residency status, as a tax-paid amount. This would provide the newcomer with a tax basis in out-of-state property owned at the commencement of residency equal to the property's fair market value at that time. In a "fresh state," the newcomer gets a "fresh start."

The fresh start approach to the problem of taxing deferred gain attributable to a relocating resident's replacement of a principal residence addresses the constitutional concerns raised by pure piggybacking⁶⁴ as well as some of the policy concerns raised by exemption of the previously deferred gain.⁶⁵ Under the fresh start rule, the new resident's sale of the state *B* residence would not result in taxation by state *B* of the gain deferred from the sale of the state *A* residence. State *B* would tax only the appreciation in value of the state *B* residence. The taxpayer would have a basis in the state *B* residence equal to the cost of acquisition. The taxpayer's source of funds used to purchase the residence would be irrelevant. Because those funds were part of the taxpayer's net worth at the

⁶³ See, e.g., *Boykin v. Commissioner*, 344 F.2d 889 (5th Cir. 1965); *Hoven v. Commissioner*, 56 T.C. 50 (1971); *Merrill v. Commissioner*, 40 T.C. 66 (1963).

⁶⁴ See text accompanying notes 59 and 86-95.

⁶⁵ See text accompanying notes 60-63.

time of change in residency status, they would be treated as tax-paid amounts. It would not matter that part of the taxpayer's funds are traceable to nonrecognized gains from the sale of the state *A* residence, or that federal income tax laws mandate a continuation of the tracing.

Furthermore, adoption of the fresh start rule renders irrelevant the timing of the change of residency compared to the sale of the state *A* residence. If the taxpayer sells her state *A* residence before moving to state *B*, state *B* may not inquire into her prior ownership and sale for tax purposes. If the taxpayer sells her state *A* residence after moving to state *B*, she has a basis in the state *A* residence for state *B* tax purposes equal to its fair market value on the date of the move. Thus, when she sells the state *A* residence, state *B* can tax only the gain representing appreciation in value while she was a resident.⁶⁶

The fresh start approach, however, does not solve all of the problems identified above. Unless state *A* has adopted and implemented a policy of

⁶⁶ Permitting state *B* to tax post-move appreciation of the former residence does create potential valuation problems. Ideally, the amount of appreciation, if any, would be determined by comparing the sales price to an appraisal that establishes value as of the date of residency change. In appropriate cases, perhaps an appraisal would not be necessary. If the sale occurred shortly after the move, there could be a presumption that the sales price and value at the time of move are equal on the ground that any real appreciation over a short time period generally would be de minimis.

Alternatively, on the assumption that appreciation of a residence occurs at a relatively steady rate, state *B* could tax a proportionate part of the entire appreciation on the state *A* residence, comparing the holding period after the taxpayer became resident to the entire holding period.

The latter approach is illustrated by the lower court's approach in *Franklin v. New York State Tax Comm'n*, 120 Misc. 2d 404, 466 N.Y.S.2d 138 (Sup. 1983), rev'd, 101 A.D.2d 949, 476 N.Y.S.2d 27, aff'd, 64 N.Y.2d 694, 474 N.E.2d 1196, 485 N.Y.S.2d 527 (1984), in which the lower court held that only the portion of capital gain from the sale of out-of-state realty accruing while the taxpayers were residents of the state was taxable by New York. The taxing authority argued that the entire capital gain was taxable by New York because the taxpayers were residents at the time of the sale. The court held the gain was taxable by New York only in the ratio of the taxpayers' days of New York residency to the total days they owned the property. In so holding, it relied on a regulation that provided that capital gains are to be calculated separately for periods of residency and nonresidency, N.Y. Comp. Code Rs. & Regs. tit. 20, § 148.7(a) (1983), and on the principle that "[t]he taxing power exercised by New York State must bear a fiscal relationship between the tax levied and the benefits afforded by the State." 120 Misc. 2d at 405, 466 N.Y.S.2d at 139. As a technical matter, the court's reading of the regulation as requiring this result is open to question because the capital gain was realized when the taxpayers were residents. Hence, there was no capital gain income on the out-of-state realty realized by the taxpayers while they were nonresidents. The Appellate Division reversed the lower court, however, holding that the state of New York could properly tax the entire capital gain, inasmuch as it had been realized at the time of sale of the out-of-state realty (by which time the taxpayers were residents of New York). Thus, the entire gain was properly includable in the taxpayers' income without consideration of the appreciation in value that had occurred before they became residents. Note that a separate calculation of their capital gain income as nonresidents, even on an accrual basis (see N.Y. Comp. Code Rs. & Regs. tit. 20, § 148.10 (1986) (providing, in cases of change of residency, for accrual of items of income, gain, loss or deduction accruing prior to change of residency)), would not reflect the taxpayer's unrealized appreciation in their out-of-state property.

taxing its departing residents on the federally deferred gain from sale of their state *A* homes, the taxpayer who moves interstate will enjoy a tax preference not extended to the taxpayer who moves intrastate when both dispose of their homes in a taxable transaction. As discussed below,⁶⁷ however, the Constitution may forbid state *B* from solving this problem. Nor does the fresh start approach deal with the differential treatment of short-term and long-term residents who sell out-of-state realty while residents.⁶⁸ In the process of putting all newly arrived residents on an equal footing, whether they dispose of their former residences before or after becoming residents of state *B*, the fresh start approach necessarily deviates from the general principle that residents are taxable on all their income from whatever source derived.⁶⁹

2. *Constitutional Considerations*

Whatever may be the dictates of sound tax policy with respect to the appropriate state tax treatment of income that is deferred for federal income tax purposes in connection with the sale of a personal residence, they cannot sensibly be evaluated in a vacuum. An analysis of the policy issues must also take into account the federal constitutional restraints imposed on the states, at least if the analysis is to be of any practical assistance in solving the problems identified above. In this section, we therefore consider constitutional concerns that may be raised with respect to the alternative approaches described above.

a. *Taxation by the State of Former Residency*

Of the alternative taxing regimes considered above with respect to the state tax treatment of the departing homeowner—forgiveness, federal piggybacking (i.e., deferral), taxing the gain when the replacement property is outside the state, and taxing the gain upon change in residency—only the latter two approaches raise constitutional issues.⁷⁰ The essential claim in both cases is that the statutory denial of nonrecognition treatment discriminates against nonresidents in violation of the privileges and immunities clause.⁷¹

⁶⁷ See text accompanying notes 86-95.

⁶⁸ See text accompanying notes 61-62.

⁶⁹ See note 61.

⁷⁰ Arguably, due process could inhibit federal piggybacking, when a former resident is taxed on the deferred gain at the time of federal recognition. One court mentioned, but did not decide, this issue. *Taylor v. Conta*, 106 Wis. 2d 321, 345-46, 316 N.W.2d 814, 827 (1982). This argument appears insubstantial. See note 84 and accompanying text. See also note 40 and accompanying text.

⁷¹ U.S. Const. art. IV, § 2. On its face, a statute of this type explicitly discriminates only on the basis of situs of the property, and not on the basis of the taxpayer's residency. E.g., Ga. Code Ann. § 48-7-27(b)(6) (Supp. 1989), quoted in note 45; former Wis. Stat. § 71.05(1)(a)5

The Wisconsin courts have considered the constitutionality of denying deferral of gain on the sale of a Wisconsin residence where the replacement residence purchased by the taxpayer is located outside the state.⁷² In *Taylor v. Conta*,⁷³ former Wisconsin residents asserted that the denial of nonrecognition treatment on the sale of their Wisconsin residences was a violation of 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. 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.

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.⁷⁴ 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.⁷⁵ Because there was a "substantial relationship between the problems caused by former residents for the state in achieving the state's tax objectives

(repealed 1981), discussed immediately below. Nonetheless, such a statute, as applied, has the necessary effect of discriminating on the basis of residency. While a taxpayer who moves to another state and becomes a resident of that state is free, at least technically, to buy a new residence in the former state, that new residence could not qualify as the taxpayer's new *principal* residence. A taxpayer can have only one principal residence at any one time and, by definition, that principal residence virtually always must be in the state of the taxpayers' legal "residency." Thus, only continuing residents, and not former residents who become nonresidents, are permitted the tax benefit of deferring gain by means of residence replacement.

Theoretically, of course, it is possible for the definition of "principal residence," governed by federal law, and "residency," governed by state law, to diverge. When a taxpayer simultaneously owns and occupies two residences, one in state *A* and one in state *B*, she conceivably could be a legal resident of state *A* under state law while owning a principal residence in state *B* under federal law. This divergence is sufficiently improbable, however, that the statute can be said to discriminate on the basis of residency.

⁷² Former Wis. Stat. § 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 note 45.

⁷³ 106 Wis. 2d 321, 316 N.W.2d 814 (1982).

⁷⁴ 106 Wis. 2d at 343, 316 N.W.2d at 825.

⁷⁵ *Id.*

and the burden placed on non-residents,”⁷⁶ 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*.⁷⁷ 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 residences⁷⁸ so that the denial of nonrecognition treatment amounted to “a migration or exit tax.”⁷⁹ The court also found that the administrative convenience concern was not justified because “the state routinely imposes and collects income taxes against nonresidents.”⁸⁰

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.⁸¹ Hence, a taxpayer in her 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, 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 she purchases for an extended period, as many homeowners do, she will enjoy significant deferral while living there, even if she eventually sells that home, wholly apart from the benefit of the exclusion for taxpayers over

⁷⁶ 106 Wis. 2d at 350, 316 N.W.2d at 829.

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

⁷⁸ 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 IRC § 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 note 10.

⁷⁹ 143 Wis. 2d at 149, 420 N.W.2d at 407.

⁸⁰ 143 Wis. 2d at 150, 420 N.W.2d at 408.

⁸¹ The present value of one dollar in 20, 30, or 40 years, assuming a 10% discount rate, amounts to about \$.15, \$.06, and \$.02, respectively.

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.

The question remains as to which Wisconsin court was correct. 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.⁸² 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.⁸³

We recognize 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,⁸⁴ 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.

We nevertheless conclude that denying departing residents nonrecognition treatment on the sale of a principal residence should not survive constitutional scrutiny when continuing residents enjoy that treatment. 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.⁸⁵ On

⁸² 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.

⁸³ *Hicklin v. Orbeck*, 437 U.S. 518, 525-26 (1978); *Toomer v. Witsell*, 334 U.S. 385, 395-96 (1948).

⁸⁴ In our judgment, a state has power under the due process clause to impose a tax on the deferred gain that was realized from the sale of an in-state residence, but is recognized when the seller has become a nonresident. The due process nexus that the state plainly has with the income generating transaction does not evaporate merely because tax liability on the realized gain is postponed for policy reasons. The *Taylor* court did not resolve this question, but declared:

We need not, and do not, decide whether the requisite nexus would exist if Wisconsin attempted to tax the deferred gain of the former resident on the sale of the residence in a sister state. It is sufficient in this case to acknowledge that the state's concern about the constitutionality of taxing a former resident has some merit and that the state's endeavors to tax residents and former residents equitably on the gains from the sales of their Wisconsin residences are evidenced in the legislative history of [the challenged statute]. *Taylor*, 106 Wis. 2d at 346-47, 316 N.W.2d at 827.

