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# Constitutional Aspects of State Income Taxation

David Schmudde

*Fordham University School of Law*, [dschmudde@law.fordham.edu](mailto:dschmudde@law.fordham.edu)

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# CONSTITUTIONAL LIMITATIONS ON STATE TAXATION OF NONRESIDENT CITIZENS

David Schmudde\*

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\* Associate Professor of Law, Fordham School of Law.

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## I. NONRESIDENT TAXATION - THE PROBLEM

### A. Nonresident Taxpayers Have No Protection from Aggressive State Taxing Authorities

No one wants to pay taxes. Politicians have frequently been reminded that taxation of constituents can be the cause of their political ruin.<sup>1</sup> Tax administrators find more difficulty in enforcing taxes which are perceived as harsh.<sup>2</sup> One statement of the desired goal of any new tax, from a policy viewpoint, has been presented as "plucking the goose as to obtain the largest amount of feathers with the least possible amount of hissing."<sup>3</sup>

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1. Tax increases and decreases have become dominant issues in political campaigns. See, e.g., Gloria Berger, *Don't Fake Out the Voters*, U.S. NEWS & WORLD REP., Nov. 15, 1993, at 37; Ronald Brownstein, *More Conflicts Likely in Era of Empty Pockets*, L.A. TIMES, July 18, 1991, at A5 (recalling that "[t]axes were a major issue in the defeat of all but one of the six governors who lost reelection bids in 1990"); Eleanor Clift, *Not the Year of the Women*, NEWSWEEK, Oct. 25, 1993, at 31; Richard S. Dunham, *Clinton's Coattails Can't get Much Shorter*, BUS. WK. Nov. 15, 1993, at 47; Stephen Moore & Dean Stansel, *The Great Tax Revolt of 1994*, REASON, Oct. 14, 1994, at 20 (detailing the wide variety of citizen initiated anti-tax actions which swept the states in 1994); Robert Shogan, *Rival's Bumbling Helps New Jersey's Florio Make Comeback*, L.A. TIMES, Aug. 10, 1993, at A5 (noting that a November 1991 "taxpayer revolt gave Republicans 'veto proof' majorities in both houses of the legislature").

2. Enforcement becomes difficult when individuals, businesses, and other legislative bodies undermine efforts to collect taxes. In a classic avoidance technique, individuals use flea markets and garage sales to avoid paying sales taxes. See Matthew N. Murray, *Would Tax Evasion and Tax Avoidance Undermine a National Retail Sales Tax?*, NAT'L TAX J., Mar. 1997, at 167, 172. Businesses also develop alternative plans to avoid or minimize taxes. For example, "firms could aggressively market the use of electronic bulletin boards to link buyers and sellers." *Id.* at 172.

3. PAUL A. SAMUELSON & WILLIAM D. NORDHAUS, *ECONOMICS* 785 (13th ed. 1989). This quotation has been attributed to Jean Baptiste Colbert (1619-1683), the Finance Minister of King Louis XIV of France. Although this philosophy did not specifically contribute to Louis' downfall, it did contribute to the fall of the Bourbons in 1789. Huey Long put it into his own words when he said "Don't tax you, don't tax me. Tax that fellow behind the tree." For extensive history of this quote see William Safire, *"On Language: Isn't it Rich,"* NEW YORK

Since any new tax imposed on constituents will create some distress, and may create significant distress, legislators are always seeking taxes which will generate the least reaction from constituents. The category of tax which best fits this requirement is the tax laid upon those people who are not constituents. Since non-constituents cannot vote against the legislator, and have little opportunity to be heard in their complaint, these taxes can be very popular.<sup>4</sup> In many instances, the effect of the tax is relatively small with respect to individual taxpayers, thus providing little incentive to complain or seek redress. There is little constraint upon a state legislature when it enacts a tax on non-constituents. At times, these legislatures become overly aggressive and impose taxes upon nonresidents of their states which are offensive and economically counterproductive.

#### B. The Courts Have Shown a Reluctance to Protect Nonresident Taxpayers

Some states have constitutional restrictions upon such taxes, but generally, taxpayers' only recourse against a tax which is laid on them without the benefit of complaint, is found in the Constitution of the United States.<sup>5</sup> This article will summarize the types of taxes imposed by states and municipalities upon nonresidents, and describe the constitutional bases for challenges of these taxes. Additionally, the article will also consider and analyze the availability to taxpayers of other remedies.

The available constitutional protections have, at times, proven insufficient. Furthermore, the courts have typically taken a cavalier approach to state taxation of nonresidents.<sup>6</sup> Most courts grant legislators free reign over taxation.<sup>7</sup> But, at some point the taxation of nonresidents becomes excessive

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TIMES, Nov. 11, 1990, § 6, at 22.

4. An excellent example of a tax which is not subject to complaint is the departure tax imposed by many countries when a foreign visitor is leaving that country. The tax is usually a small amount, between \$15 and \$25, so that it will not cause great distress, but will generate significant income from a class that has no basis for challenging the tax. In addition, it does not appear in the calculated costs of the trip, since it is not levied upon the airline ticket. See Janet Piorko, *For Car Renters, Bigger Tax Bites*, N.Y. TIMES, Nov. 2, 1997, § 5 (Magazine), at 4 (describing recent changes to the airport tax).

5. See U.S. CONST. amend. XIV, § 1, which guarantees equal protection of the law for all person; see also U.S. CONST. art. IV, § 2, cl. 1, which protects the privileges and immunities of citizens.

6. See, e.g., *Lunding v. New York Tax Appeals Tribunal*, 675 N.E.2d 816 (N.Y. 1996), *rev'd*, 522 U.S. 287 (1998).

7. See, e.g., *Goodwin v. Tax Commission*, 146 N.Y.S.2d 179 (App. Div. 1955).

and needs to be restricted.<sup>8</sup> Therefore, it is imperative that new protections be developed, or the current constitutional analyses be amended.

The U.S. Supreme Court recently decided *Lunding v. Tax Appeals Tribunal*,<sup>9</sup> a case involving taxation of nonresidents by New York State. Following the New York Court of Appeals' decision upholding the discriminatory taxation,<sup>10</sup> the Supreme Court reversed, holding New York's practice unconstitutional.<sup>11</sup> This case is useful to examine the issue of state taxation of nonresidents and to develop a more modern test with respect to discriminatory taxes imposed by one state upon the residents of another state.

### C. Does the Constitution Guarantee Nonresidents Fair Treatment?

The basic underlying question posed in challenging taxation of nonresidents by a state, is whether the U.S. Constitution guarantees each citizen "fair" treatment by states other than the state of his residence. It is clear that the state can tax nonresidents having sufficient nexus with that state,<sup>12</sup> but in doing so, to what extent must fairness be maintained? Must a state treat nonresidents in the same manner as residents? Is the nexus so minimal as to include any act of engaging in commerce? Are nonresidents fair game once they cross state lines? All of these questions appear to be answered affirmatively by the courts.<sup>13</sup> Nonresidents appear to be both fair game for heavy taxes, and an expanding target of legislatures.<sup>14</sup> The reality of living in the United States and earning a living is that multitudes of citizens cross state lines to seek employment and carry on business.<sup>15</sup> All of these people are affected when a state in which they engage in commerce taxes their commerce at discriminatory rates. These taxes favor residents of the state to the detriment of the nonresident.<sup>16</sup> They increase the costs of earning a living for the nonresidents, and affect the cost of carrying on interstate business. Overall, discriminatory taxes act as an economic drag on commerce. The misguided goal of favoring residents over nonresidents can have economic consequences for the individual state and for the entire country. While an

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8. *Travis v. Yale & Towne Manufacturing Co.*, 252 U.S. 60 (1920); see *Lunding*, 522 U.S. 287 (1998).

9. 522 U.S. 287 (1998).

10. See *Lunding v. Tax Appeals Tribunal*, 675 N.E.2d 816 (N.Y. 1996).

11. See *Lunding*, 118 S.Ct. at 766.

12. See *Shaffer v. Carter*, 252 U.S. 37, 52 (1919); see also *Travis*, 252 U.S. at 75.

13. See *Shaffer*, 252 U.S. at 52.

14. See *id.*

15. See *Travis*, 252 U.S. at 60.

16. See *Shaffer*, 252 U.S. at 37; *Travis* 252 U.S. at 60.

effort is under way to decrease barriers to international trade, the exact opposite is taking place as states are increasing their efforts to create new taxes on nonresidents, and thereby hindering interstate trade.<sup>17</sup>

#### D. Types of Nonresident Taxation

In the United States there are two predominant situations in which taxation of individual nonresidents presents problems: excessive taxation of income earned in a state by nonresidents and excessive taxation of nonresident travelers.<sup>18</sup> States surrounding major cities such as New York, Philadelphia, Washington, D.C., Chicago, and Portland, Oregon, are good examples of metropolitan areas with a workforce derived from more than one state.<sup>19</sup> Many citizens are residents of one state while earning all or a significant part of their income in another state. States long ago received approval to tax these nonresident earners.<sup>20</sup> Some courts allow the state legislature to tax these nonresidents at higher rates than residents.<sup>21</sup> This type of heavy taxation of nonresident earners by states crosses the line of fairness. Not only is the nonresident receiving far less in services from the taxing state, but they are asked to pay a higher tax merely for the privilege of entering the state and

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17. The creation of artificial economic barriers to interstate commerce in the form of excess taxation discourages individuals and business from engaging in commerce in the taxing state. This causes the costs of carrying on business to increase, and ultimately, costs are increased for both local businesses and businesses in the affected state. See the discussion in Sec. IV of this Article at page 35.

18. For example, nonresidents of New York are taxed at a rate which is equal to or higher than residents of New York. These nonresidents use far fewer services of the state than do residents. Although they do use services such as rapid transit and police protection, they are not eligible for most social benefits that are available to residents. This imbalance in the use of state services by nonresidents results in an imbalance whereby nonresidents are paying significantly more tax to the state which does not provide them services than they pay to their state of residence which provides their majority of services. When a taxpayer pays income taxes to a state in which they work, the taxes paid to their resident state are reduced by credits. Thus, the significant majority of their income tax payments are made to the nonresident state.

19. New York is intimately connected in commerce with Connecticut and New Jersey, and to a smaller extent with Pennsylvania. Philadelphia is connected with New Jersey and Delaware. Washington, D.C. is connected with Maryland and Virginia. Portland is connected with Washington. Chicago is connected with Indiana and Wisconsin. See, e.g., Al Frank, *Planners Urge Hudson Tunnel: \$3.5 Billion Rail Project Called Vital to Region*, STAR-LEDGER, Dec. 29, 1997, at 3 (reporting that New Jersey residents currently comprise 13% of Manhattan's work force of 2.3 million workers).

20. See *Shaffer*, 252 U.S. at 52.

21. See *Lunding v. Tax Appeals Tribunal*, 675 N.E.2d 816, 820 (N.Y. 1996), *rev'd*, 522 U.S. 287 (1998).

earning their living.<sup>22</sup> Certainly, a person may make the decision to pay a higher tax rate in another state when they seek employment in the other state. But, when the other state uses this opportunity to tax the nonresident at a higher rate than the state taxes its own citizens earning the same wage, the boundary of fairness is crossed. This increased tax burden is usually hidden within a complex tax statute, making its existence very difficult to perceive.<sup>23</sup>

Travel, whether for business or pleasure is another significant source of expenditures in states in which a citizen is a nonresident. This presents a delicious opportunity for a state or municipality to impose a tax on a transient who has stopped for so little time, that he or she is very unlikely to complain or will merely treat the expenditure as a tax deductible business expense. Taxes are imposed on those areas where a nonresident is most likely to partake-hotels and rental cars.<sup>24</sup> In order to further focus on the nonresident, many states and municipalities exact an even higher tax on rental cars rented at the airport.<sup>25</sup> The sole recourse for the unfair taxation of nonresidents has been the avoidance of the taxing state or city. The often quoted tax which failed was a tax of twenty percent on hotel rooms by New York City. This tax was ultimately rolled back to fifteen percent due to economic pressure, and twenty percent is now perceived as a threshold which should not be crossed, but only because of the economic deterrence.<sup>26</sup>

These two areas, disparate taxation of income of nonresidents and excessive taxation on transients, appear to be the most common and expensive methods of taxing nonresident individuals.<sup>27</sup> The use of excessive transient taxes to raise funds for new local facilities has been a common trend.<sup>28</sup> For example, San Antonio, Texas imposed a very high tax on rental cars for the

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22. The basis for taxing nonresidents' income has been that they are using some of the services of the state in which the income is earned. However, nonresidents are generally using far less of the services provided by the state in which the income is earned. A nonresident who is employed in another state is not using the schools, the welfare system, or the courts. While they place some demand on police and fire protection and can utilize other services such as libraries, in the final analysis, the nonresident uses far less of the state's resources and expenditures than its residents. In many states, the place where the income is earned determines the (situs) for taxation, not the relationship of services used.

23. Anyone doubting the complexity of state taxation statutes need only look to New York's tax laws. See N.Y. TAX LAW § 601. But, New York is typical of most states which have drafted statutes with guidance only from their administrative tax offices.

24. See *Piorco*, *supra* note 4, at 4.

25. See *id.*

26. See *id.*

27. Other significant sources of tax by local governments are real property taxes, personal property taxes, estate taxes and sales taxes. These are focused upon residents.

28. See Mike Monroe, *Spurs' Plan for Dynasty A Bit Shaky*, DENVER POST, Oct. 10, 1999, at C4.

purpose of funding a new stadium in order to attract a professional football team to the area.<sup>29</sup>

Taxation of nonresidents takes many forms. Some types of non-constituent taxation is overt, but many types are imposed in such a manner that they are less apparent and more likely to escape notice. "Covert" would be a good description. These taxes are the result of centuries of thought given to new revenue sources for governments. The clearest form of nonresident taxation is the income tax exacted by some states and cities on nonresidents of those governmental areas.<sup>30</sup> This taxation in itself is not necessarily wrong, but may become prohibited if it is enforced in a manner which discriminates against the nonresident.<sup>31</sup> The rationale is that because nonresidents use emergency services, transportation, roads, etc., the costs should be shared.<sup>32</sup> However, in the case of commuters, the services used are often much less than the taxes paid.<sup>33</sup> Commuters certainly use some services, but usually far less than those used by residents.