⁸⁵ *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

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 immunities clause precludes such unjustifiably disparate treatment of residents and nonresidents.

b. Taxation by State of New Residency

Of the alternative taxing regimes considered above with respect to the state tax treatment of the arriving homeowner—federal piggybacking, exempting the deferred gain, and giving the taxpayer a fresh start fair market value basis in her property—only the first raises federal constitutional issues. The following fact pattern illustrates the problem. *T*, while still a resident of state *A*, sells her home at a gain in anticipation of her move to state *B*. *T* purchases a new, pricier home in state *B*, reinvesting the entire proceeds from the state *A* home in the state *B* home, thereby deferring the recognition of gain under § 1034. *T* subsequently disposes of her state *B* home at a gain without reinvesting the proceeds in a replacement residence.⁸⁶ Because *T* has now recognized a gain for federal tax purposes (including the gain that was realized on disposition of the state *A* residence), *T* must include the entire gain in her state *B* tax base if state *B* adopts federal adjusted gross income as its starting point.⁸⁷

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.

⁸⁶ The following analysis assumes that *T* is a resident of state *B* when the gain is federally recognized, but other factual variations commonly occur. *T* may change residency once again, moving to state *C* before a taxable sale of the state *B* home. Alternatively, *T* may roll over the gain a second time under § 1034, buying a replacement home in state *C* which is subsequently transferred in a transaction triggering federal recognition. See note 37. Under these variations, *T* is no longer a state *B* resident when the deferred gain from the sale of the state *A* home is federally recognized. Thus, the gain in question was federally realized *before* she became a state *B* resident and federally recognized *after* she relinquished state *B* residency. As a practical matter, it is unlikely that state *B* will attempt to assert its taxing power over such gain. See text accompanying notes 28-34. Were state *B* to do so, the constitutional arguments against the propriety of such action would be even weightier than those discussed in this subsection, where we assume *T* has remained a state *B* resident. See text accompanying notes 189-192.

⁸⁷ *T* may raise an argument of statutory interpretation. Even though state *B* uses a federalized definition of income that on its face captures the deferred gain, a limiting construction is plausible—that the state legislature did not intend to reach income realized prior to the new resident’s arrival. See text accompanying note 91.

The constitutional issue is whether a state has the power to tax a resident on gain from the sale of her prior residence, which she realized while a nonresident, but which she currently recognizes because of the taxable disposition of her replacement residence.⁸⁸ The few tribunals that have considered this question have answered it in the negative. The Massachusetts Appellate Tax Board found it unconstitutional for Massachusetts to tax a former Connecticut resident who sold his Connecticut residence before moving to Massachusetts. The court held that the tax would violate the fourteenth amendment in that there was no due process link between Massachusetts, the Connecticut resident, and the gain on the sale of the Connecticut residence. It noted that although Massachusetts had jurisdiction to tax a resident's income from any source, this jurisdiction did not extend to taxing a prior year's income from real property in a state while a resident of that state.⁸⁹

The California Franchise Tax Board (FTB) has likewise taken the position that a nonresident who sells her principal residence and purchases her residence in California under circumstances that allow her to defer gain for federal tax purposes is not required to reduce the basis of the California residence by the amount of the unrecognized gain for California tax purposes.⁹⁰ The FTB reasoned that by reducing the basis of the California residence, a tax would be imposed on income accruing to a nonresident from non-California sources and would be unconstitutional under due process principles.

Without reaching the constitutional question, the Oregon Supreme Court has held that similar deferred gain was not taxable by Oregon. Although acknowledging that a literal reading of the Oregon piggyback statutes would result in imposition of a tax on the deferred gain, the court reasoned that there was "no apparent legislative intent to tax income which was earned, realized and received before a taxpayer became

⁸⁸ It is important to stress one aspect of the chronology. If *T* had moved to state *B* before she sold her home in state *A* and was therefore a state *B* resident at the time she sold her home, there would be no constitutional prohibition on state *B*'s taxing the deferred gain upon taxable disposition of the state *B* residence. Residents are taxable on their income from all sources, and state *B* clearly has the power to tax *T* on the gain from the sale of out-of-state realty. The constitutional issue considered in the text arises only when the taxpayer sells her home while still a resident of state *A*.

⁸⁹ *Murnane v. Commissioner of Revenue*, [Mass.] St. & Loc. Tax Serv. (P-H) ¶ 58,336, at 58,283 (Feb. 23, 1987) (citation omitted). For some time prior to *Murnane*, Massachusetts had followed the practice of taxing the previously realized gain of new residents. See Dep't of Revenue Ltr. Rul. 1980-62, [1 Mass.] Tax Rep. (CCH) ¶ 15-405.20 (Oct. 1, 1980) (Wisconsin resident, who sells Wisconsin home and pays full tax thereon to Wisconsin, will have federal reduced basis in Massachusetts replacement home).

⁹⁰ FTB Ltr. Rul. No. 329, [1 Cal.] St. Tax Rep. (CCH) ¶ 16-557.40 (July 25, 1968). Ten years earlier, the Franchise Tax Board had taken a contrary position, requiring a new resident to reduce the basis in his new California home. FTB Ltr. Rul. No. 107, [1 Cal.] St. Tax Rep. (CCH) ¶ 16-557.41 (Dec. 5, 1958).

an Oregon resident."⁹¹ It therefore construed the Oregon statutes as not reaching gain realized by a taxpayer while a nonresident, even though recognized by the taxpayer while a resident.⁹²

The Massachusetts, California, and Oregon rulings are sound. They ultimately rest on the belief that recognition of income for federal tax purposes does not, in and of itself, provide a state with a sufficient connection to tax the income. One can readily distinguish cases in which cash basis taxpayers, who have earned income as residents of other states, are held to be taxable on such income when they receive it in their new state of residency.⁹³ Not only is the income first recognized for federal tax purposes in their new state of residency, it is also first *received* in

⁹¹ *Denniston v. Department of Revenue*, 287 Or. 719, 726, 601 P.2d 1258, 1261 (1979).

⁹² The taxpayers sold their California residence at a gain before moving to Oregon and purchasing a replacement residence, which they subsequently disposed of in a taxable transaction. 287 Or. at 726, 601 P.2d at 1261-62. Because Oregon law generally conformed to federal law, the taxpayers, as Oregon residents, were in principle required to include the income from the deferred gain as part of their Oregon income. The taxpayers, however, did not include the income in their Oregon returns, arguing that the statute should not be construed to tax such gain and, if so construed, the statute would violate the due process clause because Oregon allegedly had no power to tax the gains realized by taxpayers on the sale of an out-of-state residence while they were nonresidents. The Department of Revenue responded that the principle of conformity to the federal tax laws justified taxing the deferred income when it was recognized, and that the taxpayers' Oregon residency at the time the income was recognized was a sufficient constitutional nexus for Oregon to tax the income.

⁹³ The courts have uniformly sustained the states' power to tax cash basis taxpayers on compensation received in their new state of residency for work performed in their former state of residency. *Rogers v. Chilivis*, 141 Ga. App. 407, 233 S.E.2d 451 (1977), cert. denied, 434 U.S. 891 (1977); *Evans v. Comptroller*, 273 Md. 172, 328 A.2d 272 (1974); *Hardy v. State Tax Comm'r*, 258 N.W.2d 249 (N.D. 1977). These holdings combine two well established principles, one of constitutional law and the other of tax accounting. First, a resident is taxable on all of her income from whatever source derived. See note 61. Second, a cash basis taxpayer recognizes as income all items of income actually or constructively received during the taxable year. Reg. § 1.446-1(c)(i). The fact that the income may have been earned in an accrual sense by the taxpayer while she was nonresident does not deprive the taxpayer's state of new residency from taxing such income which the cash basis taxpayer first recognizes as a resident of the taxing state. These same principles have been invoked in sustaining a state's assertion of power to tax income of resident taxpayers from pensions, annuities, and other deferred compensation from employment in other states. E.g., *Petersen v. Department of Revenue*, 301 Or. 144, 719 P.2d 869 (1986), discussed in note 94; *Appeal of Kodyra*, [Cal. 1984-1986 Transfer Binder] St. Tax Rep. (CCH) ¶ 401-032 (Cal. State Bd. of Equaliz. 1985); *Appeal of Walters*, [Cal. 1981-84 Transfer Binder] St. Tax Rep. (CCH) ¶ 400-819 (Cal. State Bd. of Equaliz. 1984). These holdings are not inconsistent with the holdings of a number of other cases that states may not tax income of new residents received from sources outside the state during the taxable year but prior to the time they became residents. E.g., *Forrester v. Culpepper*, 194 Ga. 744, 22 S.E.2d 595 (1942); *Martin v. Gage*, 281 Ky. 95, 134 S.W.2d 966 (1939); *Kennedy v. Commissioner of Corps. Tax'n*, 256 Mass. 426, 152 N.E. 747 (1926); cf. *District of Columbia v. Davis*, 371 F.2d 964 (D.C. Cir. 1967), cert. denied, 386 U.S. 1034 (1967) (acknowledging the likelihood of constitutional limitations, but interpreting statute so as to avoid the out-of-state income issue). Courts have rejected the assertion by states that their right to tax residents on their income from all sources extends to income earned and received before they were residents, and they have observed that to so hold would create constitutional concerns. See, e.g., *Kennedy*, 256 Mass. at 430, 152 N.E. at 749.

that state. Hence, the state of residency can justify its exercise of tax power over the new resident because its power is "founded upon the protection afforded to the recipient of the income by the state, in his person, on his right to receive the income and in his enjoyment of it when received."⁹⁴ The state of new residency cannot make any similar claim of protection afforded to the taxpayer merely because income that was earlier received was first recognized for federal tax purposes while the taxpayer was a resident.⁹⁵

3. *Replacement of Principal Residence: Concluding Observations*

In light of the tax policy and constitutional considerations examined above, how should states tax the deferred gain from the sale of principal residences in the context of an interstate move? As the preceding discussion indicates, these considerations do not all point in the same direction. Equity and efficiency concerns militate in favor of a solution that puts taxpayers who move interstate on the same tax footing as taxpayers who move intrastate. Equity dictates that taxpayers who are similarly situated should shoulder equivalent tax burdens. Taxpayers who move interstate and taxpayers who move intrastate are similarly situated since state

⁹⁴ *Lawrence v. State Tax Comm'n*, 286 U.S. 276, 281 (1932).

⁹⁵ See note 93. This distinction between receipt and recognition can also explain the holding in a subsequent Oregon case involving deferred compensation. In *Petersen v. Department of Revenue*, 301 Or. 144, 719 P.2d 869 (1986), a California resident, who contributed amounts to a tax deferred annuity through a salary reduction agreement, was held taxable by Oregon after he retired to that state and withdrew his contributions. In contrast to the case of income from sale of the California residence, where the taxpayer actually received the income from the sale while a nonresident, in *Petersen* the income was not received until the taxpayer became an Oregon resident. It is worth noting, however, that the distinction in these cases is *not* between realization and recognition. Even though taxpayers realize income while residents of another jurisdiction (either because they are on the accrual basis or because they constructively receive it), it would seem that there is no constitutional bar to the new state of residency taxing the income so long as it is received in the state, thus giving the state a constitutional predicate for taxing it. See note 93 and accompanying text.

Under the foregoing analysis, there would be a constitutional bar to a state's taxation of income received while a nonresident, but deferred because invested in an individual retirement account or in a similar account (e.g., Keogh plan accounts or simplified employee pension accounts). The taxpayer who withdraws such funds after moving to a new state, thereby triggering federal recognition of the deferred income, stands in the same position as the resident who recognizes in the new state gain from a home disposed of while a resident of another state. But see S.C. Priv. Ltr. Rul. 89-4, S.C. State Tax Comm'n, April 7, 1989, reported in [S.C.] St. Tax Rep. (CCH) ¶ 200-320 (resident fully taxable on amounts withdrawn from IRA even though amounts were contributed while a nonresident and were not deductible from other state's income tax). In the pension context, however, the analysis is complicated by the fact that some of the recognized income may well reflect interest or dividend income that accrued while the taxpayer was a resident of the new state, and such portion of the federally recognized income is clearly taxable by such state.

lines should not be determinative of state tax liabilities.⁹⁶ Efficiency, when viewed in the context of our federal system, likewise requires that interstate and intrastate moves be taxed in the same fashion so as to preserve the ability of taxpayers to make tax neutral decisions⁹⁷ with respect to a move.

Administrative considerations, on the other hand, point to a solution that facilitates the states' tax collection process. Close conformity to the federal model (piggybacking) or collecting federally deferred taxes from departing residents satisfies this criterion. These approaches, however, create disparities between the treatment of taxpayers who move interstate and those who move intrastate.

Constitutional considerations impose further constraints on the search for an ideal solution to the interstate rollover problem. Federal piggybacking—at least insofar as it sweeps into the tax base the deferred gains of resident taxpayers who, while residents of other states, disposed of their former residences—has been held a denial of due process.⁹⁸ There is also a powerful argument that taxing departing residents on their realized but unrecognized gains from the sale of their residences violates the privileges and immunities clause.⁹⁹

Taking all these factors into account, we believe the state from which the relocating homeowner departs should tax her on the gain she realizes from the sale of her in-state residence when she recognizes the gain for federal tax purposes. Taxing her upon her departure creates inequalities between those who move intrastate and those who move interstate, and is probably unconstitutional. Forgiving the tax on the gain altogether likewise creates inequalities between interstate and intrastate moves. While this inequality does not have a constitutional dimension because it is the continuing resident who is disadvantaged (and the Constitution does not protect the wolves from the sheep), it nevertheless offends our notions of fairness to provide the person who moves interstate with a tax windfall not available to one who moves intrastate. Even if the windfall is not of major proportions, in light of the fact that many homeowners will never recognize gain on the sale of their residences¹⁰⁰ and the present value of whatever future tax liabilities may arise are not likely to be substantial, there is no compelling reason for the state to permit it.

The principal problem with our solution is enforcement. Even though a state has jurisdiction to impose the tax on the deferred gain when rec-

⁹⁶ "[A] State may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State." *Armco, Inc. v. Hardesty*, 467 U.S. 638, 642 (1984).

⁹⁷ See note 32.

⁹⁸ See text accompanying notes 88-90.

⁹⁹ See text accompanying notes 82-85.

¹⁰⁰ See text accompanying notes 10 and 78-79.

ognized,¹⁰¹ it will not be easy for the state to locate the taxpayer and collect the tax. There are, however, several possible courses of action the states could take to mitigate this problem. The states could monitor former residents' tax returns or informational returns on real estate transactions under tax information sharing arrangements with the federal government. They could compel the departing resident to file a bond for the amount of tax liability with the revenue department in the year the taxpayer departs.¹⁰² Or, the state could impose a lien on the departing resident's replacement residence.¹⁰³

Even if these procedures for collecting a state tax from the departing resident are not administratively feasible, we adhere to our approach as the best solution among the alternatives available. As we have already noted, the tax liability of the departing resident is likely to range from slim to none, causing relatively little inequality between taxpayers who move interstate and those who move intrastate. For the same reason, the states are likely to suffer only minor revenue losses from their inability effectively to enforce such a tax. Hence, the least satisfactory aspect of our proposed solution is of minimal practical significance.

When we turn to the appropriate treatment of the incoming resident, we favor treating the taxpayer's purchase price of the new residence as the basis for state tax purposes. Strict conformity to the federal model,

¹⁰¹ See note 84.

¹⁰² See N.Y. Comp. Code Rs. & Regs. tit. 20, § 148.11 (1987) (taxpayers may file surety bond or other security in lieu of accruing items of income upon change of status from resident to nonresident). One could argue that requiring a bond from departing residents is subject to the same constitutional objections as taxing departing residents on their deferred gain. Cf. *Taylor v. Conta*, 106 Wis. 2d 321, 349, 316 N.W.2d 814, 828 (1982) (court inexplicably gives credence to constitutional challenges to a bond, while finding an immediate tax to be constitutionally justified). However, the imposition of such a requirement as a means of enforcing the states' constitutional right to tax the departing resident when the gain is recognized appears to be less onerous and more reasonable than imposition of the tax itself.

¹⁰³ The state could require the recordation of a lien affidavit in the real property records in the county and state where the taxpayer's new residence is located. As a matter of content, the affidavit would refer to the fact (and probably the amount) of the deferred gain, and recite that an income tax on that gain is due to the state upon a taxable sale or disposition of the property. The lien, unlike most other tax liens, would secure a contingent tax obligation, and the state would subsequently be obligated to release the lien upon receipt of evidence that the deferred gain was entitled to forgiveness. Functionally, the filing of the lien affidavit would have the practical consequence of compelling the homeowner, and any prospective purchaser, to deal with the state with respect to the deferred gain before completing any proposed sale of the residence. A title search at the time of a proposed sale would reveal the lien affidavit, which undoubtedly would be considered an encumbrance on title. Thus, the use of such a lien would virtually guarantee the state that it would receive actual notice (and a request for action) upon a commercial sale of the out-of-state replacement residence.

From the homeowner's standpoint, use of the lien device would be much less burdensome than posting a bond. The only initial cost would be the de minimis fee for recordation. The only significant downside would be the possibility that the state could interfere with a proposed transfer of the residence if it unreasonably delayed in responding to a requested release of the lien.

with the consequent denial to the taxpayer of a full cost basis in her new residence, is probably unconstitutional, at least if the taxpayer sold her former residence before becoming a resident of the taxing state. We see no persuasive policy basis for distinguishing between taxpayers based on the timing of the sale of their former residence, i.e., before or after they become residents of their new state of residency.¹⁰⁴ Giving all incoming residents a cash basis in their replacement residences treats all taxpayers who move interstate the same. If incoming residents are taxed on the deferred gain by their state of former residency upon disposition of their replacement residences in a taxable transaction, all taxpayers will be treated alike whether they move intrastate or interstate. If incoming residents are not taxed on such gain, our approach will provide some advantage to the taxpayer who moves interstate. As indicated above, however, that advantage is not likely to be significant,¹⁰⁵ and, in any event, the state to which the taxpayer is moving is constitutionally constrained from solving this problem on a comprehensive basis.¹⁰⁶ Hence, our proposed solution remains preferable to the constitutionally permissible alternatives.

III. BUSINESS AND INVESTMENT PROPERTY: LIKE-KIND EXCHANGES AND INVOLUNTARY CONVERSIONS

A. Federal Deferral Rules

The Internal Revenue Code accords nonrecognition treatment to like-kind exchanges and involuntary conversions of property. The two nonrecognition devices are alike in that both allow the nontaxable disposition of property, within statutory limits, when the taxpayer maintains the continuity of his investment by acquiring replacement property. There are, however, some significant differences between the two provisions.

When the taxpayer exchanges property held for productive use in trade or business or for investment for property of a like kind to be used for productive use in a trade or business or for investment, the recognition of gain or loss is postponed indefinitely.¹⁰⁷ If the taxpayer also receives cash or other nonqualifying property (often called "boot") in the exchange, he recognizes gain to the extent of cash or other boot received,

¹⁰⁴ See text following note 62.

¹⁰⁵ See text accompanying notes 68-69.

¹⁰⁶ As noted above, incoming residents could be taxed on their deferred gain if they disposed of their former residences after becoming residents of the taxing state, but this would create inequalities between incoming taxpayers who sold their former residences before and after their interstate moves.

¹⁰⁷ IRC § 1031(a)(1).

but will not recognize loss.¹⁰⁸ A complex web of tax law, mostly consisting of litigated cases, has developed in an effort to draw lines between those transactions that qualify for like-kind exchange treatment and those that do not.¹⁰⁹ Deferral of tax is the chief motivation for property owners to engage in exchanges. A qualifying exchange permits the owner of real estate that has appreciated in value to dispose of that property without recognizing gain and paying resulting income tax. Very often, such deferral of gain is a substantial benefit that justifies the great amount of effort and planning needed for a well-structured tax-free exchange. With a qualifying exchange, the taxpayer gains the free use of money, i.e., for an indefinite period of time he receives the use of the tax payment he would have made on the gain realized from the exchange.¹¹⁰ Moreover, there is complete forgiveness if an individual taxpayer dies while owning the replacement property. No income tax is payable when a decedent dies owning appreciated property, and the decedent's heirs or devisees take the property with a stepped-up basis equal to its fair market value at the date of the decedent's death.¹¹¹

The rules governing involuntary conversions are similar to those governing like-kind exchanges both in their underlying tax policy rationales and in the scope of the tax benefits that they confer. The tax liability on the realized gain is deferred, and there is the same prospect of ultimate forgiveness of the tax.¹¹² However, the technical requirements of the two

¹⁰⁸ IRC § 1031(b), (c). To assure that the deferred gain will be recognized upon a future taxable disposition of the property, the Code assigns a carryover basis to the replacement property. The carryover basis is equal to the taxpayer's adjusted basis in the old property, with adjustments for any gain or loss recognized by the taxpayer in the exchange and for the value of any boot received or given by the taxpayer. I.R.C. § 1031(d); Reg. § 1.1031(d)-1.