The simplest question to be answered in the taxation of nonresidents is what the basis for taxation can be. It is clear that nonresidents use fewer governmental services than residents. If the tax is laid upon income, should all income of a nonresident be taxed, or only the income derived from within the taxing body's boundaries? It is not necessary that the tax burden be apportioned on the nonresident in proportion to the use of governmental services, but it should be based upon some reasonable rationale. Generally, states tax the entire amount of income earned by a nonresident within the state.<sup>34</sup> Because of this, a person must allocate their income to the various states in which it is earned, and pay taxes to each of these states. For example, when a professional football player plays sixteen games in a season, eight of which are out of state, his salary is allocated by one-sixteenth to each state based on the games played in that state, so that nine returns and nine state taxes would be paid.

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29. *See id.*

30. *See Travis*, 252 U.S. at 60.

31. *See Lunding*, 522 U.S. 287 (1998).

32. *See, e.g., Shaffer v. Carter*, 252 U.S. 37 (1920) (the court believed that income taxes on nonresidents were a valid method of defraying government expenses).

33. A taxpayer will generally use the majority of government services in the place where she lives. Police, fire, highways, schools, and social services are used mostly in the place of residence, while a commuter will use only some of the police, fire, highway and rapid transit services used in the place of residence.

34. *See Shaffer v. Carter*, 252 U.S. 37 (1920).



### E. Nonresident Taxes Used to Pay for Specific Projects

The possibility that the Yankees will move from the Bronx to a new \$1 billion stadium on Manhattan's West Side is only one chapter in a nationwide drama that might be best described as "Stadium Mania."<sup>35</sup> In every major sport, owners are asking for, and often receiving, new stadiums and arenas to finance their income, player salaries, loans to buy their teams and estate plans.<sup>36</sup>

The wave of construction has spurred a heated public debate: Should millionaire owners coping with the high cost of business reach into their own pockets to build luxurious sports places? Or, should state and local governments pay for such places in order to keep the team in town or attract a team from another city? When the local populace is not enamored with the idea of supporting a wealthy owner for the sake of keeping a major league sports franchise, legislatures look to nonresident sources of income in the form of taxes.<sup>37</sup>

The *New York Times* has had a continuing series of articles detailing the struggles occurring between sports teams and the cities where they currently play.<sup>38</sup> The following incorporates many of the findings in those articles. Owners argue that there is a great economic value to the municipality in supporting a professional team.<sup>39</sup> Some typical rationales used by owners are often repeated.

"You don't measure sports teams just in dollars and cents," said Peter Karmanos, who last month moved his hockey team, the Hartford Whalers, to North Carolina. "You measure it in cultural spirit. Ask people in Hartford what they think it means to the city when they lost the team, or in Minneapolis-St. Paul. Ask if they'd reconsider subsidizing a team to come back there."

"Opponents say that subsidies, such as broad-based sales taxes, constitute corporate welfare, mocking the public's need to pay for essential services. In

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35. See Richard Sandomir, *Never Mind Titles, Teams Clamor for New Stadiums*, N.Y. TIMES, June 4, 1997, at B9.

36. See *id.*

37. See Piorko, *supra* note 4, at 4; Sandomir, *supra* note 35, at B9.

38. See Sandomir, *supra* note 35, at B9.

39. See *id.*

addition, many studies show that there is little economic gain from these kinds of projects, and that spending on stadiums merely diverts spending from other areas.<sup>40</sup>

Still others believe that this use of taxpayer money is not the most beneficial expenditure for the community. There is much disagreement as to the community benefits.<sup>41</sup>

Still, a hodgepodge of public and private financial resources make up the construction plans of 44 professional teams (spread over the four major sports) that are seeking . . . or building new stadiums or arenas. The list includes two arenas in Miami and possibly two in Los Angeles, plus two stadiums in Cincinnati, Detroit, Seattle and San Francisco. But it excludes a stadium being built for the Browns in Cleveland, and one proposed for the Coliseum's site in Los Angeles, which has lost two football teams since 1995.

In New York, besides the Yankees' desire for a new stadium, the Mets are planning a retractable domed stadium on a site opposite Shea Stadium, for which they may ask government aid. The Islanders are also looking for a new arena to replace the aging Nassau Coliseum, with help from [Nassau] County.

....

Each referendum is, in a way, a plebiscite on how far governments should go to help finance stadiums and arenas for privately owned teams. Owners say they merit public subsidies because of the intangible psychological benefits of being a major league town and the economic advantages that teams generate. They wield the ultimate hammer, leaving town, which can bring a vulnerable city to its knees . . .<sup>42</sup>

40. *Id. See Professional Sports: The Challenges Facing the Future of the Industry: Hearings Before the Senate Comm. on the Judiciary*, 104th Cong. 55 (1996); *Antitrust Issues in Relocation of Professional Sports Franchises: Hearings on S.500 Before the Subcomm. on the Judiciary*, 103d Cong. 113 (1995).

41. *See generally*, Daniel J. Lathrope, *Federal Tax Policy, Tax Subsidies, and the Financing of Professional Sports Facilities*, 38 S. TEX. L. REV. 1147 (1997) (discussing the fallacies of the economic justifications typically presented by proponents of state and local subsidies for professional sports facilities). "Once you take taxes to pay for a stadium or arena, you can't spend it somewhere else . . . Stadium construction creates no real wealth. It just transfers it." Sandomir, *supra* note 35, at B9.

42. Sandomir, *supra* note 35, at B9. *See* Katherine C. Leone, *No Team, No peace: Franchise Free Agency in the National Football League*, 97 COLUM. L. REV., 473, 476, 489, n.120 (1997); Matthew Mitten & Bruce Burton, *Professional Sports Franchise Relocations from Private Law and Public Perspectives: Balancing Marketplace Competition, League Autonomy, and the Need for a Level Playing Field*, 56 MD. L. REV. 57, 97 n.208 (1997); Sanjay Jose' Mullick, *Browns to Baltimore: Franchise Free Agency and the New Economics of the NFL*, 7 MARQ. SPORTS L.J. 1, 19, 22 (1996); *Around the Majors*, WASH. POST., Oct 27, 1997, at D3; Dan Barry, *Feverish Dreams of Baseball as Mets Look at Brooklyn*, N.Y. TIMES, Jan 17, 1998, at B3; Dan McGraw, *Playing the Stadium Game*, U.S. NEWS & WORLD REP., June 3, 1996, at 46; Phil Mintz & Denise Flaim, *The LI Look: A Landscape Full of Shining Stars and*

A San Francisco group interested in building a new stadium to be home to the 49ers "wanted the city to issue \$100 million in bonds."<sup>43</sup> The team and city presented studies to show that taxes generated by the complex would pay the project's debt. The investors stated that they would buy insurance to guarantee payments.<sup>44</sup>

"It's not viable," said Andrew Zimbalist, an economics professor at Smith College. "The incremental revenues from the mall and stadium won't pay the debt service." He said the city's estimate of \$6.1 million in yearly debt payments—to be repaid with sales taxes—should be raised to \$10 million . . .

In Seattle, the question of whether Paul Allen, whose Microsoft stock is worth \$12.4 billion, deserves help from the public, is frequently heard.

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*Concrete Chaos*, NEWSDAY, Oct 12, 1997, at 37; Michael K. Ozanian, *Suite Deals: Inside the Built Cleveland Boom*, FIN. WORLD, May 9, 1995, at 50; Richard Sandomir, *How Compromise Built Cleveland a New Stadium*, N.Y. TIMES, Feb. 12, 1996, at C4. Sandomir goes on to describe the situation:

#### From the Ball Park To the Ballot Box

The stadium and arena action accelerates almost daily: Columbus, Ohio, voters reject a tax increase for an arena and a soccer stadium. The Whalers pay Connecticut \$20.5 million over 15 years to become the Carolina Hurricanes. The Minnesota Twins threaten to leave the Metrodome. The Cincinnati Bengals sign a lease through 2026 for stadium paid for mostly with a half-cent sales tax.

"It's a renaissance," said Jerry Bell, the president of the Twins. But not for the Twins, at least not yet. The State Legislature has not enacted any measures to finance a new ball park, or even bit at an offer by the owner Carl Pohlad to trade the state 49 percent interest in the team for financial backing. And the Twins are not alone in seeking public aid:

A referendum was being voted on in San Francisco to decide whether to approve \$100 Million in public funds for a \$525 million 49ers stadium and entertainment complex at Candlestick Point.

. . . Seattle voters will be asked to approve a \$300 million package of financial aid for construction of a \$425 million Seahawks stadium in an election that has been financed, with the approval of the Washington State Legislature, by Paul G. Allen, the Microsoft billionaire.

The Pittsburgh Steelers and the Pirates, uneasy partners at the 26-year-old Three Rivers Stadium, are the month to put a referendum to build two stadium on a November ballot. The financing includes a 10-county sales tax increase.

Sandomire, *supra* note 35, at B9.

43. Sandomir, *supra* note 35, at B9.

44. *See id.*

"Remember, Paul Allen was coaxed into this," said Bob Gogerty, a campaign consultant to Allen. "This is a team whose owner was going to move the team in a van and Paul picked up the option." He's saying, "I'll be a part of this."

But skepticism persists. In 1995, voters spurned a referendum providing financing for a \$320 million Mariners ball park, then watched the Washington Legislature retool the measure and pass it . . .

In Columbus, Ohio, a referendum to impose a three-year, half-cent sales tax increase to help finance a \$285 million soccer stadium-arena venture failed, hurting a downtown revitalization effort. The referendum was defeated partly by voters not wanting a new tax or not believing the tax would end in three years.

. . . .

Still, each city's situation is different; many do not use referendums, others want to enhance their reputations by getting a team, regardless of municipal fiscal woes. Team situations differ, too. Are voters being asked to say "yes" to a tax or a lottery to lure a team? Or help a beloved one? Is the team in first place? Or last?

. . . [P]assing referendums depends on how they are marketed and explained. Public money will most likely remain a key element of most stadium and arena construction. But Marc Ganis, president of Sportscorp, a consulting firm, said public money is risky. "You add significant cost because the public doesn't build things efficiently," he said. "If a project goes over cost, everyone knows politicians will find extra money."<sup>45</sup>

In Illinois, a departure tax on airport flights was implemented to pay for construction of McCormick Place, a convention center.<sup>46</sup> When the tax was challenged, the Illinois courts upheld the tax because the tax bore a "reasonable relationship" to the object of the legislation.<sup>47</sup> The fact that it tended to fall on nonresidents did not affect their decision.<sup>48</sup> Similarly, a Pennsylvania court upheld a hotel tax to pay for a new convention center.<sup>49</sup> The perception of local authorities and the courts has been that these "foreigners," the nonresidents, are using the facility and therefore should pay for it. However, the real economic benefit is to the local community, in the form of employment opportunities and increased economic activity. The

45. *Id.*

46. *See Terry v. Metropolitan Pier & Exposition Auth.*, 648 N.E.2d 1047 (Ill. App. Ct. 1995).

47. *See Terry*, 648 N.E.2d at 1054.

48. *See id.*

49. *See Torbik v. Luzerne County*, 696 A.2d 1141, 1149 (Pa. 1997); *Leventhal v. City of Philadelphia*, 542 A.2d 1328 (Pa. 1988).

actual rationale for building these facilities is to benefit the local population, maybe at the cost of nonresidents.<sup>50</sup> Clearly, the economic decision to build or not build a new facility, is made with respect to the economic gains to residents of the state or municipality, not the gain to nonresidents who may attend the facility. It is deceiving to attempt to justify these taxes on nonresidents as being for their benefit.

#### F. Income Taxes

Most states impose some form of taxation on the income of individuals. The basis for the taxation is the income attributable to the state. When a person lives in one state, but earns income in another, both states will tax the person's income. Generally, the income can be allocated to the state where it was earned, and it will be subject to income taxation in that state.<sup>51</sup> Therefore, a citizen would have to allocate his or her income to each state and pay the tax accordingly to the proper state. If a person is a resident of State A and earns income in State B, State B would tax what is termed the individual's State B source income—income derived in State B. Source income includes salaries earned in that state, partnership income from a partnership doing business in that state, investments held in that state, real estate income earned in that state, business income from a business in that state or income earned by a performer or athlete from activities in that state. An individual's first step is to allocate his or her income between the various states in which activities are carried on or investments made. The next issue involves the proper allocation of deductions to the various states.<sup>52</sup> For example, if a state grants a personal exemption for dependents, how should these be used to reduce income from each state? Most states apply a percentage to the deductions.<sup>53</sup> The percentage is the percentage of total income attributable to the individual state.<sup>54</sup> This percentage is then applied to the allowable

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50. Since it is politically unpopular to pay for new facilities with taxes on voting residents, the tax should be shifted to nonresidents. The facility generates tax revenue for the residents because it brings in new sources of sales tax.

51. See, e.g., N.Y. TAX LAW § 631(a)(1) (McKinney 1987); MICHIGAN STATUTES ANNOTATED § 7.557 (130)(5)(1967).

52. As an example of the allocation of income, income from athletes and entertainers is subjected to income tax in the state in which it is earned. For example, a member of the Dallas Cowboy Football team who plays one game in Massachusetts, is taxed on one-sixteenth of his salary by Massachusetts. This is based on the salary being earned over a sixteen game season. See N.Y. TAX LAW § 631(b)(3) (McKinney 1987).

53. See *id.*

54. See *id.*

deductions.<sup>55</sup> In theory, an individual would have 100% of the deductions when allocated against the numerous states. However, in practice, since the size and availability of deductions varies from state to state, the actual percentage could be less than 100%.

## II. WHAT IS "FAIR TREATMENT"?

The question of what fairness is guaranteed to nonresidents, is not a simple one. Most taxes are not structured merely to impose a higher tax on the nonresidents, but carry some other underlying rationale.<sup>56</sup> However, some taxes are simply imposed with the goal of collecting substantial sums from a group of non-constituents.<sup>57</sup> The sole reason for these taxes is that the paying group is made up of non-constituents that are unlikely to complain. Under the current system of legal application, only economic pressures can limit the imposition of these taxes. This paper will explore the provisions of the U.S. Constitution, their application to non-constituents taxation, their guarantee of fairness, and the definitions of fairness. "Fairness" when applied to the taxation by a state of nonresidents should provide that nonresidents are treated the same as residents. There are certain instances where the state has an interest in taxing non residents, but the trend in state taxation has been to shift as much burden as possible to nonresidents. Once this path is taken, it can lead to ever greater shifts. In fact, with increasing pressure to lower or not increase taxes on residents, legislatures have increasingly moved their focus to nonresidents. This places an increasing burden on interstate commerce, and can result in economic imbalances. The state courts have not been the proper place for a taxpayer to seek redress for these taxes. Many cases have been brought by newly burdened businesses—hotels and rental car agencies. However, for most of these taxes, there is no natural constituency to protect the interest of the nonresident taxpayer. In some instances, the effect of the tax on an individual taxpayer makes the costs of litigating the issue too burdensome for an individual to undertake. Even in cases with very expensive taxes, the only taxpayer to challenge the constitutionality of a discriminatory

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55. *See id.*

56. For example, N. Y. TAX LAW § 631 (b)(6) denies a deduction for alimony paid by a nonresident while allowing such deductions to a resident. The rationale is stated that the nonresident's paying this alimony is not related to New York income. *See Lunding*, 118 S. Ct. at 752.