¹⁰⁹ For an exchange to be eligible for federal nonrecognition, the property acquired must be like-kind with the property transferred; both the properties must be used in the taxpayer's trade or business or held for investment, and the property must be transferred in a transaction that constitutes an "exchange." This last requirement has become a tax term of art, with the evolution of three-party exchanges and nonsimultaneous exchanges. Many commercial like-kind exchanges involve at least three principal parties: the taxpayer, the person who wants to buy the taxpayer's property, and the person (usually identified later in planning the transaction) who owns property that the taxpayer wants to acquire. See, e.g., *Biggs v. Commissioner*, 632 F.2d 1171 (5th Cir. 1980). A nonsimultaneous exchange is a type of three-party exchange in which the taxpayer transfers his property to a buyer, who agrees to acquire and transfer (i.e., exchange) certain like-kind property to the taxpayer within a certain time period. Section 1031(a)(3) requires that the replacement property be identified within 45 days after the taxpayer transfers his property, and be received within 180 days after the transfer. *Starker v. United States*, 602 F.2d 1341 (9th Cir. 1989) (validating concept of nonsimultaneous exchange).

¹¹⁰ When tax deferral extends for a substantial number of years, its economic value, under present value analysis, rapidly approaches that of forgiveness of the tax. See text following note 80.

¹¹¹ IRC § 1014(a)(1). See note 10.

¹¹² In terms of numbers of transactions, however, replacements of involuntarily converted property are not as common as like-kind exchanges. There is less opportunity for tax planning

provisions vary.

When real property is compulsorily or involuntarily converted,¹¹³ a taxpayer may elect to defer the realized gain. For real property there are two types of conversion: either (1) destruction of improvements to real estate, with insurance proceeds or other amounts paid on account of such a loss, or (2) condemnation or the threat thereof by a governmental or other entity having the power of eminent domain. To qualify for nonrecognition, the taxpayer must timely acquire qualifying replacement property. Under rare circumstances, the conversion into replacement property may occur directly, when the condemning authority agrees to convey replacement property to the taxpayer. More commonly, the taxpayer receives money in the form of condemnation proceeds or insurance proceeds and purchases replacement property¹¹⁴ within the appropriate period of time.¹¹⁵ The replacement property generally must consist of "other property similar or related in service or use" to the converted property.¹¹⁶ A less restrictive rule applies when real property held for business use or for investment is condemned. Such condemned real property can also be replaced with property of a like kind.¹¹⁷

B. Multistate Transactions

A majority of the states look to federal adjusted gross or federal taxable income as a starting point for determining a taxpayer's state taxable income.¹¹⁸ Thus, most state legislatures implicitly have adopted the federal like-kind and involuntary conversion rules, presumably along with their underlying policy rationales. Consequently, when a like-kind exchange or replacement of involuntarily converted property is wholly intrastate (i.e., when a resident taxpayer replaces in-state property with

because the transaction at the outset depends upon the fortuity (or bad luck, depending upon the owner's point of view) of an involuntary conversion of the property.

¹¹³ IRC § 1033(a). The Code requires "destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof."

¹¹⁴ To avoid recognizing any gain, the taxpayer must invest all the proceeds in the replacement property. Gain is recognized from an involuntary conversion to the extent that the amount realized on conversion exceeds the cost of the replacement property. IRC § 1033(a)(2)(A). The basis of the replacement property is equal to its cost, less the amount of the unrecognized gain. IRC § 1033(b). Consequently, that deferred gain will be taxed upon a subsequent taxable disposition of the replacement property.

¹¹⁵ For real property held for business use or for investment that is converted by condemnation or threat thereof, the time period for replacement ends three years after the close of the first taxable year in which any part of the gain upon the conversion is realized. IRC § 1033(g)(4). For all other involuntarily converted property, the replacement period ends two years after the close of that taxable year. IRC § 1033(a)(2)(B)(i).

¹¹⁶ IRC § 1033(a)(2)(A). A controlling block of shares in a corporation owning such similar property can also be purchased. *Id.*

¹¹⁷ IRC § 1033(g)(1).

¹¹⁸ See note 2.

other in-state property), the issues that arise at the state level generally mirror the issues that arise at the federal level, most significantly, whether the transaction in fact qualifies for tax-free treatment.

When like-kind exchanges or involuntary conversion transactions involve property or taxpayers in more than one state, however, problems arise under state taxing regimes that do not arise under the federal income tax. Because at least two states, sometimes more, will have jurisdictional contacts of some type with the taxpayer and the transaction, the question of deferral assumes a spatial dimension at the state level that does not ordinarily exist at the federal level. As in the case of principal residence replacements that cross state lines, states must determine, subject to constitutional restraints, whether to follow the federal nonrecognition rules governing like-kind exchanges and involuntary conversion transactions or to prescribe other rules more consistent with their own policy objectives.

1. Tax Policy Considerations

a. Taxation by State Where Old Property Located

Assume a taxpayer who owns real property situated in state *A* replaces it with like-kind or similar property located in state *B* in a transaction that qualifies for federal nonrecognition treatment. Assume, further, that the taxpayer held both the old and the new properties for investment or for use in his trade or business,¹¹⁹ and that a gain was realized upon the disposition of the old property.¹²⁰ At the federal level, the gain is deferred, and the basis of the replacement property is adjusted downward to reflect the fact of deferral.¹²¹ For state tax purposes, the question is

¹¹⁹ Like-kind exchanges are limited to these categories (IRC § 1031(a)(1)), but involuntary conversions may also include replacement of property used by the taxpayer for personal purposes (IRC § 1033(a)). The latter category, practically speaking, is not of great significance economically, especially because involuntarily converted principal residences are eligible for replacement under § 1034. Throughout the remainder of this part, we will assume that both the old and new properties are used for investment or business purposes. For involuntary conversions of nonbusiness property having interstate dimensions, the analysis would include some of the considerations set forth below, as well as some contained in Part III, dealing with principal residences.

¹²⁰ Nonrecognition of gain is provided for involuntary conversions (IRC § 1033(a)(2)(A)), while nonrecognition of gain and loss is provided for like-kind exchanges (IRC § 1031(a)(1)). Although multistate exchanges that result in nonrecognition of realized losses can raise issues of where and when the loss should be recognized, which are analogous to the issues confronted in the context of nonrecognition of realized gains, for ease of exposition we have confined our focus to the deferral of gain.

¹²¹ See notes 108, 114. If only part of the realized gain is federally deferred because the taxpayer receives taxable boot in a like-kind exchange (see note 108 and accompanying text), or reinvests less than the amount realized from an involuntary conversion (see IRC § 1033), the discussion throughout this part of this article fully applies to such partially deferred gain.

when, if ever, state *A* should require the taxpayer to recognize the federally deferred gain.

There are four alternative approaches which state *A* could adopt. While these alternatives parallel those considered for state *A*'s treatment of the gain from the sale of a principal residence,¹²² there is one significant difference from a tax policy perspective between out-of-state replacements of like-kind and converted property and out-of-state principal residence replacements: the question of the taxpayer's residency.¹²³ The rollover of gain from the sale of a principal residence, by definition, requires the taxpayer to change principal residences. Thus, the residence selling taxpayer necessarily becomes a former resident of state *A*. By comparison, there is no necessary link between out-of-state replacement of like-kind and involuntarily converted property and a change in the

¹²² There is considerable overlap between the tax policy considerations bearing on the principal residence problem and the like-kind exchange/involuntary conversion problem. To avoid repetition, the discussion refers only briefly to questions addressed above and focuses instead on issues that are unique to the like-kind exchange/involuntary conversion problem and on relevant differences between principal residence and like-kind exchange/involuntary conversion deferral issues.

¹²³ Another difference arises from the fact that corporate taxpayers can engage in like-kind exchanges and involuntary conversion transactions, whereas principal residence replacements involve only individual taxpayers. The same federal tax principles are applicable to both individual and corporate taxpayers with respect to like-kind exchanges and involuntary conversions, except that for corporate taxpayers, there is no possibility of forgiveness of the nonrecognized gain due to a step up in basis at death. Much of the discussion in the text, which is couched in terms of individual taxpayers, is therefore equally applicable to corporate taxpayers.

There are, however, some distinctions between state taxation of individuals and corporations to keep in mind in considering the applicability of the textual discussion to corporate taxpayers. Corporations are generally taxable on the basis of the source of their income rather than on the basis of their residency (whether defined as their state of incorporation or commercial domicile). Thus, even though a corporation in some sense may be a resident of a particular state, a corporation's income from the disposition of property will be taxed in one of two ways: If the property was used in the corporation's business having a connection with more than one state, the gain will be taxed on an apportioned basis by all of the states having a connection with that business; or, if not connected with business carried on by the corporation in more than one state, the gain will be taxed entirely by the state in which the property is located. See Unif. Div. of Income for Tax Purposes Act §§ 2,4,6,9, 7A U.L.A. 331 (1978); Hellerstein, *State Income Taxation of Multijurisdictional Corporations: Reflections on Mobil, Exxon, and H.R. 5076*, 79 Mich. L. Rev. 113, 116-18 (1980); Hellerstein, *State Income Taxation of Multijurisdictional Corporations, Part II: Reflections on ASARCO and Woolworth*, 81 Mich. L. Rev. 157, 160-61 (1982). Consequently, the state corporate income tax issues arising from multistate like-kind exchanges and involuntary conversions that are analogous to the state personal income tax issues arising from such transactions involve corporations that have either (1) realized federally deferred income that was taxable, at the time of the transaction, by a state or states in which the corporation no longer does business when the gain is recognized for federal purposes, or (2) recognized federally deferred income that was not taxable, at the time of the transaction, by a state or states in which the corporation currently does business. Additional complexities may arise when an apportioning taxpayer is involved in a like-kind exchange or involuntary conversion and the apportionment factors have changed between the time the gain is realized and the time it is federally recognized.

taxpayer's residency status. They are independent variables. A resident of state *A* may exchange state *A* investment property for out-of-state investment property and still remain a state *A* resident. Alternatively, a state *A* resident's exchange of state *A* business property for state *B* business property may coincide with or anticipate a residency shift from state *A* to state *B*. There is probably a positive statistical correlation between the direction of capital flows and residency changes as there is a tendency for the taxpayer to be near his property. Nonetheless, the degree of correlation is not high enough for use in designing rules for proper tax treatment by the respective states.

i. Forgiveness of Tax on Deferred Gain

The most lenient position state *A* could adopt would be to forgive the tax on the deferred gain. That forgiveness would result from state *A*'s embrace of two discrete rules, applied at two different points in time, which have the combined effect of completely exempting the realized gain from tax. First, if state *A* were to follow the federal nonrecognition provisions, it would permit the gain on the disposition of the state *A* property to escape taxation at the time of the like-kind exchange or involuntary conversion transaction. Second, if state *A* were to fail to impose a tax when the taxpayer disposes of the state *B* replacement property in a federally taxable transaction, the result would be complete forgiveness, rather than mere deferral, of the gain.