57. The 18% tax on rental cars at O'Hare airport in Chicago is a prime example of such action.

statue have been lawyers suing on their own behalf.<sup>58</sup> This indicates that "fairness" is not something the average person affected by nonresident taxation can afford to challenge. Since some states provide a tax court to hear issues, it would appear that a taxpayer would have a reasonable recourse. But, since these tax courts do not have jurisdiction over constitutional challenges, any real challenge must be played out in the state courts at great expense.

Too often, the state courts have given very little protection to nonresidents. They seem to have a little interest in protecting the rights of nonresidents. Consequently, the federal courts are the most likely place for a nonresident to successfully challenge an unfair tax. The federal courts need to set forth a test to stem the aggressive proliferation of the taxation of nonresidents by states. The U.S. Supreme Court recently decided a case involving the unfair taxation of a resident of Connecticut by the State of New York.<sup>59</sup> This is the proper venue for the federal government to reinforce the constitutional provisions guaranteeing fair treatment by a state of the citizens of another state. The lack of protection from state courts and the aggressive imposition of taxes on nonresidents is exactly the problem that the "privileges and immunities" clause of the U.S. Constitution was meant to avoid.

Unfair taxation should be broadly defined to include any tax which has the practical effect of being targeted predominantly at nonresidents or any tax which has the practical effect of taxing nonresidents at a higher rate than residents without any rationale related to a specific extra cost imposed on the taxing state. These taxes should be violative of constitutional protection unless there is some specific rationale for the taxing state to require higher revenues when dealing with nonresidents. Currently, the message given by many states is that if you enter my state for purposes of earning a living, you must prepare to pay more for that privilege than if you were a resident of that state. It is time that fair treatment of nonresident taxpayers be required of states.

### III. THREE POSSIBLE REMEDIES FOR UNFAIR TAXATION

Currently, there are three possible remedies available to nonresidents subjected to what they perceive to be an unfair tax. Nonresidents can (1) look to the legislature to reduce or eliminate the tax; (2) bring suit in the hope that the judiciary will provide the protection of the equal protection clause and the

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58. See *Lunding v. Tax Appeals Tribunal*, 675 N.E.2d 816 (N.Y. 1996), *cert. granted*, 117 S. Ct. 1817 (1997), *rev'd*, 522 U.S. 287 (1998); *Goodwin v. State Tax Comm'n*, 146 N.Y.S.2d 172, 174 (1955), *aff'd*, 1 N.Y.2d 680 (1956); *Wood v. Department of Revenue*, 749 P.2d 1169 (Or. 1988).

59. See *Lunding*, 118 S. Ct. at 766.

privileges and immunities clause; and (3) demonstrate to the taxing state that nonresident taxation actually causes economic harm to the taxing state. The first possible remedy is unlikely to be effective, unless the group is large enough to create some pressure on legislators. But, since the legislators do not answer in any way to a nonresident, they are generally unresponsive. The second possible remedy is also unlikely because courts have rarely used constitutional protections to invalidate taxes on nonresidents.<sup>60</sup> At best, the attitudes of the courts have been indifference.

The third available remedy, economic deterrence, has been the only useful tool, for nonresidents looking for relief from unfair taxation.<sup>61</sup> However, because it usually requires the activity of an organized group, it has rarely been successful. The economic deterrence occurs when a significant effect results from the imposition of an unfair tax. First, the tax must be higher than what is normally expected, and it must cause a change in consumer's behavior to the extent that a local group becomes interested and to an extent that the legislature takes action. A good example of this occurred when New York City imposed a hotel tax on luxury hotel rooms of twenty-one percent.<sup>62</sup> This tax was perceived to result in a decrease in room utilization—causing lost profits for the hotels.<sup>63</sup> It became apparent to the hoteliers from the loss of convention bookings.<sup>64</sup> Conventions are planned and booked by people with negotiating power who can complain of high costs.<sup>65</sup> More importantly, they have the ability to move large segments of business away from the high cost area. This occurred in New York, and the resulting economic pressure caused the hotel tax to be lowered.<sup>66</sup> However, in many instances, the groups affected do not have the economic effectiveness to bring about such a reduction.

#### A. Voting Disapproval: Attack the Legislative Source

A legislature has the ultimate power to levy a tax on any citizen. As a matter of legislative conduct and constitutional theory, legislatures have been

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60. See *Goodwin*, 146 N.Y.S.2d 172; see *Lunding*, 675 N.E.2d at 816.

61. See, e.g., Betsey Wade, *Tax Collectors Lean on Out of Towners*, N.Y. TIMES, Aug. 25, 1991, at B3; Daniel Savirp, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895 (1992).

62. See Kirk Johnson, *What saved the Hotels? Not just Tax Cuts*, N.Y. TIMES, July 30, 1997, at B1.

63. See *id.*

64. See *id.*

65. See *id.*

66. See Johnson, *supra* note 62.



given broad power to tax.<sup>67</sup> There are only two controls on this power within the legal system.<sup>68</sup> The electorate can refuse to elect the politicians,<sup>69</sup> and the judiciary can apply constitutional protections against the tax. A non-constituent does not have the availability of the first control—refusing to elect the legislator. In addition, courts have been reluctant to protect nonresidents against unfair taxation.<sup>70</sup> The ability of taxpayers to avoid nonresident taxation depends upon their ability to avoid contact with the taxing state. This, however, is not a possibility for many people. The ultimate resolution of this problem lies in the economic realities of the situation. A citizen working in another state, and paying higher taxes, is likely making the decision to pay the higher tax based upon the ability to earn a higher income in the other state. If this higher earning ability diminishes, then the incentive disappears. There is a natural force at work in this context. If a state is taxing at a higher rate than other states, its employers must pay premium labor rates to induce nonresidents to enter its market place. This raises the marginal cost of business, and encourages employers to move. This effect is higher in states which have major employment centers near the borders of neighboring heavily populated states.<sup>71</sup> In a city which is remote from state borders there is little or no effect.<sup>72</sup> When a non-constituent has no economic power or choice, he or she is at the mercy of the other taxing authority.

Another aspect of the powerlessness of a non-constituent is that in good economic times, the economic pressures are not felt by states as strongly as

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67. See *Lunding*, 675 N.E.2d at 819; *Austin v. New Hampshire*, 420 U.S. 656, 661-62 (1975); *Lehnhausen v. Lake Shore Auto Parts Co.*, 410 U.S. 356, 359 (1973); *Madden v. Kentucky*, 309 U.S. 83, 88 (1940).

68. See Leo Martinez, *Taxes, Morals and Legitimacy*, 1994 BYU L. REV. 521 (1994).

69. Probably the foremost issue in any political campaign now is the candidate's record on raising or lowering taxes. A number of political losses have been attributed to the raising of taxes on the electorate. See George F. Will, *The Politics of Discomfort Levels*, NEWSWEEK, Nov. 1, 1993, at 80.

70. See *Lunding*, 675 N.E.2d at 819.

71. Where the cost of a move is relatively low, just a few miles into another state, employers can easily move their business to take advantage of the cheaper costs of labor. Existing employees would incur no greater tax by moving to the new location. There may be some increased commutation costs for existing employees. Each new employee costs less in the new location than in the old. An employee who would work for \$10 per hour in his own state would require \$10 plus increase in tax to work in the higher taxing state. Thus, the employer could pay the same employees less for the same work, and the employee would be in an even position.

72. Where the additional cost to move because of a remote location would be high, the incentive to move would be much lower. Existing employees would be reluctant to move because of the relocation involved.

when economic times are bad.<sup>73</sup> Thus, the loss of some visitors or employees is not readily apparent. When economic growth is slow or non-existent, states are more likely to react to complaints of groups or to the economic dislocations caused by excessive taxes. When state coffers are filled, and business is booming, the negative effects of over taxation are masked by general economic good. The fact that some conventions are bypassing a state or city are less likely to be noticed, because others step in to fill the empty space. In the current economic climate, the economic power of non-constituents is unlikely to be effectively heard.

## B. Judiciary: Constitutional Protection

Some states have become too aggressive in taxing non-residents—treating them worse than residents. There are two main issues to be decided in determining whether a statute taxing nonresidents violates constitutional protections. First, does the constitution require equal treatment of nonresidents and residents? Second, how is equal treatment defined?

The equal treatment requirement could be found in any of three provisions of the Constitution, the Commerce Clause,<sup>74</sup> the Equal Protection Clause of the Fourteenth Amendment,<sup>75</sup> or the Privileges and Immunities Clause of the Fourteenth Amendment.<sup>76</sup>

### 1. *Commerce Clause*

The Commerce Clause provides that states may not interfere with the flow of commerce between states.<sup>77</sup> In the area of taxation, courts have interpreted this to mean that a state may not give advantages to its own citizens at the expense of non-citizens. However, not all discrimination against outsiders will be found to be unconstitutional. If there is a sufficient rationale for the state to enact a discriminatory tax, and if the burden on the outsiders is not too great, the statute has been held constitutional.<sup>78</sup> Discriminatory taxes have been permitted when the burden placed on the

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73. When employment is high, income tax receipt of states increase substantially. When employment is low, the receipts decrease and place pressure upon governments to cut programs and to raise taxes. See, e.g., Jackie Calmes, *Tax Revenues May Continue Recent Surge*, WALL STREET JOURNAL, MAY 1, 1997, at A3.

74. See U.S. CONST. art 1, § 8, cl. 3.

75. See U.S. CONST. amend. XIV, § 1.

76. See *id.*

77. See U.S. CONST. art. 1, § 8, cl. 3.

78. See *Goldberg v. Sweet*, 488 U.S. 252, 265 (1989); *Exxon Corp. v. Governor of Maryland*, 437 U.S. 117, 128 (1978).

citizens of other states is only to serve the purpose of increasing services to the citizens of the state, and to provide a strong market for the local businesses.<sup>79</sup> If the taxpayers from other states have a credit from their state for this tax, then there is said to be no burden on those taxpayers.<sup>80</sup> The Commerce Clause is used to prohibit any state from interfering with commerce or impeding the operation of businesses on an interstate basis.<sup>81</sup> To avoid this prohibition, the rationale for a tax is that the tax only increases a burden on a business choosing to do business within the state. It does not impose any restriction or burden on the business doing business in any other state. This tax is only imposed upon businesses doing business within the taxing state and on the business done within the state. Therefore, it is believed that the tax is only imposed on "intrastate commerce," not "interstate commerce."<sup>82</sup> If it imposed a higher tax on business done over state borders, it would be considered interstate commerce.<sup>83</sup>

Under *Goldberg v. Sweet*,<sup>84</sup> the Court upheld a tax in which the burden fell solely upon the resident of the state.<sup>85</sup> In this case the increased tax fell only upon the residents of the state, thus it was not impermissible.<sup>86</sup> The residents were not of the disenfranchised class who could not complain. *Complete Auto Transit, Inc. v. Brady*<sup>87</sup> stated the following four pronged test: a state tax will withstand scrutiny under the Commerce Clause if (1) the tax is applied to an activity with a substantial nexus to the taxing state, (2) the tax is fairly apportioned, (3) the tax does not discriminate against interstate commerce, and (4) the tax is fairly related to the services provided by the state.<sup>88</sup> Under *Boston Stock Exchange v. State Tax Commission*,<sup>89</sup> it appears that a tax may not cause a discriminating burden on activities which take place someplace else, such as goods manufactured outside the state, or transactions which take place outside the state.<sup>90</sup> However, when the tax is imposed only on transactions taking place within the state, the state has been allowed to tax

79. See *Goldberg*, 488 U.S. at 252.

80. See, e.g., *Clark v. Lee*, 406 N.E.2d 646 (Ind. 1980).

81. See *Cheney Bros. v. Massachusetts*, 246 U.S. 147 (1918).

82. See *Maine v. Grand Trucking Railway*, 142 U.S. 217 (1891).

83. See *Cheney Bros.*, 246 U.S. at 153. See *Austin v. New Hampshire*, 420 U.S. 656 (1975).

84. 488 U.S. 252 (1989).

85. See *Goldberg*, 488 U.S. at 252.

86. See *id.* at 266.

87. 430 U.S. 274 (1977).

88. See *Brady*, 430 U.S. at 279.

89. 368 N.E.2d 284 (N.Y. 1977).

90. See *Boston Stock Exch.*, 368 N.E.2d at 284.

such activity.<sup>91</sup> Since the activity which is taxed takes place within the state, the burdens on the state regulatory body are increased, because of the need for regulation to protect consumers.<sup>92</sup> In addition, the cost of regulating nonresident businesses, and the cost of enforcing claims against nonresident businesses, will be higher than for resident businesses.<sup>93</sup> Foreclosure and litigation costs, will be higher, collection of fees and fines will be more difficult, and consumer reporting costs will increase. This tax is operating as a subsidy to the local banks. It is not intended as a discriminatory tax. It has the effect of encouraging local banks, and of recovering the extra cost involved in regulating out of state banks doing business within the state. A similar analysis can be applied to discriminatory taxation of nonresident citizens.

## 2. Equal Protection

The Equal Protection Clause guarantees all persons the equal protection of the laws.<sup>94</sup> This clause does not prohibit all discrimination in tax statutes. It requires that any tax which discriminates against nonresidents be based upon a rational basis and not resort to arbitrary classifications.<sup>95</sup> In *Metropolitan Life Insurance Co. v. Ward*,<sup>96</sup> the Supreme Court looked at whether a state could use a tax differential to encourage capital investment within the state.<sup>97</sup> Alabama enacted a tax which was three to four times as high as the tax on resident insurance companies.<sup>98</sup> The Court found that the excessive tax was not rationally related to a legitimate state purpose.<sup>99</sup> The Court went on to find that this tax actually penalized foreign insurers.<sup>100</sup> It was effectively a barrier for out of state insurance companies, not a rational tax discrimination.<sup>101</sup> The difference in allowable cases is that the tax has a rational relationship to the extra burdens placed on the state regulatory bodies.<sup>102</sup> It is not so great as to form a barrier to doing business in the

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91. See *Pullman's Palace Car v. Pennsylvania*, 141 U.S. 18 (1891).

92. See *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250 (1938).

93. See *id.*

94. See U.S. Const. amend. XIV, § 1.

95. See *Allied Stores of Ohio, Inc. v. Bowers*, 358 U.S. 522, 528 (1959).

96. 470 U.S. 869 (1994).