As indicated above,¹²⁴ this laissez faire approach reflects the prevailing state tax treatment of federally deferred gain from interstate residence replacements. In the context of like-kind exchanges and involuntary conversion transactions, however, the indeterminacy of the taxpayer's residency adds an additional wrinkle. If the taxpayer who replaces state *A* property for state *B* property remains a state *A* resident at the time he disposes of his state *B* property at a gain in a federally taxable transaction, he will, as a matter of course, be required to pay tax to state *A* on the gain. The taxpayer, as a resident of state *A*, will be taxed on his income from all sources, including all recognized deferred gains from the disposition of out-of-state property.

Forgiveness of tax on the deferred gain, then, is a plausible approach for state *A* only with respect to nonresident taxpayers. For this group, state *A* will undoubtedly have the statutory authority to tax the deferred gain when recognized upon the transfer of the state *B* property.¹²⁵ If

¹²⁴ See text accompanying notes 28-34.

¹²⁵ It does not matter whether the taxpayer was ever a resident of state *A*. It is true that if the taxpayer were a resident of state *A* at the time of the exchange or involuntary conversion, such residency would justify state *A* in taxing the realized gain when subsequently recognized after the taxpayer became a nonresident. However, even if the taxpayer was never a resident of

state *A* nonetheless fails to enforce the tax as to nonresidents, its *laissez faire* policy can be attributed either to the state tax administrators' lack of awareness of the issue or to an informal determination that the costs and difficulties of enforcement outweigh the probable tax collections that could be achieved by enforcement.¹²⁶

The policy choices implicated by the strategy of forgiving the tax on the deferred gain from like-kind exchanges and involuntary conversion transactions for nonresidents closely parallel those encountered with respect to replacement of a principal residence.¹²⁷ Forgiveness is contrary both to state *A*'s fiscal interests and to the mandate that it should collect taxes that are due. How forgiveness is evaluated under the criteria of equity and efficiency again depends upon whether state *B* taxes the deferred gain. These criteria are satisfied only if state *B* will fully tax the deferred gain, an assumption that must take into account the possibility that constitutional barriers will preclude state *B* from doing so. If the deferred gain is taxed by neither state *A* nor state *B*, however, the nonresident taxpayer who replaces in-state property with out-of-state property receives an unfair advantage as compared to other taxpayers who make in-state replacements.¹²⁸ The failure of either state to tax the deferred gain is also inefficient, in the sense of lack of tax neutrality. If the taxpayer is a nonresident or anticipates the possibility of becoming one, a tax-induced incentive would be created for an out-of-state replacement as opposed to an in-state replacement in order to reap the tax windfall of forgiveness. For two reasons, this efficiency concern may be more pronounced in this context than in the context of rollovers of gain on principal residences. First, it is much more likely that the gain deferred upon the acquisition of in-state replacement property will be recognized in the former context. Second, taxpayers making business and investment decisions for like-kind exchanges and involuntary conversion replacements are more likely to be driven by purely economic motives than are those making decisions regarding the location of personal residences.

state *A*, state *A* would have power to impose a tax on his disposition of state *A* property at a gain as income of a nonresident derived from an in-state source. For discussion in the context of principal residence replacements, see notes 38-40 and accompanying text.

¹²⁶ See text following note 34.

¹²⁷ See text accompanying notes 29-34.

¹²⁸ The discrimination is not merely preferring nonresidents to residents, as was the case in the principal residence context; nor is it solely predicated on engaging in or refraining from interstate transactions. The group potentially disadvantaged by this forgiveness is comprised of two classes: residents who replace anywhere (with in-state or out-of-state property), and nonresidents who effect in-state replacements.

ii. Federal Piggybacking

State *A* may elect to follow the federal model for nonrecognition of gain for like-kind exchanges and involuntary conversions. Deferral will then continue indefinitely, until there is federal recognition of gain triggered by a taxable transfer of the replacement property.¹²⁹

The federal piggybacking approach is both administratively workable and sound from a tax policy perspective when applied to continuing residents of state *A* who invest in out-of-state replacement property. Those residents will file annual income tax returns with state *A*, and it is easy and practical to tax the realized gain when the out-of-state property is sold. Moreover, complete incorporation of federal nonrecognition rules achieves perfect tax neutrality between in-state and out-of-state replacements. Similarly situated taxpayers are treated alike as the tax on the deferred gain is paid at the same time, regardless of where the replacement property is situated. Efficiency is not compromised for there is no tax-induced motivation to prefer in-state over out-of-state property, or vice versa.

The only problem with federal piggybacking, therefore, is taxing non-resident taxpayers—specifically, those taxpayers who are nonresidents when they make federally taxable dispositions of out-of-state replacement property. State *A* possesses legal authority to tax a nonresident's deferred gain upon its federal recognition on the ground that it represents income derived from a source within the state.¹³⁰ The difficulty is one of administrability: How can state *A* monitor and enforce the contingent tax liability of the nonresident in light of the uncertainty as to when, if ever, a tax will be due?

The administrative burdens of monitoring the deferred gains of non-residents from like-kind exchanges and involuntary conversions closely resemble those confronted in connection with a former resident's gain from a replacement of a principal residence.¹³¹ The same possible solutions are available here: tax information sharing with the federal government, bonding the tax liability, or recording a state tax lien affidavit.¹³²

There is one additional factor that arguably makes enforcement even more difficult. State *A* will have no way to determine which resident taxpayers who acquire tax-deferred replacement property outside the state will be continuing residents (for the period of ownership of the re-

¹²⁹ Under certain circumstances, if no such taxable transfer occurs, the gain will be forgiven. See text accompanying note 111.

¹³⁰ See note 125 and accompanying text. For purposes of state *A*'s taxation of the nonresident's federally deferred gain, the amount realized from the taxable sale or disposition of the out-of-state replacement property should be immaterial. For further discussion in the principal residence context, see note 38.

¹³¹ See text accompanying note 40-43.

¹³² See text accompanying notes 42-43, 101-103.

placement property) and which will later move interstate, becoming non-residents. In contrast to a taxpayer's acquisition of an out-of-state principal residence, which is inextricably intertwined with his change in residency, a taxpayer's acquisition of out-of-state replacement property and change of residency are independent events in the context of like-kind exchanges and involuntary conversion transactions. To deal with this problem, state *A* would have two choices. First, it could attempt to monitor the residency status of resident taxpayers who have engaged in like-kind exchange or involuntary conversion transactions, and could apply one of the enforcement techniques listed above to any who become nonresidents. State tax administrators would have to identify on an annual basis which resident taxpayers who had previously acquired out-of-state replacement property had moved out of state. Short of conducting a head count, presumably impractical, the only evidence of continuing residency readily available would be a resident tax return. If the resident ceased filing after a certain tax year, one plausible explanation would be a residency change.¹³³ The last return filed might directly indicate the change in residency by reporting income for a final partial year of residency. If no partial year return were filed, it might be possible to pursue other means of investigating the status of residents with federally deferred gain who have ceased filing tax returns.¹³⁴

The second solution is to apply one of the enforcement devices prophylactically to all residents with deferred gain related to out-of-state properties, on the theory that any one of them may subsequently relocate to another state. Whether this solution is justified depends upon (1) how difficult it is to monitor actual changes in residency and to apply an enforcement plan only to those who subsequently move interstate; and (2) how onerous it is to the resident taxpayer, who in fact remains a long-term resident, to comply with an enforcement device designed to ensure the compliance of nonresident taxpayers.

iii. Nonrecognition Only for In-State Replacement

The two approaches to out-of-state like-kind exchanges and involuntary conversions discussed above have substantial drawbacks. Forgiveness of the tax on the deferred gain for nonresidents not only contravenes the state's fiscal interest, but is questionable on grounds of equity and

¹³³ Other plausible explanations, besides tax evasion, include a decline in taxable income below the filing threshold or death of the taxpayer. The latter event may be reflected by a decedent's income tax return.

¹³⁴ See text accompanying notes 42-43, 101-03. If the taxpayer has in fact become a nonresident, other avenues of investigation would include checking for a change of driver's license in another state, a post office forwarding address, or the address indicated on the taxpayer's most recent federal income tax return.

efficiency.¹³⁵ Complete adherence to the federal model, on the other hand, poses substantial administrative difficulties,¹³⁶ and, perhaps, constitutional issues.

A third possible solution for state *A* is to adopt a statutory modification to the federal rules limiting nonrecognition treatment to cases in which the like-kind or similar replacement property is located within the state. Several states have followed this approach.¹³⁷ Oregon, for example, has required in-state replacement since 1957 pursuant to a statute providing: "[W]here laws relating to taxes imposed upon or measured by net income make provision for deferral of tax recognition of gain upon the voluntary or involuntary conversion or exchange of tangible real or personal property, such provisions shall be limited to those conversions or exchanges where the property newly acquired by the taxpayer has a situs within the jurisdiction of the State of Oregon."¹³⁸ With such a provision, the taxpayer's failure to make a qualifying in-state replacement causes immediate recognition of the gain from the exchange or the involuntary conversion at the time of realization. Denial of deferral for out-of-state replacements clearly promotes state *A*'s interest in enforcing and collecting taxes. Administration of the rule is easy for residents; and for taxpayers who are nonresidents at the time of realization, administration is no more difficult than for nonresidents who sell state *A* realty at a gain.

The conditioning of nonrecognition treatment on the acquisition of in-state replacement property, however, is subject to serious criticism on the basis that it fails to promote interstate equity. Consider two persons who exchange like-kind properties, whose only differing characteristic is that one happens to select in-state and the other out-of-state replacement property.¹³⁹ Because they are similarly situated, both should pay the same tax or enjoy the same deferral. Yet, one would enjoy deferral and the other would not, due solely to the situs of the replacement property, an irrelevant fact from the standpoint of interstate equity.

Efficiency concerns likewise militate against the in-state location rule. Prohibiting nonrecognition for out-of-state property replacements creates

¹³⁵ See text accompanying notes 127-28.

¹³⁶ See text accompanying notes 130-34.

¹³⁷ Ga. Code Ann. § 48-7-27(b)(6) (Supp. 1989) (for the text of the statute see note 45); Or. Rev. Stat. § 314.290(1) (1987); S.C. Code Ann. § 12-7-430(b)(5) (Law. Co-op. Supp. 1988). The territorial limitation is inapplicable to the purchase of a new principal residence outside Oregon. Unlike Georgia and Oregon, which restrict both like-kind exchanges and involuntary conversions, South Carolina imposes the territorial restraint only upon exchanges.

¹³⁸ Or. Rev. Stat. § 314.290(1) (1987).