97. See *Metropolitan Life Ins. Co.*, 470 U.S. at 883.

98. See *id.* at 871.

99. See *id.* at 880.

100. See *id.* at 878.

101. See *Metropolitan Life Ins. Co.*, 470 U.S. at 882-83.

102. See *id.* at 881.

state.<sup>103</sup> In *Western and Southern Life Ins. Co. v. State Board of Equalization*,<sup>104</sup> a tax which promoted the insurance business in California was upheld by the Court.<sup>105</sup> The Court, in *Metropolitan Life* distinguished this case by noting that the sole purpose in *Metropolitan Life* was to favor local insurance companies, no matter what the cost to nonresident companies.<sup>106</sup> The major difference was the size and effect of the discrimination, not the simple existence of discrimination.

### 3. Privileges and Immunities

Imbedded in the Constitution of the United States are two clauses protecting the privileges and immunities of "citizens." Article IV Section 2, commonly known as the Privileges and Immunities Clause provides: "The Citizen of each State shall be entitled to all Privileges and Immunities of citizens in the several States."<sup>107</sup> This Clause was part of the Constitution as originally adopted.

Following the Civil War, the Privileges and Immunities Clause of the Fourteenth Amendment was adopted. Section One of that Amendment provides: "No state shall make or enforce any law which shall abridge the privileges and immunities of citizens of the United States."<sup>108</sup> It is well settled that corporations cannot invoke the protection of either of these constitutional guarantees.<sup>109</sup> Both privileges and immunities clauses by their express terms afford protection only to "citizens," and corporations are not regarded by the Court as citizens for purposes of standing under either clause.<sup>110</sup>

The effect of discrimination in law against citizens of another state may be large or small, but it is never positive; its negative effect can be amplified by the creation of a new source of interstate tension. Each unjustified discrimination against a citizen of a sister state is a constitutional wrong to that citizen.

There are general constitutional values of national unity and equal treatment of individual citizens. These values must be read, "Privileges and Immunities of Citizens" as referring to all the ways in which citizens are

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103. See *id.* at 879-80.

104. 451 U.S. 648 (1981).

105. See *Western & S. Life Ins. Co.*, 451 U.S. at 650-52.

106. See *Metropolitan Life Ins. Co.*, 470 U.S. at 877.

107. U.S. CONST. art. IV, § 2, cl.1.

108. U.S. CONST. amend. XIV, § 1.

109. See *Metropolitan Life Insurance Co. v. Ward*, 470 U.S. 869 (1985).

110. See *Hemphill v. Orloff*, 277 U.S. 537 (1928); *Blake v. McClung*, 172 U.S. 239 (1898); *Paul v. Virginia*, 75 U.S. 168 (1868).

treated by the state. The scope of the clause is co-extensive with the scope of interaction, between states and citizens.<sup>111</sup> One of these interactions is to allocate taxation between citizens of different states, and to choose the law that taxes such citizens.

The Supreme Court had defined "Privileges and Immunities" as a term of art not limited to certain categories of rights.<sup>112</sup> It has limited the scope of the term by saying that it includes only those rights of citizens that are "fundamental."<sup>113</sup> Fundamental in this definition appears to mean merely "important," or "not insignificant." A right can be fundamental for privileges and immunities purposes even though it is not a fundamental right. It is fundamental because a compelling interest would be required to override it for citizens and non-citizens alike. Thus, all the rights of trade, commerce, and pursuit of a livelihood are fundamental rights for this purpose. These economic rights get strong interstate equality protection, even though the Constitution gives them almost no substantive protection.<sup>114</sup> It would appear that these rights include the taxes imposed on a nonresident citizen who is engaged in commerce in another state.

In taxation, the Privileges and Immunities Clause is where taxpayers find protection against discriminatory taxes levied by states in which they are nonresidents.<sup>115</sup> They have no voting voice in those states. The "fairness" which nonresident taxpayers must receive from other states is guaranteed by the Privileges and Immunities Clause. The Clause must be upheld by federal courts in providing the constitutional guarantee of fairness in treatment from other states. Without such an interpretation, the nonresident is "fair game" for the taxing state. This discriminatory taxation leads to border wars. If one state treats the citizens of another state in an unfair manner, the response of the other states has been to enact retaliatory taxes.<sup>116</sup> This results in economic

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111. See *Ward v. Maryland*, 79 U.S. 418, 430 (1970) (stating that "beyond a doubt those works are very comprehensive in meaning."); see also *Paul v. Virginia*, 75 U.S. 168, 180 (1868) (stating that "it secures to them in other States the equal protection of their laws").

112. See *Baldwin v. Fish & Game Comm.*, 436 U.S. 371, 387 (1978).

113. See *id.* at 387-88.

114. Compare *Supreme Court v. Piper*, 470 U.S. 274, 279-83 (1985), and *Hicklin v. Orbeck*, 437 U.S. 518, 523-34 (1978) (protecting nonresidents' right to pursue an occupation under the Privileges and Immunities Clause of Article IV), with *Ferguson v. Skrupa*, 372 U.S. 726 (1963), and *Williamson v. Lee Optical, Inc.*, 348 U.S. 483, 484-89 (1955), and *Slaughter-House Cases*, 83 U.S. 36, 59-60, 76-78 (1872) (rejecting residents' claim of Fourteenth Amendment right to pursue an occupation).

115. See, e.g., *Ward v. Maryland*, 79 U.S. at 430 (1870); see *Toomer v. Witsell*, 334 U.S. 385 (1948).

116. This scenario is exactly what occurred in New Jersey, and New York in 1955 through 1961. See *Goodwin v. State Tax Comm'n*, 146 N.Y.S.2d 172, 174 (1955), *aff'd*, 133

inefficiencies and barriers to work and trade. This is the exact problem that the Privileges and Immunities Clause should be used to avoid. The Clause should be interpreted to abolish the discriminatory taxation of nonresidents in a very broad sense.

It has been a mistake to limit the Clause to fundamental rights, even if the limitation is rarely invoked. Much of the writing and analysis of the Privileges and Immunities Clause has been with regard to "choice of law" issues. This has been result of a number of cases arising in the area, and the constant conflict involving adjacent states. Both critics and supporters of interest analysis have agreed that this limitation is irrelevant to choice of law.<sup>117</sup> To receive equal justice in the courts, to be governed by equal application of equal laws, to be treated fairly by other states, is at the core of our government's system. Equal treatment in the courts was a central part of the Founders' understanding of privileges and immunities; the Privileges and Immunities Clause was closely linked to diversity jurisdiction.<sup>118</sup> There is one other possible interpretation of privileges and immunities. In 1787, the term carried a sense of civil rights as distinguished from political rights. The Privileges and Immunities Clause does not mean that visitors from sister states can vote in local elections or hold local office.<sup>119</sup> These rights are not privileges and immunities at all.

#### a. The Standard of Review

Douglas Laycock has analyzed the attempt to undermine the Privileges and Immunities Clause utilizing a lower standard of review. The standard of review is independent of the scope of the Clause. Within its scope—with respect to whatever "privileges and immunities" it applies to—the Clause is written in absolute terms. States are not merely to refrain from "irrational" or "inefficient"<sup>120</sup> discrimination, or to treat citizens of sister states "reasonably equally," or equally except where there is some reason to discriminate, or even some "substantial" reason to discriminate. Rather, Laycock believes that the Clause says without qualification that states are to treat citizens of sister

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N.E. 2d 711 (1956); Michael Solomon, *Nonresident Personal Income Tax: A Comparative Study in Eight States*, 29 *FORDHAM L. REV.* 105 (1961); see also NONRESIDENT TAX STUDY COMMITTEE, REPORT ON TAXATION OF NONRESIDENT BY NEW YORK 48 (1959).

117. See John Hart Ely, *Choice of Law and the State's Interest in Protecting Its Own*, 23 *WM. & MARY L. REV.* 173, 182-83 (1981); see also Larry Kramer, *The Myth of the "Unprovided-For" Case*, 75 *VA. L. REV.* 1045, 1067 n.71 (1989).

118. See U.S. CONST. art. IV, § 2, cl. 1; see also Douglas Laycock, *Equality and the Citizens of Sister States*, 15 *FLA. ST. U. L. REV.* 431, 433-36 (1987).

119. See Laycock, *supra* note 122, at 433-36.

120. See U.S. CONST. art. IV, § 2, cl. 1; see also Laycock, *supra* note 122, at 445.

states as citizens.<sup>121</sup> This should mean that the tax burden imposed on those citizens should not be greater than the burden imposed upon citizens of the taxing state.

The narrow focus of the Privileges and Immunities Clause is also relevant to the standard of review, sharply distinguishing this clause from the general guarantee of equality in the Equal Protection Clause. Laycock further argues that because the Equal Protection Clause literally applies to every distinction the government makes, the only sensible interpretation is that some distinctions are more suspect than others.<sup>122</sup> An example of the difference between the two clauses is like the difference between the Equal Protection Clause and the rejected Equal Rights Amendment. When lawyers argued whether sex was a suspect classification under the Equal Protection Clause, few doubted that sex would be a suspect classification if the Equal Rights Amendment was ratified.<sup>123</sup> The Privileges and Immunities Clause specifies its suspect class, absolutely forbids discrimination against that one class, and applies to nothing else. The class which is discriminated against in nonresident taxation includes all the nonresidents of the taxing state who are subject to the offending tax. In the case of a tax on hotel rooms to pay for a convention center, the argument is made that the specific tax used to build the convention center will directly benefit those who are taxed.

Exceptions can be found to the Privileges and Immunities Clause. In the First Amendment, even when a constitutional right is stated in absolute terms, courts must imply exceptions for sufficiently compelling reasons.<sup>124</sup> An implied exception to an expressly absolute constitutional right should be an extraordinary thing. Courts cannot legitimately imply exceptions to absolute provisions in the same free way they construe rights that expressly depend on what is reasonable or what is due. All constitutional rights require balancing, but with respect to the absolute rights, balancing should be tilted heavily against the government.

Discrimination against citizens of sister states will sometimes be justified, but only (or almost only) when such discrimination serves federal interests and not merely the interests of the discriminating state.<sup>125</sup> If a state's

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121. See U.S. CONST. art. IV, § 2.

122. See Laycock, *supra* note 122.

123. Compare *Frontiero v. Richardson*, 411 U.S. 677, 688 (1973) (Brennan, J., plurality) (concluding that sex is inherently a suspect classification), with (Powell, J., concurring) (stating that the Equal Rights Amendment would "resolve the substance of this precise question . . .") *Id.* at 692.

124. See Gary J. Simson, *Discrimination Against Nonresidents and the Privileges and Immunities Clause of Article IV*, 128 U. PA. L. REV. 379, 388 (1979).

125. See *Shaffer v. Carter*, 252 U.S. 37 (1920); see Laycock, *supra* note 122.



parochial interests can ever justify discrimination against citizens of sister states, it can only be to avoid intolerable harms. Laycock has stated that

[t]he rationale and benefit from the privileges and immunities clause is to treat citizens of any state as citizens of the Republic, not allowing them to be subject to mistreatment by any state merely because they are not residents of that state. Its purpose is to allow citizens to freely travel, work and to do business in any state of the union. Its purpose is to keep peace among the states, encourage cooperation among the states and to discourage unfair treatment of nonresidents. The failure of the courts to enforce these rights and to further the goals of the clause will lead to economic wars between the states.<sup>126</sup>

This view of the Clause derives in part from the belief that we should examine the Constitution as a whole.<sup>127</sup> We cannot legitimately pick and choose the clauses we want enforced. But the Privileges and Immunities Clause is not an arguable constitutional mistake, nor is it an obsolete provisions that modern Americans are stuck with; it fits neatly into modern conceptions of nondiscrimination.<sup>128</sup> Discrimination against fellow Americans is intuitively unjust. Citizens of sister states are outsiders, subject to in-group/out-group bias, denied the right to vote (the key to power in the political process), and are thus dependent on judicial protection. The state courts of the taxing states have been failing to give the proper protections to overtaxed nonresidents. Interpreters of the Constitution should not seek out ways to minimize the Privileges and Immunities Clause.

The Supreme Court has not treated all textually absolute constitutional rights equally. Nor has it applied the compelling interest test to the Privileges and Immunities Clause. But it has come close. It has held that only a "substantial" interest can justify discrimination against natural persons from sister states,<sup>129</sup> and it has invalidated much of the local discrimination under that formulation.<sup>130</sup>

126. See Laycock, *supra* note 122; see Douglas Laycock, *Equal Citizens of Equal and Territorial States: The Constitutional Foundations of Choice of Law*, 92 COLUM. L. R. 249 (1992).

127. See Laycock, *supra* note 122, at 433-36.

128. See Douglas Laycock, *Notes on the Role of Judicial Review, the Expansion of Federal Power, and the Structure of Constitutional Rights*, 99 YALE L.J. 1711, 1745-47 (1990) (reviewing ROBERT F. NAGEL, *CONSTITUTIONAL CULTURES: THE MENTALITY AND CONSEQUENCES OF JUDICIAL REVIEW* (1989)); Laycock, *supra* note 122, at 433-36; Douglas Laycock, *Equal Citizens of Equal and Territorial States: The Constitutional Foundations of Choice of Law*, 92 COLUM. L. REV. 249 (1992).

129. See *Supreme Court v. Piper*, 470 U.S. 274, 284 (1985); *Toomer v. Witsell*, 334 U.S. 385, 396 (1948); *Travis v. Yale and Towne Mfg. Co.*, 252 U.S. 60 (1920).