¹³⁹ In contrast to the case of interstate residence replacements, here there is no effective classification based upon residency. The two taxpayers treated unequally both may be residents, one of whom replaces in-state, and one out-of-state; both may be nonresidents; or, indeed, the taxpayer who replaces in-state may be a nonresident while the taxpayer who replaces out-of-state is a resident.

an artificial tax incentive for acquisition of in-state property and a disincentive for acquisition of out-of-state property that may be more suitable for physical, economic, or other reasons. A locational inhibition is placed on the interstate market for like-kind or similar property. The restriction will necessarily promote inefficient behavior. The magnitude of the inefficiency will depend upon the particular interstate market in question and the quantum of the tax imposed if deferral of gain is unavailable. Moreover, the tax induced incentive to invest in in-state replacement property may also raise serious constitutional problems.¹⁴⁰

iv. Nonrecognition for Out-of-State Replacement Only for Residents

Assume state *A* has decided that its policy should be to follow the federal like-kind and involuntary conversion rules, permitting deferral of gain but not letting the gain escape taxation when there is a federally taxable disposition of the replacement property.¹⁴¹ State *A*'s only real concern is how to police and enforce this policy with respect to present or future nonresidents who, realizing gain from the disposition of in-state property, reinvest outside the state. Residents who replace with out-of-state property present no unusual problems of enforcement, provided that they maintain their residency. The solution used by a number of states and described in the preceding subsection—prohibition of out-of-state replacements by both residents and nonresidents—is therefore over-inclusive.

To achieve its enforcement objectives, a more narrowly tailored rule would be equally effective. State *A* could prohibit tax-free replacement with out-of-state property for nonresident taxpayers. To be wholly effective, this restriction would have to encompass not only persons who are nonresident at the time of exchange or replacement of converted property, but also those residents who, after deferring gain, become nonresident. This assumes that the latter group of individuals can be identified when the change in residency occurs,¹⁴² and, for this group, the rule essentially would make change in residency an event triggering recognition of the deferred gain.

As to efficiency, the approach of denying out-of-state, tax deferred replacements to nonresidents suffers from the same infirmity as does the denial of tax deferral for all taxpayers who replace outside the state.¹⁴³ But, here, the magnitude of the distortion caused by the inefficient rule is

¹⁴⁰ See text accompanying notes 167-80.

¹⁴¹ For the policy rationales undergirding this conclusion, see text accompanying notes 127-28.

¹⁴² For discussion of the prospects of identifying residents who depart, see notes 131-34 and accompanying text.

¹⁴³ See text accompanying note 140.

less because there is a smaller group of taxpayers who will have a tax incentive to prefer in-state replacement.¹⁴⁴ The constitutional obstacles to this approach, however, may be insuperable.¹⁴⁵

b. Taxation by State Where Replacement Property Is Situated

In this section, we shift our focus to the alternative regimes available to state *B*—the state in which the replacement property is located—to tax the gain recognized upon a disposition of the state *B* replacement property. The concern here is exclusively with that part of the gain from the disposition that represents the previously realized, but unrecognized, gain from the like-kind exchange or involuntary conversion. Under federal law, computation of the gain from the disposition of the state *B* property will also depend upon the difference between the cost and sales price of the property, as well as intervening adjustments to the basis, such as depreciation. These determinants of gain (or loss) are properly taxable by state *B* in any event, and they stand wholly apart from whatever tax strategy state *B* adopts with respect to the federally deferred component of gain realized in an earlier out-of-state property transaction.

i. *Federal Piggybacking*

The federal piggybacking approach, measuring state income by reference to federal adjusted gross or taxable income, will result in full taxation by state *B* of all the federally deferred gain upon the taxpayer's sale or disposition of the state *B* replacement property. Literally construed, most state tax codes lead to this outcome because they lack provisions that explicitly address taxation of this type of deferred gain.¹⁴⁶

State *B* may choose to invoke incorporation of the federal model regardless of the taxpayer's state of residency. However, evaluation of the merits of this approach depends heavily upon the variable of residency at two points in time: when the taxpayer acquires, and when the taxpayer disposes of, the like-kind or replacement property. Four different permutations, as indicated by the following chart, are possible:

¹⁴⁴ This group consists only of those persons who are nonresident when the exchange or replacement is accomplished on the assumption that continuing residents who later move interstate and trigger nonrecognition did not, at the time of replacement, foresee their subsequent move.

¹⁴⁵ See text accompanying notes 181-86.

¹⁴⁶ Thus, there is no express mechanism by which the taxpayer may exclude or deduct the deferred gain realized upon the disposition of the old state *A* property.

	Time of Like- Kind Exchange or Involuntary Conversion of State <i>A</i> Property	Time of Disposition of Replacement Property Located in State <i>B</i>
Residency	(1) Resident	Resident
Status	(2) Resident	Nonresident
Vis-a-vis State <i>B</i>	(3) Nonresident	Resident
	(4) Nonresident	Nonresident

Under categories (1) and (2), the taxpayer was a resident of state *B* when, in a multistate like-kind exchange or involuntary conversion, he acquired an in-state replacement. Because the taxpayer was a state *B* resident when the deferred gain was realized from the disposition of out-of-state property, and recognition occurs by reason of an in-state sale, state *B* may tax all of the gain when it is federally recognized.¹⁴⁷ For taxpayers in category (1), state *B* unquestionably should tax the entire gain.¹⁴⁸ For category (2), from the perspective of tax policy, state *B* should tax the deferred gain, even though the taxpayer is nonresident at the time of recognition.¹⁴⁹

Category (3) is an analogue to the interstate principal residence replacement, discussed above,¹⁵⁰ where the taxpayer is nonresident when the deferred gain is realized, but is a state *B* resident upon federal recognition. The conclusions we reached above should also apply here. While *B*'s full taxation of the deferred gain is justifiable by administrative simplicity, and it comports with the dictates of tax equity or efficiency, it presents serious constitutional difficulties.¹⁵¹

¹⁴⁷ For category (2), state *B* clearly has a sufficient nexus to this income to justify its taxation under due process principles. Because recognition occurs by reason of the sale of in-state property, the case is even stronger than taxing the realized gain of a former resident upon recognition by reason of an out-of-state sale, which we have concluded satisfies the connection mandated by due process, see note 84.

¹⁴⁸ Any hardship to the taxpayer because state *A* also taxes the deferred gain (see text accompanying notes 129-145), should be alleviated by whatever credit mechanism state *B* provides.

¹⁴⁹ Category (2) is a close analogue to state *A*'s taxation of the deferred gain upon recognition by a former resident who acquires an out-of-state replacement (either a principal residence, or like-kind or similar property). For discussion of these policies, see text accompanying notes 37-43 and 129-34. One significant difference, however, is that in category (2) the property is travelling in the opposite direction from the path taken by the taxpayer. Here, a state *B* resident has replaced state *A* property with state *B* property, and then departed state *B*. Compared to the state *A* analogue, the policy reasons for state *B* to exercise its taxing authority are even weightier because not only was the taxpayer a resident at the time of income realization, but the event triggering recognition occurred within the state. See note 147.

¹⁵⁰ See text accompanying notes 57-59.

¹⁵¹ For discussion of the constitutional issues, see text accompanying note 188.

Category (4) represents the taxpayer's continuing nonresidency, both when the deferred gain was realized (upon the like-kind exchange or conversion of out-of-state property) and when the gain was federally recognized (upon the disposition of the in-state replacement property). Wholly apart from the constitutional problems that would be raised by state *B*'s attempt to tax such gain,¹⁵² state *B*'s attempt to impose a tax on the deferred gain would expose the taxpayer to the potential hardship of being taxed by three states: state *A*, the state of the taxpayer's residency (assuming it is not state *A*), and state *B*. Because state tax credits are typically granted only by the taxpayer's state of residency,¹⁵³ a state *B* tax could well subject the taxpayer to a multiple tax burden not borne by similarly situated taxpayers who had contacts with only one or two states. Hence, state *B*'s effort to impose a tax on the deferred gain would violate the criterion of interstate equity. For the same reason, it would tend to frustrate efficiency by creating tax-induced constraints on the choice of states in which a nonresident acquires replacement property.

ii. Exemption of Previously Deferred Gain

State *B* could decide to exempt the deferred gain realized on the like-kind exchange or the involuntary conversion of state *A* property. Such a policy could be implemented easily by authorizing an adjustment to the taxpayer's federal adjusted gross or taxable income. As noted above,¹⁵⁴ state *B* very probably would confer such an exemption only upon taxpayers in categories (3) and (4)—those persons who were nonresident at the time of exchange or conversion.

Providing an exemption for continuing nonresidents (category (4)) is eminently sound from the standpoint of tax policy¹⁵⁵ and is probably constitutionally compelled.¹⁵⁶ A harder question is whether the deferred gain should be exempted for persons who become state *B* residents between the time of exchange or conversion and the disposition of the state *B* property (category (3)). Analysis here closely tracks that for an exemption for a new resident with deferred gain from the sale of a principal residence.¹⁵⁷ The case for the exemption is rooted in the notion that it is inappropriate for state *B* to tax a nonresident on income realized with respect to out-of-state activities, even though the nonresident has become a resident by the time the income is recognized for federal tax purposes. Underlying this position is the thought that state *B* has an insufficient

¹⁵² See text accompanying notes 189-92.

¹⁵³ See [1 All States] St. Tax Rep. (CCH) ¶ 15-110, at 1523 (Mar. 1989).

¹⁵⁴ See text accompanying notes 147-49.

¹⁵⁵ See text accompanying notes 152-53.

¹⁵⁶ See text accompanying notes 189-92.

¹⁵⁷ See text accompanying notes 60-63.

fiscal relationship to the taxpayer's realization of the income from the disposition of the state *A* property to justify the exercise of state *B*'s tax power over that income.

If state *B* adopts this position, however, and exempts the residency changing taxpayer from gain realized from the disposition of state *A* property, the question must be raised whether this creates interstate equity between taxpayers changing residency and taxpayers maintaining their residency. The answer depends on how state *A* treats the deferred gain. Interstate equity will be achieved if state *A* taxes the deferred gain. Both the residency changing taxpayer and the taxpayer who maintains his residency will pay a tax on the deferred gain from the state *A* property at the time of the disposition of the state *B* property. If, however, state *A* forgives the tax on the deferred gain from the disposition of the state *A* property, taxpayers moving interstate will enjoy a tax advantage not available to those who engage in similar transactions but do not move interstate.¹⁵⁸ This outcome would violate principles of interstate equity.

One drawback to the exemption for new state *B* residents which we identified in the principal residence context was the likelihood that eligibility for the exemption would depend largely upon the fortuitous question whether the taxpayer sold his home before or after changing his residency.¹⁵⁹ For like-kind exchanges and involuntary conversions, the timing problem is less pronounced. Change of residency and like-kind and involuntary conversion transactions are not intrinsically bound together as they are for interstate residence replacements. There should, therefore, be far fewer cases of close timing between the property transaction and a residency change, and the probability that many similarly situated taxpayers will incur markedly different tax burdens is much lower.

iii. Fair Market Value Basis

State *B* could employ the fresh start approach, developed above,¹⁶⁰ to treat incoming residents who have made tax deferred investments in like-kind or similar property within state *B*. This rule would cover new residents in two categories: those who move to state *B* before disposing of their state *A* property in a tax-free transaction (category (1))¹⁶¹ and those

¹⁵⁸ It is relevant to inquire where the category (3) taxpayer resided at the time of gain realization. If the new resident's state of former residency was other than state *A*, and that state taxes the deferred gain (either upon realization or recognition), the new resident who receives an exemption for that gain from state *B* is not unfairly advantaged, even though state *A* also forgives taxation of that gain.

¹⁵⁹ See text accompanying notes 60-63.

¹⁶⁰ See text accompanying notes 64-69.

¹⁶¹ This is a subset of category (1), consisting of those taxpayers who were resident at the time of disposition of the state *A* property and disposition of the state *B* replacement property, but who were once residents of another state.

who move to state *B* after such a disposition (category (3)). The category (1) resident would have a basis in the old state *A* property equal to its fair market value as of the date of change of residency, and the category (3) resident would have an initial basis in the replacement property equal to its cost upon acquisition.

The fresh start approach does provide a solution to the federally deferred gain of incoming resident category (3) taxpayers. It reflects the principle that incoming residents should not be taxed on their previous, out-of-state gain with which their new state of residence has no nexus. To the extent there are timing issues concerning the change of residency and the nonrecognition transaction that often have little bearing on sound tax policy considerations,¹⁶² they are resolved by the fresh start rule.

The fresh start approach suffers, however, from the same weaknesses we identified in the context of principal residence replacements.¹⁶³ Unless state *A* has adopted and implemented a policy of taxing nonresidents on deferred gains from like-kind exchanges and involuntary conversion transactions when recognized for federal tax purposes, the taxpayer who moves interstate before recognizing the gain will enjoy a tax preference over the taxpayer who fails to move before the federal recognition occurs. The solution to this problem, however, may lie outside of state *B*'s power due to constitutional considerations.¹⁶⁴ The fresh start approach also suffers from another problem identified in the context of principal residence replacements, namely, that short-term and long-term residents who dispose of out-of-state realty are treated differently. Newly arrived residents (category (1)) are not taxed on the gain realized from the transfer of out-of-state property, whereas long standing residents receive no such tax advantage when they transfer out-of-state property in similar transactions.

Moreover, the fresh start concept, as applied to new residents of state *B* who engage in like-kind exchanges and involuntary conversion transactions, presents additional drawbacks that were not present in the principal residence context. First, the property valuation required by the fresh start rule is more likely to be administratively burdensome. In the home replacement context, when change in residency and sale of the old residence usually occur at about the same time, the sales price and the market value on the date of change of residency will typically be approximately the same.¹⁶⁵ For exchanges and replacements of converted property, on the other hand, a taxpayer's move may take place long before a

¹⁶² That is, differentiating between taxpayers in category (1) and category (3).

¹⁶³ See text accompanying notes 67-69.

¹⁶⁴ See text accompanying notes 150-53.

¹⁶⁵ The close approximation results from the legal tie-in between interstate principal residence replacement and state of residency. See note 71.

like-kind property transaction, and it may not be reasonable to presume that the property's value at the time of the transaction approximates its value at the start of residency. Property appraisals will therefore be necessary; these appraisals are not only likely to be costly, but, if not promptly obtained at the time of residency change, may be of questionable reliability.

Second, the fresh start rule may provide an unintended tax advantage if it is not extended to all former nonresidents of state *B*, who dispose of out-of-state property owned while they were nonresidents of state *B*, after they become state *B* residents. Under most states' taxing regimes, such taxpayers will be fully taxed by state *B* on the difference between their cost basis in their out-of-state property and its sales price. Under the suggested fresh start approach, however, taxpayers acquiring state *B* business and investment property in nonrecognition transactions will pay no tax on the appreciation in their out-of-state property between the time of acquisition and the time they became residents of state *B*. Taxpayers engaging in nonrecognition transactions are therefore permitted to shelter from taxation by state *B* appreciation on out-of-state property accruing between the time of acquisition and the time the taxpayer becomes a resident of state *B*—an advantage not available to other former nonresidents. There is no equivalent problem of disparate treatment of similarly situated former nonresidents of state *B* in the context of principal residence replacements. Almost all former residents of state *A* who purchase a home in state *B* will be eligible to use the fresh start rule because the purchase will be part of a rollover. It will thus be the rare taxpayer who will be required to pay a tax to state *B* on the premove appreciation in his state *A* residence due to his failure to meet the federal standards.¹⁶⁶

2. *Constitutional Considerations*

a. *Taxation by State Where Old Property Located*

Of the alternative taxing regimes considered above for the taxation of like-kind exchanges and involuntary conversions by the state where the old property was located—forgiveness, federal piggybacking, limiting nonrecognition to in-state replacements, and limiting nonrecognition to

¹⁶⁶ Another problem with state *B*'s fresh start rule is the calculation of the basis of the out-of-state property held by new residents (category (1)) in the period *before* the like-kind exchange or involuntary conversion replacement. Where the property is depreciable, should the taxpayer have a stepped-up basis equal to fair market value for state depreciation purposes? Assuming the fresh start concept is confined to nonrecognition transactions, and not extended generally to all property of the incoming resident, then at the time this question must be answered, the state does not know whether the taxpayer subsequently will engage in a nonrecognition transaction. For this reason, the basis probably should not be stepped up until the nonrecognition transaction in fact occurs. When it does, the basis adjustment should be retroactive only in the sense that it looks to the value at the start of the taxpayer's residency.

in-state replacements by nonresidents—only the latter two approaches raise constitutional issues.

The constitutionality of limiting nonrecognition to in-state replacements was considered by the Oregon Supreme Court in *Wilson v. Department of Revenue*, which challenged the Oregon statute set out above.¹⁶⁷ The taxpayers were Oregon residents who realized gain from the condemnation of real property located in Oregon, and who reinvested the proceeds in Illinois.¹⁶⁸ The critical claim in the case was that denial of nonrecognition treatment based solely on the out-of-state location of the property discriminated against interstate commerce in violation of the commerce clause. The threshold question was whether the commerce clause even applied to the transaction in light of the fact that “[a]cquisition or disposition of interests in real property has historically and traditionally been regarded as a most local concern.”¹⁶⁹ Recognizing that the commerce clause protects freedom of interstate capital flows no less than it protects freedom of interstate product flows,¹⁷⁰ the court held that the commerce clause was indeed implicated by the Oregon statute.¹⁷¹

On the merits, however, the court held that limiting nonrecognition treatment to in-state replacements did not offend the commerce clause because it had neither a discriminatory purpose nor a discriminatory effect. The court noted that, in contrast to cases invalidating statutes under the commerce clause because of the legislature’s discriminatory purpose,¹⁷² the statute’s purpose was not to keep money and business in

¹⁶⁷ 302 Or. 128, 727 P.2d 614 (1986). The statute under review was quoted in text at note 138.

¹⁶⁸ In contrast to the analogous question raised in the context of principal residence replacements (see text accompanying notes 70-85), a like-kind exchange or involuntary conversion need not involve a claim of discrimination against nonresidents. There is no necessary connection between the location of replacement property and the residency of the taxpayer. See text accompanying notes 147-53. Resident taxpayers may acquire out-of-state replacement property and nonresident taxpayers may acquire in-state replacement property.

¹⁶⁹ 302 Or. 128, 134, 727 P.2d 614, 618 (1986).

¹⁷⁰ For this proposition, the court relied on *Boston Stock Exch. v. State Tax Comm’n*, 429 U.S. 318 (1977), which held that the commerce clause prohibited New York from imposing higher stock transfer rates on transfers of securities through out-of-state exchanges than on transfers through the New York exchange.

¹⁷¹ “The exchange of corporate shares for money and the exchange of land for money have a basic similarity. Both transactions involve a capital investment (in stock or realty). Because capital investment is basic to a system of free trade, and because the framers intended to create an area of free trade under the Commerce Clause, a state law keeping investment capital, even for land, within the state can have a restrictive impact on the capital markets and implicate the Commerce Clause. [The Oregon statute] may affect a taxpayer’s decision to make an out-of-state investment in real property because of the immediate obligation to pay taxes on the gain realized; therefore, the statute affects interstate commerce and the common market as a whole.” 302 Or. at 135, 727 P.2d at 619.

¹⁷² E.g., *Boston Stock Exchange*, note 170, discussed in *Wilson* at 302 Or. at 136-137, 727 P.2d at 619 (legislature intended to protect local stock exchange); *Bacchus Imports, Ltd. v.*

state.¹⁷³

Nor, in the court's eyes, did the statute have a discriminatory effect, which the commerce clause forbids even if the legislature's purpose is benign,¹⁷⁴ because the statute did not insulate local residents from taxation. The court noted that the statute affects the time at which taxes are due, not the tax rate or tax liability. Furthermore, it said, the statute is applied regardless of whether the taxpayer resides within the state or outside its boundaries.¹⁷⁵

The *Wilson* court's commerce clause analysis is dubious. Even assuming that the Oregon statute "only affects the time at which payment must be made," the timing of tax payments can and frequently does make an enormous difference in actual tax liabilities.¹⁷⁶ Indeed, tax deferral, rather than outright tax avoidance, is often the prize sought by taxpayers and their advisers. Thus, a tax scheme that limits deferral to those who invest in in-state replacement property imposes a substantial penalty on out-of-state investment.

To be sure, there is a reasonable justification for the discrimination against investment in out-of-state property: protection of the state from the loss of revenue it might incur due to its inability to assure collection of the tax when the out-of-state property is subsequently sold. Such a justification would presumably pass muster under the equal protection clause, which requires only that the state's tax classification be rationally related to a legitimate state purpose.¹⁷⁷ But a state taxing measure that discriminates against interstate commerce¹⁷⁸ is not rendered constitutionally tolerable merely because a state can advance a rational basis for the discrimination. Indeed, once the United States Supreme Court determines that a state tax has a discriminatory impact on interstate commerce, it routinely strikes down the levy without "balancing" the

Dias, 468 U.S. 263 (1984), discussed in *Wilson* at 302 Or. at 136-37, 727 P.2d at 619 (legislature intended to protect local liquor industry).

¹⁷³ "The statute was enacted in recognition of the difficulties in collecting deferred taxes if the property owner leaves the state after having exchanged Oregon property for out-of-state property. In such a case, the taxable event might well not be discovered. Even if discovery occurred, the Oregon tax collector would encounter the added burden of locating the taxpayer and enforcing liability. The state should not be required to monitor each taxpayer who might convert his or her investment from Oregon property to out-of-state property." *Wilson*, 302 Or. at 136, 727 P.2d at 619.

¹⁷⁴ See, e.g., *Bacchus*, 468 U.S. at 271 (commerce clause forbids state taxes with discriminatory purpose or effect).

¹⁷⁵ *Wilson*, 302 Or. at 137-38, 727 P.2d at 620.

¹⁷⁶ See text following note 80.

¹⁷⁷ See, e.g., *Western & S. Life Ins. Co. v. State Bd. of Equalization*, 451 U.S. 648, 668 (1981).