130. See *Piper*, 470 U.S. 274 (discussing discrimination in bar admissions); *Hicklin v. Orbeck*, 437 U.S. 518 (1978) (discussing discrimination in employment on state oil leases); *Austin v. New Hampshire*, 420 U.S. 656 (1975) (discussing discriminatory income tax);

Discrimination against sister-state corporations has been treated differently, because the Privileges and Immunities Clause protects only citizens. Corporations cannot be citizens, and so far the Court has been unwilling to look through the corporation and protect the sister-state investors.<sup>131</sup> Instead, discrimination between local and sister-state corporations violates the Commerce Clause and the Equal Protection Clause.<sup>132</sup> The Supreme Court's enforcement of these prohibitions has gradually strengthened over the years. The Court once viewed incorporation as a privilege that could be granted or withheld for any reason or no reason, and thus, states were free to exclude sister-state corporations or to condition their admittance on consent to discriminatory treatment.<sup>133</sup> This view was wrong even in its own time, but it became profoundly obsolete after general incorporation statutes made corporate status a right available for the asking.<sup>134</sup>

Today, the Court interprets the Commerce Clause to forbid all or nearly all discrimination on the basis of economic factors from sister-states. It has held that discrimination against interstate commerce is "virtually *per se* invalid,"<sup>135</sup> without hope of justification by further inquiry into state

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Mullaney v. Anderson, 342 U.S. 415 (1952) (discussing discriminatory fee for commercial fishing license); *Toomer*, 334 U.S. at 395-403 (discussing discrimination against out-of-state shrimpers); *Travis*, 252 U.S. at 78-82 (1920) (discriminatory tax exemptions); *Chalker v. Birmingham & N.W. R.Y. Co.*, 249 U.S. 522, (1919) (discussing discriminatory taxation); *Blake v. McClung*, 172 U.S. 239, 247-54 (1898) (discussing discrimination in distribution of insolvent estates); *Williams v. Bruffy*, 96 U.S. 176, 183-84 (1877) (discussing law confiscating debts owed to citizens of nonseceding states but not confiscating debts owed to citizens of nonseceding states but not confiscating debts owed to citizens of debtor's state or other seceding states); *Ward v. Maryland*, 79 U.S. 418, 430-32 (1870) (discussing discriminatory licensing tax)

131. See *Western & S. Life Ins. Co. v. State Bd. of Equalization*, 451 U.S. 648, 656 (1981); see also *Paul v. Virginia*, 75 U.S. 168, 177-78 (1868).

132. See *Bendix Autolite Corp. v. Midwesco Enters.*, 486 U.S. 888, 891-95 (1988) (discussing discriminatory statute of limitations); *Maryland v. Louisiana*, 451 U.S. 725, 753-60 (1981) (discussing discriminatory tax exemptions); cf. *Ward*, 79 U.S. at 425 (discussing holding that discriminatory licensing tax applied to individuals violates both the Commerce and Privileges and Immunities Clauses); *Metropolitan Life Ins. Co. v. Ward*, 470 U.S. 869 (1985) (discussing discriminatory taxation); *WHYY, Inc. v. Borough of Glassboro*, 393 U.S. 117 (1968) (per curiam) (discussing discriminatory tax exemption); *Wheeling Steel Corp. v. Glander*, 337 U.S. 562 (1949) (discussing discriminatory taxation), *rev'd sub nom.*, U.S. Gypsum Co. v. Glander 337 U.S. 951 (1949).

133. See *Paul*, 75 U.S. at 181.

134. See *Western & S Life Ins. Co.*, 451 U.S. at 659-68. See also Julian N. Eule, *Laying the Dormant Commerce Clause to Rest*, 91 YALE L.J. 425, 451 (1982); Martin H. Reish & Shane V. Nugent, *The Dormant Commerce Clause and the Constitutional Balance of Federalism*, 1987 DUKE L.J. 569, 611 (1987).

135. *Brown-Forman Distillers Corp. v. New York State Liquor Auth.*, 476 U.S. 573, 579 (1986).

interests.<sup>136</sup> In other cases, it has said that such discriminations subject to the "strictest scrutiny,"<sup>137</sup> or "more demanding scrutiny."<sup>138</sup> This rule applies with equal force to discrimination against *out-of-state* persons and discrimination against *out-of-state* goods.<sup>139</sup>

Discrimination against sister-state corporations violates the Equal Protection Clause as well, unless it bears "a rational relation to a legitimate state purpose."<sup>140</sup> This rule is not as weak as it appears, because it carries the important proviso that a mere desire "to favor domestic industry within the State"<sup>141</sup> is not a legitimate state purpose. Rather, discrimination so motivated "constitutes the very sort of parochial discriminations that the Equal Protection Clause was intended to prevent."<sup>142</sup> Congress can authorize state regulation of interest commerce that would otherwise be precluded by the Commerce Clause, but presumably it cannot authorize violations of the Equal Protection Clause.

Review of discrimination against natural persons or corporations from sister-states should be equally stringent under any of these clauses. The objections to discrimination against citizens of sister-states do not change when those citizens choose to do business in corporate form. The owners of a sister-state corporation are still fellow Americans exposed to the risk of local bias, and their right to do business throughout the country is still essential to national unity. The omission of corporations from the Privileges and Immunities Clause is not an element of the constitutional scheme; it is a relic from a time before general incorporation laws. The same constitutional policies of national unity and interstate equality are at work in all three clauses. The specific concerns that underlie the Privileges and Immunities Clause form the more general right of equity in the Equal Protection Clause and the equality component of the Commerce Clause. The Court should be reluctant to imply exceptions to any of these protections.

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136. See *Bendix Autolite Corp.*, 486 U.S. at 89; *Brown-Forman*, 476 U.S. at 578-79.

137. See *Sporhase v. Nebraska ex rel. Douglas*, 458 U.S. 941, 958 (1982) (quoting *Hughes v. Oklahoma*, 441 U.S. 322, 337 (1979)).

138. *Maine v. Taylor*, 477 U.S. 131, 138 (1986).

139. See *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 268, n.8 (1984).

140. See *Western & S.*, 451 U.S. at 668.

141. *Metropolitan Life*, 470 U.S. at 878.

142. *Id.*

Examples of such state discrimination are quite easily found.<sup>143</sup>

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143. For examples of discrimination practices in states taxing non-residents, see:

Alaska:

Carlson v. State, 919 P.2d 1337 (Alaska 1996): Class action challenged the State of Alaska's practice of charging nonresident commercial fishers licensing and limited entry permit fees three times greater than those fees charged to resident commercial fishers. The court concluded that the State's pro rata formula in calculating and comparing the taxation burden placed on resident and nonresident commercial fishers results in a significant difference between the two classes. Therefore, the case was remanded for the application of the class's per capita formula which determines the fee differential as constitutional.

California:

Davis v. Franchise Tax Bo., 139 Cal. RPTR. 787 (Cal. App. 3d 1977): Plaintiffs challenged the constitutionality of § 18243 of the California Revenue and Taxation Code, which denies to non-Californians the option of income averaging in computing their California income tax. The Court of Appeals held that the denial of the option did not violate the Privileges and Immunities Clause of the Constitution. Instead of forcing non-residents to show out-of-state income as a condition of income averaging, California chose to deny the option. The denial is consistent with the State's general policy of ignoring out-of-state income as a factor in progressive taxation.

Delaware:

DEL. CODE ANN. tit. 7, § 552 (1975): [License fees: Raw Fur Dealers-] "A resident of Delaware shall pay to the Department a fee of \$28.75 for a license under § 551 of this title. A nonresident of Delaware shall pay a fee of \$287.50 for such a license."

Illinois:

Broeckl v. Chicago Park Dist., 131 Ill. 2d 79, 544 N.E.2d 792 (1989). Nonresidents challenged statute permitting the park district to charge nonresidents of Chicago a higher fee than residents. The Appellate Court held that the statute was constitutional because the Privileges and Immunities Clause of the Constitution applies to discrimination against citizens of other states. The privileges and immunities do not apply where a city or municipal ordinance discriminates against intrastate residents.

Indiana:

Clark v. Lee, 273 Ind. 572, 406 N.E.2d 646 (1980): Case wherein courts declared Indiana occupation income tax statute unconstitutional. The Supreme Court found that the burden of the occupation income tax fell upon nonresidents and residents. However, that burden is removed from residents through the credit mechanism; therefore, the tax discriminates against nonresidents and violates the privileges and immunities guaranteed under the United States Constitution.

Iowa:

Borden v. Selden, 259 Iowa 808, 146 N.W.2d 306 (1966): Case involved the issue of whether the Agricultural Land Tax Credit Act of Iowa denying to nonresident owners of Iowa land a tax credit granted resident owners of Iowa land, violates the Constitution of the United States. The Supreme Court held that since there was no reasonable basis for the allowance of a credit against taxes on agricultural land owned by residents, the resulting discrimination upon nonresidents violates the Privileges and Immunities Clause of the Constitution.

Maine:

Stevens v. State Tax Assessor, 571 A.2d 1195 (Me. 1990): Court held that Maine's application of a graduated tax rate applicable to nonresident taxpayers did not violate nonresident

However, the dearth of recent cases in either the federal or state courts is a testament to the expense and difficulty of litigating such issues. The lack of relief granted to non-residents by the state courts is another indication of the unavailability of remedy to taxpayers who have been discriminated against.

## b. The Exceptions

### i. Legitimate Discrimination Against Citizens of Sister States

The Privileges and Immunities Clause has some legitimate implied exceptions. For example, Alabama residents do not vote or collect welfare in Louisiana, and they pay out-of-state tuition to attend Louisiana universities. It is important to identify the principle that explains these exceptions, and to examine what that principle implies for choice of law. Critics of any constitutional clause argue that the legitimacy of some exceptions implies the legitimacy of others.<sup>144</sup> Such arguments are inane unless it is shown that the proposed exception is implied by the same principles as the acknowledged

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taxpayers' due process, privileges and immunities or equal protection rights. The Stevens' challenged the method used by the State of Maine in taxing the Maine source income of nonresidents. However, there was no improper discrimination in the application of Maine's income tax because similarly situated residents and nonresidents are taxed at an equal rate. *Green v. State Tax Assessor*, 562 A.2d 1217 (Me. 1989): Nonresidents appealed court ruling denying tax refund. The plaintiffs' argued that they should have been allowed to carry forward operating losses realized in Maine during previous years in which plaintiff could not deduct the losses on their Maine income tax returns due to insufficient Maine source income. The Assessor disallowed the losses, interpreting Maine tax law to permit taxpayers to deduct losses on their Maine income tax return only in the year that they deduct the same losses on their federal income tax returns. The court found that the Maine income tax law prohibits both residents and nonresidents from carrying forward losses if those losses are not also entered on their federal income tax returns for the same tax year. Although the Maine Income Tax Code does permit some disparity of treatment between residents and nonresidents, Maine's Tax scheme is neutral in its effect on residents and nonresidents.

#### New Hampshire:

*Austin v. New Hampshire*, 420 U.S. 656 (1975): New Hampshire Commuter's Income Tax was struck down because the burden fell exclusively upon nonresidents. Residents of Maine employed in New Hampshire brought a class action for a declaratory judgment that the tax violated the Privileges and Immunities Clause. The Court found that the fact that Maine residents working in New Hampshire were required by New Hampshire Commuters Income Tax law to file New Hampshire tax return and that their employers were required to withhold four percent of their earnings even though they were not subject to tax at that rate, and they were thus deprived of use value of excess withheld over their ultimate tax liability, was unconstitutional.

144. See Laycock, *supra* note 122, at 438.

exception. The essential features of the uncontroversial exceptions to the Privileges and Immunities Clause is that they are implied by the needs of the federal structure. They serve the interest of the nation, and not merely the interest of a single state. These exceptions must be limited to that narrow scope. The state courts have been broadening this view for the selfish interest of the state itself.<sup>145</sup>

The most fundamental exception to the rule of equal treatment is that each state can reserve the exercise of governmental power, including the right to vote, to its own citizens.<sup>146</sup> This exception is consistent with, and required by, the Founders' dual purpose of achieving national unity and preserving the states as separate polities. It may seem odd to conclude that the principal exception to a rule requiring visitors to be treated as citizens is that they cannot exercise those ultimate political powers that we have come to think of as the quintessential rights of citizens.

The oddity here is not in the rule. No one thinks citizens of each state should vote in all fifty states. Residency requirements for voting have been thought "necessary to preserve the basic conception of a political community [...] . . ."<sup>147</sup> They protect local autonomy from meddling outsiders who will not have to live with the consequences of their votes. What seems odd is to use the language of citizenship to describe a broad set of rights that does not include the right to vote.

The link between citizenship and voting was much less natural and apparent to the Founders than it is to us. Voting rights were left to positive law, and each state determined its own qualifications for voting.<sup>148</sup> The Constitution has since been amended seven times to expand rights.<sup>149</sup> Even today, not all citizens are entitled to vote. Children are excluded from the franchise without controversy, as are most felons with only modest controversy.<sup>150</sup> In the Eighteenth Century, when women were excluded and some men were still excluded due to property qualifications, only a minority of citizens were entitled to vote.<sup>151</sup> In the Nineteenth Century, when most

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145. See Laycock, *supra* note 122 at 438.

146. See Laycock, *supra* note 122 at 431.

147. See *Dunn v. Blumstein*, 405 U.S. 330, 344 (1972).

148. See U.S. CONST. art. I, § 2.

149. See U.S. CONST. amend. XIV, § 2; amend., XVII, XIX, XXIII, XXIV, XXVI.

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See *Richardson v. Ramirez*, 418 U.S. 24, 41-56 (1974) (upholding the disenfranchisement of ex-felons); *Hunter v. Underwood*, 471 U.S. 222 (1985) (invalidating disenfranchisement of persons convicted of misdemeanors involving "moral turpitude," where the provision was adopted with the intent to reduce the number of black voters).

151. See GORDON S. WOOD, *THE CREATION OF THE AMERICAN REPUBLIC 1776-1787*, 167-69 (1969).

female citizens were still excluded, many states allowed resident aliens to vote.<sup>152</sup>

Whatever the Founders may have thought about the relationship between citizenship and voting, they plainly did not think Virginians should vote in Massachusetts. Because, no one in the 1780's was urging that citizens of one state be allowed to vote in any other, the Founders had no occasion to consider whether the Privileges and Immunities Clause might be misunderstood to apply to voting.

## ii. Subsidized Social Welfare Services

The broadest exception to the Privileges and Immunities Clause covers subsidized social welfare services. States can generally restrict such services to their own residents, or account for the subsidy in a higher user fee for nonresidents.<sup>153</sup> Otherwise, individuals could benefit from subsidies without being subject to the taxes that pay the subsidies.<sup>154</sup> A claim to share benefits without sharing their cost does not flow easily from a right to equal treatment.

Of course, the assumption that subsidies are supported by taxes on residents is only approximately true. Only residents are subject to the state's full taxing power,<sup>155</sup> but nonresidents pay some taxes and receive some government benefits.<sup>156</sup> The argument that the state can confine subsidies to residents uses residence as a proxy for tax liability. Like all proxies, it is not entirely accurate.

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152. See generally, Gerald M. Rosberg, *Aliens and Equal Protection: Why not the Right to Vote?*, 75 MICH. L. REV. 1092, 1096-99 (1977).

153. Cf. *Sturgis v. Washington*, 368 F. Supp. 38 (W.D. Wash. 1973.) *aff'd mem.*, 414 U.S. 1057 (1973) (upholding differential in tuition for state university against challenge under the Equal Protection Clause); *Starns v. Malkerson*, 326 F. Supp. 234 (D. Minn. 1970), *aff'd mem.*, 401 U.S. 985 (1971) (upholding differential in tuition for state university upheld against a challenge under the Equal Protection Clause). In dictum, several cases have recognized that bona fide residence requirements are generally valid. See, e.g., *Martinez v. Bynum*, 461 U.S. 321, 325-30 (1983); *Plyler v. Doe*, 457 U.S. 202, 227, n.22 (1982); *Vlandis v. Kline*, 412 U.S.441, 452-53 (1973). *Martinez* upheld a local-residence requirement for school districts that applied equally to in-state and out-of-state residents. See *Martinez*, 461 U.S. at 328, n.8. The Court subsequently held that local and state residence requirements are equivalent for purposes of the Privileges and Immunities Clause, and that either requires justification under the Clause. See *United Bldg. & Constr. Trades Council v. Mayor of Camden*, 465 U.S. 208, 215-18, 222-23 (1984).

154. A similar argument is developed by Jonathan D. Varat. See Jonathan D. Varat, *State "Citizenship" and Interstate Equality*, 48 U. CHI. L. REV. 487, 522-23 (1981).

155. See *New York ex rel. Cohn v. Graves*, 300 U.S. 308, 312-13 (1937).

156. See *Austin v. New Hampshire*, 420 U.S. 656 (1975).

The need to confine subsidies to residents does not wholly depend on equity to individual taxpayers. The structural problem is more fundamental: If Americans were entitled to subsidized services in every state, whole states could be free-riders. A state could decide there was no need to create a state university so long as its students could be educated at the expense of the taxpayers elsewhere, and no need to pay welfare benefits so long as its citizens could claim benefits in any state they might choose. A small state like Rhode Island, where nearly the whole population lives within commuting distance of another state, could rely on its neighbors for a wide range of social services.

No body of taxpayers will support subsidized services for an unlimited number of visitors who do not help pay for the subsidy. Application of the Privileges and Immunities Clause to subsidized services would create inexorable pressure to reduce or eliminate state subsidies for such services. Ultimately, most such services would have to be provided at the federal level, and a key feature of federalism—the voters' ability to choose different levels of government to perform different functions—would be eliminated. Interstate eligibility for social services would inevitably consolidate the provision of social services just as interstate voting would consolidate our separate politics. If we are to have separate states at all, each of us must be constitutionally entitled to vote and receive subsidized services in one and only one of those states. There were few subsidized services in the Founders' time, and they did not thoroughly consider the exception. Rather, they probably took for granted the basic point.

The exception for subsidized social services must contain at least some exceptions of its own. Visitors from other states must be eligible for services that are essential to interstate travel and commerce, even if those services are subsidized. The precise borders of this category may require case-by-case protection, emergency medical care, and other emergency services.<sup>157</sup> This conclusion is also derived from the needs of the Union. If visitors could not use these services as needed, no one could safely travel interstate. Because travelers demand for necessary services is reciprocal—and because states collect substantial sums for travelers through neutral taxes on gasoline, hotels, and retail sales—this restriction on state power does not threaten the separate existence of the states or their ability to make policy choices and fund services.

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157. See Laycock, *Equal Citizens of Equal and Territorial States: The Constitutional Foundations of Choice of Law*, 92 COLUM. L.R. 249, 273 (1992).



### iii. Other Possible Exceptions

Any other legitimate exceptions to the Privileges and Immunities Clause should be construed narrowly. It should never be enough that local citizens need the benefit of discrimination, because the need of similarly situated citizens of sister-states is just as great.<sup>158</sup> The state can draw its lines on the basis of need rather than citizenship, or it can subsidize its own needy and rely on the subsidized social services exception. Exceptions can never be based on hostility or indifference to citizens of sister-states, or on a judgement that their interests are less important or less deserving of the state's attention than the interests of locals. Claims that citizens of sister-states are the source of some special difficulty requiring discriminatory legislation should be subject to strict scrutiny. The exception applying to taxation of nonresidents should not apply to any broad based discrimination practiced against nonresidents. It is important to follow the federal model of taxation to a great extent and to provide similar treatment to residents and nonresidents equally, at a rate of five percent, that would be fair treatment. But, if the state allowed residents a deduction from their income, but denied it to nonresidents, that would be unfair, because the nonresidents would be paying a five percent tax on an income which is more broadly defined.<sup>159</sup> The reality for many citizens of the United States is that they earn virtually all of their income in a state in which they are not a nonresident. This reflects the free movement of citizens across state lines to carry on business. These are the people who must be protected from aggressive taxation.

Brainerd Currie espoused the view of "interest analysis."<sup>160</sup> Interest analysis in its original version obviously violated the principle of equal citizens. It has been argued that a state's only fully legitimate interest with respect to an interstate transaction is to enrich its own citizens.<sup>161</sup> States might take an "altruistic interest" in the welfare of nonresidents, but such

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158. See *United Bldg.*, 465 U.S. at 222-23 (remanding claim of local need for further consideration).

159. See *Travis v. Yale & Towne Mfg. Co.*, 252 U.S. 60, 77-78 (1920); *Austin v. New Hampshire*, 420 U.S. 656, 656 (1975) (holding that tax laws which discriminate against nonresidents by denying them exemptions granted to residents violates the Privileges and Immunities Clause).

160. See BRAINERD CURRIE, *SELECTED ESSAYS ON THE CONFLICT OF LAWS* 190-191, (1963).

161. See *id.* Alfred Hill, *Choice of Law and Jurisdiction in the Supreme Court*, 81 COLUM. L. REV. 960, 984 (1981); Alfred Hill, *Governmental Interest and the Conflict of Laws—A Reply to Professor Currie*, 27 U. CHI. L. REV. 463, 474, 476 (1960).

interests are "of quite different order from"<sup>162</sup> nonaltruistic interests. The interests of citizens of sister states did not count in the primary analysis of state interests, and it was eventually believed that it is sometimes unconstitutional to take such interests into account.<sup>163</sup> Under this view, a state had no interest in looking after the social welfare of a nonresident. Its only inquiry and duty relates to protecting and helping its own citizens. Under this theory, each state could become interested in wrenching as much tax out of nonresidents as possible. In fact, that trend is at work in some states today.

### c. A Treaty Among States

Some commentators have analyzed the history of the Privileges and Immunities Clause to mean that it was meant to preclude economic wars between individual states.<sup>164</sup> This is exactly the purpose for which the Clause should be applied: to encourage cooperation between states in economic policies and treatment of citizens. The Clause should be used to encourage the free movement of citizens across state lines for the purpose of earning a living. State should be discouraged from placing barriers to this movement, in the form of discriminatory levies or taxes.

The application of the Privileges and Immunities Clause to disputes concerning taxes imposed by the state on a nonresident was initiated in the case of *Travis v. Yale & Towne Manufacturing Co.*,<sup>165</sup> where New York imposed a tax on the income of both residents and nonresidents. The taxing statute allowed deductions and exemptions for the residents of New York, but did not allow equal deductions for nonresidents of New York.<sup>166</sup> This unequal treatment was attacked on the grounds that it denied nonresidents the privileges and immunities granted to residents of New York.<sup>167</sup> The Court looked at a balancing of the distribution as well as the lack of a reasonable basis for such discrimination.<sup>168</sup> The *Travis* court determined that a state taxing statute, when facially discriminatory against a nonresident of a state,

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162. Brainerd Currie & Herma H. Schreter, *Unconstitutional Discrimination in the Conflict of Laws: Privileges and Immunities*, 69 YALE L.J. 1323, 1360-61, 1368 (1960).

163. *See id.* at 1365-66.

164. *See* George F. Carpinello, *State Protective Legislation and Nonresident Corporations: The Privileges and Immunities Clause as a Treaty of Nondiscrimination*, 73 IOWA L. REV. 351, 352-53 (1988).

165. 252 U.S. 60 (1920).

166. *See id.* at 73-74.

167. *See id.* at 72.

168. *See id.* at 79-81.

will not be upheld if there is no valid rationale for the discrimination.<sup>169</sup> Additionally, that rationale must be sufficient to balance the discrimination which is enacted and applied.<sup>170</sup> The Court noted that "due to the geographical situation of [New York], in close proximity to the neighboring States, many thousands of men and women, residents and citizens of the State, go daily from their homes to the city and earn their livelihood there."<sup>171</sup> The Court went on to determine that the discriminatory treatment, causing nonresidents to pay more taxes than residents, was an unwarranted denial of the privileges and immunities enjoyed by the citizens of New York.<sup>172</sup> In *Travis*, the Court's problem with the statute was the fact that it discriminated against every taxpayer, and was not discrimination based upon the personal circumstances of individual taxpayers.<sup>173</sup> However, the court did not address the issue of a discrimination against a broad group of taxpayers, as opposed to all taxpayers, because the issue was not before the Court.

#### IV. THE CREATION OF MARKET INEFFICIENCY

In analyzing a broad based discriminatory tax statute imposed by one state against residents of another state, it is important to keep in mind the issues which go behind the application of the Privileges and Immunities Clause. An early Supreme Court case laid out the application of the Privileges and Immunities Clause to a taxing statute.<sup>174</sup>

It was undoubtedly the object of the clause in question to place the citizens of each State upon the same footing with citizens of other States, so far as the advantages resulting from citizenship in those States are concerned. It relieves them from the disabilities of alienage in other State; it inhibits discriminating legislation against them by other States; it gives them the right of free ingress into other States . . . ; it insures to them in other States the same freedom possessed by the citizens of those States in the acquisition and enjoyment of property and in the pursuit of happiness; and it secures to them in them in other State the equal protection of their laws.<sup>175</sup>

When the constitutional provision was written, it was with the profound understanding that each of the several states must not act to inhibit the lives and economic pursuits of citizens of other states.<sup>176</sup> To allow discrimination

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169. *See id.* at 78-79.

170. *See id.* at 80.

171. *Id.*

172. *See id.* at 82.

173. *Travis v. Yale Towne Manufacturing Co.*, 252 U.S. 60, 78 (1920).

174. *See Paul v. Virginia*, 75 U.S. 168 (1868).

175. *Paul*, 75 U.S. at 180.

176. *See id.*

which created disincentives for the smooth flow of commerce and inhibited the ability of citizens to freely pursue a living in any state, would create barriers to economic development. Much time and effort was expended at insuring that the union of states would provide an economic system which would work to benefit all citizens of the union.<sup>177</sup>

#### A. Protective and Incentive Inefficiencies

Each state has the capacity to use its local taxation to burden interstate commerce. The danger arising from this capability has long been recognized.<sup>178</sup> The protectionist tariffs placed on the flow of goods across state boundaries was one of the principal driving forces behind the Constitutional Convention in 1787.<sup>179</sup> Barriers, such as higher taxes on nonresidents of a state, act to inhibit the movement of people across state lines to engage in commerce, the pursuit of employment, and the carrying on of business. The existence of discriminatory taxes creates market inefficiencies, which are artificial and tend to poorly allocate labor resources.<sup>180</sup> It has been viewed as critical, from an economic flow point of view, that a tax be levied without a view to the location of the taxpayer.<sup>181</sup> It has been argued that taxpayers sustain significantly higher transaction costs and tax planning costs because of the differences in states taxation.<sup>182</sup> The cost of compliance is also higher. These costs all create economic inefficiencies. They will always be present when taxpayers are employed across state lines.<sup>183</sup> These burdens should not be increased when they are faced with discriminatory taxes imposed merely because of their nonresident status. When applying the Commerce Clause, the courts have judged discrimination which is not allowable, as that discrimination which provides

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177. See THE FEDERALIST NO. 7, at 61 (Alexander Hamilton) (Clinton Rossiter ed., 1961).

178. See *Ward v. Maryland*, 79 U.S. 418 (1870) (one of the first cases invalidating taxes on nonresidents).

179. See THE FEDERALIST NO. 7 at 40 (Alexander Hamilton).

180. These tax discriminations have been described as "inconsistent with the very idea of political union." Donald H. Regan, *The Supreme Court and State Protectionism: Making Sense of the Dormant Commerce Clause*, 84 MICH. L. REV. 1091, 1113 (1986); See also Philip M. Tatarowicz & Rebecca F. Mims-Velarde, *An Analytical Approach to State Tax Discrimination Under the Commerce Clause*, 39 VAND. L. REV. 879, 898-99 (1986) (discussing the Supreme Court's view of what constitutes tax discrimination).

181. See Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895, 900 (1992).

182. See *id.*

183. See *id.* at 909-12 (providing an excellent depiction of these inefficiencies).

a commercial advantage to local business, at the expense of out-of-state business.<sup>184</sup> This type of test seems to be applicable also to the protection of citizens who are wage earners or employees. Is the taxing state providing an advantage to local residents? Does it place nonresidents at an earning disadvantage, by increasing their costs of carrying on their employment? Justice Scalia, in a series of opinions, has proposed a standard which would bar "facial" discrimination against outsiders when these outsiders are taxed more heavily.<sup>185</sup> With respect to the application of the Privileges and Immunities Clause, Justice Scalia has denied "rank" discrimination in taxing statutes.<sup>186</sup> It is unclear whether "rank" discrimination differs from facial discrimination. However, it is clear that there is strong support for prohibiting discrimination against nonresident taxpayers when it increases their burden of earning a living.<sup>187</sup>

The principle that states should not discriminate against interstate movement of commerce has been researched from many viewpoints. A locational discrimination occurs when one location taxes a person at a higher rate, that person will make choices to substitute one activity for another.<sup>188</sup> The chosen activity will be preferred in order to reduce the individual's tax burden.<sup>189</sup> These types of choices are said to create a deadweight social loss to the extent of the reduced tax liability by reason of the substitution in choice.<sup>190</sup> Thus, some neutrality of tax issues from a locational standpoint is desirable because it acts to minimize these social costs. Overall economic benefits to society are generally maximized when individuals can choose their own behavior without regard to tax externalities. The greatest social benefit is attained when each individual can choose the employment which will provide the greatest overall income—both internal to the individual and external from the viewpoint of after tax cash benefits. Imposing excessive tax costs on the decision-making process has the result of forcing choices with regard to these externalities. This should not be the case. It has been argued that an efficient tax is one that taxpayers ignore.<sup>191</sup> It would be a tax that does

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184. See *Goldberg v. Sweet*, 488 U.S. 252 (1989); see also PAUL J. HARTMAN, *FEDERAL LIMITATIONS ON STATE AND LOCAL TAXATION* § 2:19 (1981).

185. See *American Trucking Ass'n v. Smith* 496 U.S. 167, 200-05 (1990); *Goldberg*, 488 U.S. at 271 (1989); *Tyler Pipe Indus. v. Washington State Dep't of Revenue*, 483 U.S. 232, 254 (1987); *American Trucking Ass'n v. Scheiner*, 483 U.S. 266, 304 (1987).