¹⁷⁸ Imposing greater tax burdens on out-of-state than on in-state investments plainly discriminates against interstate commerce.

discriminatory burden against competing state interests.¹⁷⁹ In short, the Oregon court accorded insufficient weight to the value of deferral and too much weight to the state's justification for the discriminatory taxation of out-of-state investments in holding that the state's interest in efficient tax administration should override the national interest in preserving "tax-neutral" decision making.¹⁸⁰

Were a state to limit nonrecognition to in-state replacements made by nonresidents, it would mitigate the hardship of the Oregon rule. Under such a rule, residents would be free to invest in out-of-state replacement property without sacrificing the benefit of deferral on the like-kind exchange or involuntary conversion. The scope of the discrimination, limited as it would be to nonresidents, would therefore be considerably less than under the Oregon rule. From a commerce clause perspective, such a rule might be easier to defend than the Oregon rule. The state could argue that by confining the discriminatory burden to those taxpayers who created the greatest enforcement problems for the state, it had chosen the least discriminatory alternative available to implement its legitimate objectives.¹⁸¹

Whatever a residency-based limitation adds to the state's commerce clause defense of a nonrecognition rule confined to in-state property, however, it raises additional constitutional questions under the privileges and immunities clause. Restricting tax deferral to residents places a discriminatory burden on nonresidents that will survive constitutional scrutiny only if the state can demonstrate that nonresidents "constitute a peculiar source of the evil at which the statute is aimed."¹⁸² The evil, of course, is difficulty in enforcement, and nonresidents do appear to constitute a "peculiar source" of that difficulty. Moreover, the discrimination is easier to justify in the like-kind exchange/involuntary conversion con-

¹⁷⁹ See Hellerstein, *State Taxation of Interstate Business: Perspectives on Two Centuries of Constitutional Adjudication*, 41 *Tax Law.* 37, 60 (1987). This contrasts with the court's approach to state regulations of interstate commerce, where "balancing" is the norm. See Hellerstein, *Hughes v. Oklahoma: The Court, the Commerce Clause, and State Control of Natural Resources*, 1979 *Sup. Ct. Rev.* 51, 63-71.

¹⁸⁰ *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 331 (1977). Commerce clause arguments similar to those discussed above might be raised in the context of principal residence replacements. The arguments, however, are somewhat weaker in that context because the investments, by definition, involve personal rather than business property. Nevertheless, a case can be made that limiting the tax advantages associated with interstate principal residence replacements could certainly have a dampening effect on both interstate labor mobility and the secondary mortgage market, and hence on the national common market. Moreover, Congress has apparently recognized that changes in principal residences are often motivated by business considerations. Cf. IRC § 217 (allowing a deduction for moving expenses associated with the commencement of work by the taxpayer).

¹⁸¹ Cf. *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970); Hellerstein, *Complementary Taxes as a Defense to Unconstitutional State Tax Discrimination*, 39 *Tax Law.* 405, 461 (1986); Hellerstein, *Hughes v. Oklahoma*, note 179, at 69-70.

¹⁸² *Toomer v. Witsell*, 334 U.S. 385, 398 (1948).

text than it was in the principal residence replacement context¹⁸³ because the prospects for forgiveness differ; here, it is more probable that residents will eventually pay tax on the deferred gain.¹⁸⁴ Although we remain doubtful that the in-state investment limitation on nonrecognition should be countenanced under the commerce clause even when it is limited to nonresidents, we believe that the discrimination against nonresidents would pass muster under the privileges and immunities clause because the discriminatory means employed by the state are "closely tailored"¹⁸⁵ to the problem created by nonresidents.¹⁸⁶

b. Taxation by State Where Replacement Property Located

Of the alternative taxing regimes considered above with respect to the state in which the replacement property is located—federal piggybacking, exempting the deferred gain, and giving the taxpayer a fair market value basis in the replacement property—only the first raises federal constitutional issues. In this case, the analysis closely parallels that for principal residence replacement. Since we are concerned only with the situation in which the taxpayer is a nonresident at the time of the like-kind exchange or the involuntary conversion,¹⁸⁷ the question is whether a state has the constitutional power to tax the gain realized by a nonresident with respect to out-of-state property when that gain is subsequently recognized for federal purposes by the sale of in-state property. For the reasons set forth above,¹⁸⁸ we believe the answer to this question is, "No."

Indeed, for some taxpayers there is an even stronger constitutional case against federal piggybacking in the like-kind exchange/involuntary conversion context than there is in the context of principal residence replacements. Our analysis of that issue assumed that the taxpayer was a resident of state *B* at the time of the disposition of the replacement property, a reasonable assumption in light of the fact that the taxpayer was disposing of his principal residence in state *B* to trigger the federal recognition.¹⁸⁹ This is not necessarily the case with respect to like-kind exchanges and involuntary conversions. The taxpayer may invest in state *B*

¹⁸³ See text accompanying notes 82-85.

¹⁸⁴ See text accompanying note 100. No exclusion of gain for older taxpayers is available, but insofar as residents die owning replacement property, the appreciation from the original property will escape taxation. See IRC § 1014.

¹⁸⁵ *Hicklin v. Orbeck*, 437 U.S. 518, 528 (1978).

¹⁸⁶ *Toomer*, 334 U.S. at 398-99.

¹⁸⁷ See text accompanying notes 147-49.

¹⁸⁸ See text accompanying notes 87-95.

¹⁸⁹ For principal residence replacements, another possibility is that the taxpayer may have given up state *B* residency prior to the disposition triggering federal recognition of the deferred gain. See note 86.

property while remaining a resident of state *A* or state *C*.¹⁹⁰

For state *B* to impose a tax on a nonresident's deferred gain from the disposition of property in state *A*, it would have to contend that the gain is derived from a source within state *B* because the due process clause confines the exercise of a state's power over nonresidents to income from sources within the state.¹⁹¹ This would stretch the definition of income from sources within the state beyond all reasonable bounds, encompassing gain realized from the sale of out-of-state assets when the taxpayer's only contact with the state of "source" is a subsequent in-state event that triggers federal recognition of that gain. Whatever may be the case for federal conformity, it cannot justify the taxation of nonresidents on gain from the sale of out-of-state assets.¹⁹²

3. *Like-Kind Exchanges and Involuntary Conversion Transactions: Concluding Observations*

In light of the tax policy and constitutional considerations examined above, how should states tax the deferred gain from like-kind exchanges and involuntary conversions? As in the case of principal residence replacements, tax policy and constitutional considerations do not all point in the same direction. Equity and efficiency concerns favor a solution that puts taxpayers who invest in out-of-state replacement property on the same footing as taxpayers who invest in in-state replacement property. This suggests that location should not be a touchstone of deferral. Administrative considerations, on the other hand, point to a solution that facilitates the states' tax collection process. Collection burdens may be minimized by close conformity to the federal model (piggybacking) or by denying deferral to investors in out-of-state property, or at least to non-resident investors in out-of-state property. But those approaches may violate equity and efficiency criteria, and raise constitutional questions as well. Federal piggybacking can sweep into the tax base gain with which the state has no due process connection, and denial of deferral to investors in out-of-state property creates commerce clause concerns.

¹⁹⁰ This is the group of taxpayers previously identified as category (4). See text following note 146.

¹⁹¹ See note 23 and text accompanying note 39.

¹⁹² It follows from our conclusion that a state must allow a taxpayer to recognize a loss reflecting the decline in value of in-state property, even though the taxpayer recognizes a gain for federal tax purposes upon disposition of such property. For example, assume a taxpayer residing in state *A* exchanges his state *A* property with a basis of \$60 and a fair market value of \$100 for like-kind state *B* property with a fair market value of \$100. Assume further that the state *B* property is subsequently sold for \$90. Even though the taxpayer would recognize \$30 of income for federal purposes, state *B*, in our opinion, would be required to allow the taxpayer a loss for state *B* purposes, assuming it provided for loss recognition in the absence of a like-kind exchange. State *A*, of course, would have been entitled to tax the full \$40 gain realized at the time of the exchange.

Taking all these factors into account, we believe that the following approach, which partially tracks our recommendations in the principal residence context,¹⁹³ is the most satisfactory. The state in which the old property is located should tax the deferred gain from the disposition of the replacement property when it is recognized for federal tax purposes. This treats all taxpayers alike regardless of where the replacement property is located. Taxing the gain immediately creates inequalities between those who invest within the state and those who invest out-of-state, and it may well violate the commerce clause. Denying nonrecognition solely to nonresidents who invest in out-of-state property creates similar inequalities and may also be unconstitutional. Forgiving the tax on the gain would bestow a windfall upon the taxpayer who changes residency before disposing of the replacement property.

The principal problem with our solution is enforcement. As in the case of principal residence replacements,¹⁹⁴ the state could look to such mechanisms as monitoring federal tax and informational returns, requiring bonds, or imposing liens on the replacement property in order to assure that the taxpayer (or his security) is available to pay the tax on the deferred gain when it is recognized. We recognize that there are weaknesses to each of these alternatives.¹⁹⁵ Moreover, in contrast to the fiscal consequences of failure to collect tax on the deferred gain in the context of principal residence replacements, the revenue losses from failure to collect the tax on the deferred gain in the context of like-kind exchanges or involuntary conversions may be of some practical significance.¹⁹⁶ We nevertheless adhere to our approach because it has fewer and less fundamental flaws than the available alternatives.

When we consider the appropriate treatment of the deferred gain by the state in which the replacement property is located, we favor exempting the deferred gain when the taxpayer was nonresident at the time of the disposition of the out-of-state property. This means that such a taxpayer would have the cost of the replacement property as his basis for state tax purposes. Strict conformity to the federal model, which taxes gain realized by a nonresident from disposition of out-of-state realty, is probably unconstitutional. The fresh start approach, while it would give nonresident taxpayers a cost basis in the replacement property, extends this principle too far when it also favors taxpayers who become new residents some time before effecting the like-kind exchange or involuntary conversion transaction.¹⁹⁷

¹⁹³ See text accompanying notes 96-106.

¹⁹⁴ See text accompanying notes 101-03.

¹⁹⁵ See notes 102-103 and accompanying text and notes 131-34 and accompanying text.

¹⁹⁶ See text following note 103.

¹⁹⁷ See text following note 165.

IV. CONCLUSION

In conforming their tax schemes to the federal model, states incorporate federal tax rules that may not truly reflect state tax policy concerns or recognize the constitutional restraints on state taxing power. The federal nonrecognition provisions are a prime illustration of this problem. They reflect a federal purpose of relieving taxpayers of liability for gains realized on dispositions of property when the taxpayer reinvests in similar property. When the transaction replacement crosses state lines, however, nonrecognition assumes an interstate dimension that the federal rules do not contemplate. Mechanical application of the federal rules to these transactions at the state level produces results that are incongruous, if not unconstitutional. Only through analysis of the tax policy and constitutional questions raised by the interaction of the federal and state rules can we hope to find sensible answers to these questions.