186. See *Tyler Pipe Indus.*, 483 U.S. at 265.

187. See *City of New York v. State of New York*, 696 N.Y.S.2d 426 (N.Y. App. Div. 1st Dept. 1999).

188. See Shaviro, *supra* note 113, at 901.

189. See *id.*

190. See *id.*

191. See *id.* at 906.

not affect people's decisions about where to travel, where to live, where to invest and so forth.<sup>192</sup> Although this type of efficient locational tax scheme does not exist, it should be a policy goal which drives new taxation schemes. Many adjacent states have worked toward this goal in common schemes negotiated at meetings of the states.<sup>193</sup> One such "common scheme," is the general use of the proportionate allowance of personal deductions to nonresident taxpayers by states in which these nonresidents earn income.<sup>194</sup>

## B. The High Cost of Taxation

It can be argued that the high tax rates of a state or city act to impede the economic growth of that state or city.<sup>195</sup> For example, New York City, which has the highest rate of income taxation in the United States, has been suffering from excessive unemployment during the expansionary period of the 1990s.<sup>196</sup> Unemployment in 1997 was above 9%, which was nearly twice the national rate of 4.8%.<sup>197</sup> The city has higher rents and other costs, but clearly the high income tax rate serves as a depressant on the local economy. In addition, since a nonresident must pay a higher tax by being employed in New York City than in their home state, there is another significant disincentive to economic growth.<sup>198</sup> The skilled employee who is a resident of a nearby state would require more wages or earning in order to seek employment in New York. These barriers to entering the market create larger costs for local businesses, making the location less competitive than other locations.<sup>199</sup> If the state takes further steps to discriminate against

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192. *See id.*

193. *See* Solomon, *infra* note 260, at 121-25.

194. *See, e.g.*, DEL CODE ANN. tit. 30, § 1126 (1997); HAW. REV.STAT. § 235-5 (c) (1993); OKLA.STAT.ANN. tit. 236(4) (West 1992).

195. *See* ALAN REYNOLDS, INTERNATIONAL COMPARISIOINS OF TAXES & GOVERNMENT SPENDING, IN RATING ECONOMIC FREEDOM 336 (Stephen T. Easton & Michael Walker eds., 1992).

196. *See* Peter Passell, *Risk and Rewards in a Revived New York*, N.Y. TIMES, October 19, 1997, § 3, at 1.

197. *See id.*

198. The income tax rates in New Jersey and Connecticut are less than those in New York. *See* Steven Prokesch, *New York Sets Rules to Curb Auditors' Zeal*, N.Y. TIMES, Mar. 1, 1993, at B1. In addition, New York City imposes a commuters' tax on nonresident employees. *See* NEW YORK CITY CHARTER §1127.

199. The marginal cost for hiring an employee in New York is higher than for hiring the same employee in New Jersey or Connecticut, because the employee will require more in the form of compensation in order to be induced to work in New York. Because the tax burden will be higher on the earnings of a worker in New York, the worker would choose to work in the other states if the salaries were equal. Only by paying a higher salary can the employer in New

nonresidents, greater dislocations could be expected. Although it is difficult to pinpoint higher taxation as a cause of greater unemployment, it certainly seems to be a significant factor in increasing wage costs.

When a state takes further actions to discriminatorily tax nonresidents, it can be expected that some nonresidents will choose not to do business in the state, or not to seek employment in that state. There are many reasons why people choose not to seek employment in a state where they are not a resident, such as higher commuting costs, longer commuting time, or other possible reasons. However, the fear of being treated badly under a discriminatory tax scheme should not be a consideration. If the state discriminates in one area, and the courts of that state allow such discrimination, there is no barrier to unfair treatment in other areas. These types of artificial barriers to interstate employment serve no useful purpose.

## V. CASE HISTORY OF NONRESIDENT TAXATION

### A. *Travis v. Yale & Towne Manufacturing Co.*<sup>200</sup>

The U.S. Supreme Court heard the arguments in *Travis* in 1919, a mere six years after the passage of a federal income tax.<sup>201</sup> The decision was issued in 1920.<sup>202</sup> The timing is important because policy regarding income taxation was a very new concept in the United States. Until the Thirteenth Amendment allowed an income tax in 1913, the country relied on other sources of revenue. To place the case in its proper historic context, it is important to understand the lack of history available to the courts. Eighty years later, we have a greater amount of policy behind and history in using and abusing income taxes. The economy of the United States is far more fluid, far more interstate and far more global. The concerns and understandings of 1919 were vastly different from the present. It is questionable what we can glean from this ancient opinion. But, it is the starting point for an analysis of the maltreatment of nonresidents by a taxing state. It is interesting to note that the issue, lost by New York State in

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York lure the nonresident worker into New York. This has two effects; (1) the costs of doing business are higher in New York, meaning that fewer employees will be hired, and (2) the incentives are for businesses to locate themselves outside of New York, thereby causing jobs to be located outside of the city and state.

200. 252 U.S. 60 (1920).

201. See Income Tax Act of 1913, ch. 16 § 11, 38 Stat. 166, 169 (1913).

202. See *Travis*, 252 U.S. at 60.

*Travis*,<sup>203</sup> was once more before the Supreme Court in *Lunding v. New York Tax Appeals Tribunal*.<sup>204</sup>

To place *Travis* in proper historical perspective, the state of the income tax at the time is very relevant. The deductions from income tax that were present at that time were simply those deductions which were viewed as related to generating income. The state of policy thinking was all related to items which generated income, not personal items. Personal deductions did not arise in the federal tax law until many years later.<sup>205</sup> The deductions in effect at the time of *Travis* were the deductions for necessary business expenses, certain taxes, bad debts, depreciation, depletion, interest and net operating losses.<sup>206</sup> There was a provision which specifically denied any deduction for personal expenditures.<sup>207</sup> What we now view as personal deductions, real estate taxes and interest deductions were viewed then from the perspective of items related to generating income, or from a broad view of the fact that all taxes paid should be deductible. Thus, when reading and applying the holding in *Travis*, one must concentrate on the fact that the types of personal deductions to which some courts are now applying *Travis* did not exist at the time, and there were no policy thoughts or discussions of those deductions for many years after *Travis*.<sup>208</sup> To argue that the *Travis* court meant anything with respect to personal deductions can only be classified as disingenuous.

The facts in *Travis* are quite simple, and strikingly similar to the facts in *Lunding v. New York Tax Appeals Tribunal*.<sup>209</sup> New York State enacted an income tax on residents of the state and upon the income of nonresidents earned within New York.<sup>210</sup> The tax rates were the same for both residents and nonresidents. However, residents were granted an exemption of \$1000 per taxpayer, \$2000 for a married taxpayer, and \$200 for each additional dependent.<sup>211</sup> No such exemptions were provided for nonresidents.<sup>212</sup> Since

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203. See *id.* at 82.

204. 522 U.S. 287 (1988).

205. See Revenue Act of 1917, ch. 159, § 1201 (2), 39 Stat. 1000 (1917) (including a deduction for charitable contributions).

206. See Tariff of 1913, ch. 38, Stat. 114 (1913); Revenue Act of 1916, ch. 463, 39 Stat. 756 (1916); Revenue Act of 1917, ch. 159, 39 Stat. 1000 (1917); Revenue Act of 1918, ch. 18, § 214, 40 Stat. 1057 (1919).

207. See Revenue Act of 1918, ch. 18, 40 Stat. at 1057, 1069, 1080.

208. See *Travis*, 252 U.S. at 79-82.

209. 675 N.E.2d 816 (N.Y. 1996), *rev'd*, 522 U.S. 287 (1998).

210. See *Travis*, 252 U.S. at 72-74.

211. See *id.* at 74. The term "dependent" includes persons under the age of 18 years and persons with mental or physical defects. See *id.*

212. See *id.* at 79.



incomes were relatively low at the time, the result was that nonresident incomes were taxed at a higher rate than resident incomes.<sup>213</sup> In many instances, where a nonresident was employed full time in New York, he was taxed on his entire income. When compared to the New York resident with whom the nonresident worked, the nonresident was paying more tax to New York, and using fewer of New York's services. In effect this was a facially discriminatory taxation of nonresidents.

The Supreme Court, in applying the Privileges and Immunities Clause of the U.S. Constitution to the discrimination against nonresidents, looked at the history of that clause. Citing two previous decisions which applied the clause, they invoked the clause in this case.<sup>214</sup> It is very clear that from the earliest times of the Constitution and in a continuing manner, the federal courts have provided protection to nonresidents from unfair taxation by other states.<sup>215</sup>

In *Travis*, the U.S. Supreme Court could not find any adequate ground for the discrimination practiced by New York against nonresident taxpayers.<sup>216</sup> The Court held that the failure to grant similar exemptions to nonresident taxpayers:

213. See *Travis*, 252 U.S. at 72.

214. See *Travis*, 252 U.S. at 73.

It was undoubtedly the object of the clause in question to place the citizens of each state upon the same footing with citizens of other States, so far as the advantages resulting from citizenship are . . . concerned. It relieves them from the disabilities of alienage in other States; it inhibits discriminating legislation against them by other States, it gives them the right of free ingress into other States, and egress from them; it insures to them in other States the same freedom possessed by the citizens of those States in the acquisition and enjoyment of property and in the pursuit of happiness; and it secures to them in other States the equal protection of their laws. It has been justly said that no other provision of the Constitution has tended so strongly to constitute the citizens of the United States one people as this.

*Id.* at 73-74 (quoting *Paul v. Virginia*, 75 U.S. 168, 180 (1868)).

Beyond doubt those words [privileges and immunities] are words of very comprehensive meaning, but it will be sufficient to say that the clause plainly and unmistakably secures and protects the right of a citizen of one state to pass into any other State of the Union for the purpose of engaging in lawful commerce, trade, or business without molestation; to acquire personal property; to take and hold real estate; to maintain actions in the courts of the State; and to be exempt from any higher taxes or excises than are imposed by the State upon its own citizens.

*Id.* at 80 (quoting *Ward v. Maryland*, 79 U.S. 418, 430 (1870)).

215. See *Ward v. Maryland*, 79 U.S. 418 (1870).

216. *Id.* at 79-82.

is an unwarranted denial to the citizens of Connecticut and New Jersey of the privileges and immunities enjoyed by citizens of New York. This is not a case of occasional or accidental inequality due to circumstances persons to the taxpayer, but a general rule operating to the disadvantage of all non-residents including those who are citizens of the neighboring states, and favoring all residents including those who are citizens of the taxing State.<sup>217</sup>

The *Travis* decision should not be expanded beyond what it holds: that a state has the power to tax nonresidents, and such taxation should not be applied in a discriminatory manner.<sup>218</sup> The income tax and its history at that time were quite simple. Too often, courts have unreasonably enlarged the meaning of *Travis*. In its simplest terms, it denies discriminatory taxation of nonresidents by another state.

### B. *Austin v. New Hampshire*

The U.S. Supreme Court heard another nonresident taxation case in 1975. In *Austin v. New Hampshire*,<sup>219</sup> the State imposed a commuters tax on nonresidents who derived income in New Hampshire.<sup>220</sup> The tax was at the rate of 4% on income above \$2000.<sup>221</sup> The tax was challenged by a resident of Maine who was employed in New Hampshire.<sup>222</sup> The Supreme Court struck down the tax on the basis of the Privileges and Immunities Clause of Article IV of the Constitution.<sup>223</sup> In applying the Privileges and Immunities Clause to the taxing scheme, the Court pointed out that they had consistently applied more stringent standards to nonresident taxation by any state because, "nonresidents are not represented in the taxing state's legislative halls."<sup>224</sup> The Court summarized their history in dealing with nonresident taxation as "establishing a rule of substantial equality of [the] treatment of the citizens of the taxing State and nonresident taxpayers."<sup>225</sup> In *Travis*, the tax on residents was much less than the 4% imposed on nonresidents, in many instances as low as \$10.<sup>226</sup> *Austin* clearly shows that discrimination in taxation by one

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217. *Id.* at 80-81 (citations omitted).

218. *See Travis*, 252 U.S. at 60.

219. 420 U.S. 656 (1975).

220. *See Austin*, 420 U.S. at 657.

221. *See id.* at 658.

222. *See id.* at 657.

223. *See id.*

224. *Id.* at 662.

225. *Austin*, 420 U.S. at 665.

226. *See id.* at 658. An interesting comment in Justice Blackmun's dissent in the *Austin* case shows the lack of urgency many judges place upon discrimination in taxation. He says, "I would dismiss the appeal for want of a substantial federal question. We have far more urgent

state against the residents of another, is not to be allowed under the Privileges and Immunities Clause.

### C. *Lunding v. New York Tax Appeals Tribunal*

#### 1. *The Facts*

In December 1996, the New York Court of Appeals heard a case involving an allegedly discriminatory tax statute which was applied to the detriment of a Connecticut resident.<sup>227</sup> The case involved Christopher Lunding, an attorney with a substantial income from his practice of law in New York City.<sup>228</sup> He had claimed a deduction from his New York income for alimony which he had paid to his former wife, a resident of Connecticut.<sup>229</sup> New York allowed residents to deduct payments of alimony to ex-spouses, but it did not allow nonresidents to deduct such payments to ex-spouses regardless of where the spouse resides.<sup>230</sup> The general taxing scheme of New York as it applies to residents of New York and nonresidents, is to follow the federal tax system.<sup>231</sup> New York, however, has taken the position that one of its "adjustments to income," alimony, is not allowable as a deduction to nonresidents.<sup>232</sup> The concept of a deduction for alimony is a federal concept which derives from § 215 of the Internal Revenue Code of 1986 ("IRC"). Federal Adjusted Gross Income is determined by taking gross income and deducting certain amounts described in §62 of the IRC. These amounts include alimony paid to an ex-spouse.<sup>233</sup> New York begins its taxing scheme by accepting all of the IRC §62 deductions in determining Adjusted Gross Income. At some point, the New York Department of Taxation began to challenge the ability of nonresident taxpayers to deduct alimony from their

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demands upon our limited time than this kind of litigation." *Id.* at 668 (Blackmun, J., dissenting). Unfortunately this type of lack of interest in discriminatory taxes has emboldened the states to go even further in plucking from their non-constituents.

227. See *Lunding v. New York Tax Appeals Tribunal*, 675 N.E.2d 816 (N.Y. 1996), *rev'd*, 522 U.S. 287 (1998).

228. See *Lunding*, 657 N.E.2d at 817-18.

229. See *id.* at 818.

230. See N.Y. TAX LAW § 631(b)(6) (McKinney 1987).

231. The federal and New York tax are applied on a computation of "Taxable Income." Taxable Income is defined as follows: Gross Income minus (-) Adjustments to Income equals (=) Adjusted Gross Income. Adjusted Gross Income minus (-) Itemized or Standard Deductions (-) personal exemptions equals (=) Taxable Income. I.R.C. § 63 (1994).

232. See N.Y. TAX LAW § 631(b)(6) (McKinney 1987). This position, while initially merely an administrative decision of the Department of Taxation was enacted in 1987. See *id.*

233. See I.R.C. § 62(a)(10)(1994).

New York Adjusted Gross Income computation. It is important to note that the tax rates applied to taxable income by New York are identical whether the taxpayer is a resident or nonresident.<sup>234</sup>

In order to completely understand the manner in which the New York Department of Taxation, the state legislature and the courts in New York have acted on this issue, a history of the issue is important to consider. The history shows that the aggressive discriminatory taxation of nonresidents was substantially driven by the New York Department of Taxation and approved by a court which issued a flawed decision on the matter.<sup>235</sup> A decision which differs from the ruling of the courts of other states.<sup>236</sup>

## 2. *Goodwin v. Tax Commission*

In *Goodwin v. Tax Commission*,<sup>237</sup> the Appellate Division of the Supreme Court of New York considered whether a nonresident of New York could deduct his mortgage interest expense from his New York taxable income.<sup>238</sup> Mortgage interest is a personal item of deduction allowed by the federal government.<sup>239</sup> Since the New York Court of Appeals in *Lunding*<sup>240</sup> relies so heavily upon the holding in *Goodwin*, it is relevant to closely analyze that decision and the resulting reactions of the affected states. Goodwin, a New Jersey resident, earned all of his income in New York.<sup>241</sup> New York had a statute which allowed certain personal expenses of residents to be deducted from their taxable income, but denied the deduction to nonresidents.<sup>242</sup> In fact, this was the exact statute at issue in the *Travis* case in 1919.<sup>243</sup> It had been amended to conform with *Travis v. Yale & Towne Manufacturing Co.*,<sup>244</sup>

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234. See N.Y. TAX LAW § 601(e) (McKinney 1987).

235. See *Lunding*, 675 N.E.2d 816 (N.Y. 1996).

236. See *Wood v. Department of Revenue*, 749 P.2d 1169 (Or. 1988).

237. 146 N.Y.S.2d 172 (App. Div. 1955).

238. See *Goodwin*, 146 N.Y.S.2d at 172.

239. See I.R.C. §163 (1994).

240. See *Lunding*, 675 N.E.2d at 816.

241. See *Goodwin*, 146 N.Y.S.2d at 174.

242. See *id.*

In the case of a taxpayer other than a resident of [this] state the deductions allowed in this section [home mortgage interest, medical expenses in excess of 5% of net income, real estate taxes on a home, and \$150 of life insurance premiums] shall be allowed only if, and to the extent that, they are connected with income arising from sources within the state; and taxable under this article to a nonresident taxpayer.

N.Y. TAX LAW § 360 (McKinney 1919)(repealed in 1987).

243. See *Travis*, 252 U.S. at 73.

244. 252 U.S. 60 (1920).

but the remaining language was the same.<sup>245</sup> The court, relying on the language of *Travis*, limited deductions to those "connected with income arising from sources within the state."<sup>246</sup> However, this must be considered in the context of when *Travis* was decided.<sup>247</sup> At that time, the federal income tax did not allow any deductions for personal expenditures.<sup>248</sup> This concept did not develop until twenty-three years later.<sup>249</sup> In addition, the other adjacent states, New Jersey and Connecticut did not have income taxes in 1919, so there was no threat of retaliation from other states.<sup>250</sup> In fact, the federal income tax was only six years old.<sup>251</sup> The *Travis* court discussed deductions for personal expenses in a very different atmosphere.<sup>252</sup> Thus, it is impossible to conclude that the *Travis* court meant anything about this situation. The *Goodwin* court recognized that, given the changed circumstances, the *Travis* case may have been decided differently in modern (1955) context.<sup>253</sup> In *Goodwin*, the statute was held to be constitutional, using a reading of *Travis*.<sup>254</sup> It must be emphasized that *Goodwin* adheres to the narrow view of Privileges and Immunities espoused by Brainerd Currie.<sup>255</sup>

The *Goodwin* case brought about an immediate outcry and response.<sup>256</sup> As a direct result, Governor Averill Harriman, along with the governors of Connecticut and New Jersey, appointed representatives to recommend and report on the issues of nonresident taxation.<sup>257</sup> Governor Harriman appointed Theodore Tannenwald, who later became the Chief Judge of the U.S. Tax Court.<sup>258</sup> Governor Robert Meyner of New Jersey appointed William C.

245. See *Goodwin*, 146 N.Y.S.2d at 175.

246. *Id.* at 176 (quoting *Travis*, 252 U.S. at 73).

247. See *Travis*, 252 U.S. at 60. *Travis* was argued in 1919 and decided in 1920.

248. See GODFREY N. NELSON, *INCOME TAX LAW ACCOUNTING* (Macmillan & Co. 1918).

249. See Revenue Act of 1942.

250. New Jersey enacted an income tax in 1961, Connecticut enacted an income tax in 1992.

251. The Initial Income Tax was enacted on October 3, 1913. (38 Stat. 166, chap. 16).

252. The concept of deductions was not prevalent, and the nearby states had no income taxes.

253. See *Goodwin*, 146 N.Y.S.2d at 181-82.

254. See *id.* at 180-82.

255. At the time of *Goodwin*, Currie's ideas were well accepted, and courts believed that neighboring states were free game. That thinking has been significantly challenged in recent cases. See *Lunding v. New York Tax Appeals Tribunal*, 522 U.S. 287 (1998).

256. See Michael Solomon, *Nonresident Personal Income Tax: A Comparative Study in Eight States*, 29 FORDHAM L.REV. 105 (1960-61).

257. See *Nonresidents Get New Hope on Tax*, N.Y. TIMES, Feb. 11, 1959, at 1.

258. See generally, Solomon, *supra* note 260 (discussing and analyzing the history of nonresident taxation).

Warren, Dean of Columbia Law School, and Governor Abraham Ribicoff of Connecticut appointed Roswell Magill to the panel.<sup>259</sup> In 1959, newly elected Governor of New York, Nelson Rockefeller, began a major study of the nonresident tax issue.<sup>260</sup> A report was issued in 1959.<sup>261</sup> The report recommended that nonresidents be allowed the same nonbusiness deductions as residents, "but that such deductions be allowed to nonresidents in proportion to their New York income to income from all sources."<sup>262</sup> Comments were received, and in response to the general feeling that New York imposed a tax on nonresidents which was grossly disparate from the services provided by New York to the nonresidents, Governor Rockefeller issued legislative recommendations.<sup>263</sup> A bill was introduced into the legislature, but was not passed during the 1960 legislative session.<sup>264</sup> Due to the bill's failure, there was talk of retaliatory legislation in both Trenton and Hartford.<sup>265</sup> New Jersey, under the direction of Governor Meyner, began to enact retaliatory legislation.<sup>266</sup> In this atmosphere of threatened retaliation, New York enacted what has become Tax Law § 635, providing the proportional deduction of itemized deductions by nonresidents.<sup>267</sup> In fact, most states allow the proportioning of deductions for personal expenses.<sup>268</sup> Some states only allow such proportionate treatment if the nonresident's state

259. See *Nonresidents Get New Hope on Tax*, *supra* note 261, at 1.

260. See *id.*; see also Douglas Dales, *Talks to Ease Tax on Nonresidents Open with Jersey*, N.Y. TIMES, Aug. 1, 1959, at 1.

261. See, NONRESIDENT TAX STUDY COMM., REPORT ON TAXATION OF NONRESIDENTS BY NEW YORK STATE (1959).

262. *Id.* at 48.

263. See Warren Weaver Jr., *Governor Yields to Nonresidents on Tax Reduction*, N.Y. TIMES, Jan. 27, 1960, at 1.

264. See N.Y. Assembly No. 3829 (1960); see also N.Y. Senate No. 3158 (1960).

265. See George Cable Wright, *2 States Weigh Nonresident Tax*, N.Y. TIMES, Apr. 28, 1960, at 37.

266. See N.J. Assembly No. 65 (1960).

267. See N.Y. LEGIS. SERV., INC., 1961 NEW YORK LEGISLATIVE ANNUAL 398 (1961).

Governor Rockefeller, in approving the new Bill added the following comments:

In December 1959 the first major study since 1919 of problems surrounding nonresident taxation was completed by Commissioner Joseph H. Murphy and his special consultant, Albert C. Petite. This survey furnished the basis for subsequent discussions held by me and the Legislative Leaders with the Governors of Connecticut and New Jersey. This bill, reflecting the survey and subsequent discussions, represents the fairest and most equitable solution to this problem of many years' standing.

*Id.* Tax Law § 635 still provides for this proportioning of itemized income tax deductions by nonresidents of New York. See N.Y. TAX LAW § 635 (McKinney 1988).

268. See DEL. CODE ANN. tit. 30, § 1126(1993); HAW. REV. STAT. § 235-5(c)(1997); OKLA. STAT. ANN. tit. 68, § 2362(4) (West 1992).

allows the same to its residents.<sup>269</sup> The important point of this history and the existence of the proportionate allowance statutes is that a problem was raised, states became overly aggressive, and a solution was found in negotiations between the states.<sup>270</sup> That solution has been in effect for over 35 years, and has worked well. It should not be overturned by one aggressive state. That would begin the path away from rational reason.<sup>271</sup> If state governments act in a rational manner in approaching and resolving a problem involving economic matters between citizens of the state, it should not be in the province of a court of one of the states to upend that resolution.<sup>272</sup> This "treaty" resolution is exactly the type of impetus which the Privileges and Immunities Clause should generate.<sup>273</sup>

Acts of the New York legislature, in enacting the change in treatment of alimony, and the New York Court of Appeals in *Lunding*, appeared to be the attempt to change what had been accomplished in a reasoned governmental response to both *Goodwin* and the possibility of retribution by neighboring states.<sup>274</sup> To conclude that *Goodwin* is a decision to be followed ignores the entire history of the responses to the initial case and the reactions to it. *Goodwin* does not exist in a common law vacuum. The governors and legislatures and their representatives discussed and enacted a response to that case.<sup>275</sup> The aggressive response of the New York Department of Taxation to the change in the federal treatment of the alimony deduction now threatens to undo the whole process.<sup>276</sup> If the Department of Taxation is given a further imprimatur for taxing personal expense of nonresidents, it can reasonably be expected to do so.<sup>277</sup> There is no reason to go back to the retaliatory framework which existed after *Goodwin*. The Court of Appeals decision in *Lunding*, relying in part on the *Goodwin* holding, ignores the entire rational response.<sup>278</sup>

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269. See, e.g., MONT. CODE ANN. § 15-30-131 (1979).

270. See Solomon, *supra* note 260.

271. See *id.* What occurs when one state takes an aggressive stand toward nonresidents in often a war of new taxes. See Abby Goodnough, *Judge Upholds and Extends Commuter Tax Repeal*, N.Y. TIMES, June 26, 1999, at A1. See *Igoe v. Pataki*, 696 N.Y.S.2d 355 (1999).

272. See discussion in Sec. III(b)i.

273. See *id.*

274. See *supra* text accompanying notes 253-58.

275. See Solomon, *supra* note 260.

276. See *Lunding*, 675 N.E.2d at 818.

277. The aggressive history of the New York Department of Taxation indicates that the Department is always trying to enlarge the definition of taxable income of nonresidents. They did so before the *Goodwin* decision, and again before the *Lunding* cases.

278. See *Lunding*, 675 N.E.2d at 816.

### 3. *The Alimony Issue in Lunding*

Prior to 1976, alimony had been a deduction which was an itemized deduction for federal income tax purposes, and an itemized deduction for New York taxable income purposes.<sup>279</sup> In the Tax Reform Act of 1976,<sup>280</sup> Congress changed the alimony deduction to a I.R.C. § 62 deduction.<sup>281</sup> The change was enacted by Congress to provide a more liberal treatment of the deduction of alimony. By this Act, the alimony deduction was changed from an "itemized deduction" to a "deduction" of income in determining adjusted gross income, so that alimony payment would benefit taxpayers who take the standard deduction, as well as those who itemized their deductions.<sup>282</sup> This liberalized federal policy automatically inured to the benefit of New York residents on their New York tax returns because the starting point for a resident is the federal adjusted gross income which affords him the benefit of an alimony payment offset whether reported as an "itemized deduction" or as a "deduction" from adjusted gross income. There was no state legislative response to this liberalized federal policy and the legislature gave no indication that either New York's historical policy of following federal tax policy, or its long-standing treatment of alimony vis-a-vis nonresidents was to be changed in any respect.<sup>283</sup> The deduction would benefit some taxpayers who did not have other itemized deductions, and thus were not receiving full benefit from their alimony deduction.<sup>284</sup>

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279. The personal income tax of New York, effective on April 18, 1960 provided "that the adoption by this state for its personal income tax purposes of the provisions of the laws of the United States relating to the determination of income for federal income tax purpose will (1) simplify preparation of state income tax returns by taxpayers, (2) improve enforcement of the state income tax through better use of information obtained from federal income tax audits, and (3) aid interpretation of the state tax law through increased use of federal judicial and administrative determinations and precedents. *See* N.Y. TAX LAW § 615 (McKinney 1988). Section 615 includes alimony as an itemized deduction in New York, by reference to federal law. *See id.*

280. *See* Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976).

281. The purpose of this change was to extend the benefit of the deduction to taxpayers who took a standard deduction as well as those who itemized deductions. In effect, it was a liberalization meant to benefit taxpayers. *See* I.R.C. § 62(10) (1994).

282. *See* I.R.C. § 62(10) (1994). *See* Tax Reform Act of 1976, § 502, 90 Stat. 1520, 1531 (1975).

283. *See supra* text accompanying notes 219-27.

284. Itemized deductions are only beneficial when the total itemized deductions of a taxpayer exceeds the taxpayer's standard deduction. If the standard deduction is \$3000, then a taxpayer who paid \$3000 of alimony would not benefit from the payment. By making the deduction a reduction in adjusted gross income, there is a greater tax incentive to make the payments. The statutory change was made to benefit the taxpayer who did not have significant



Although the New York Legislature did not react to this federal change, the New York Department of Taxation, based upon their analysis of the sources of such a deduction, made an administrative determination that the deduction of alimony from New York source income would not be allowed to nonresident taxpayers.<sup>285</sup> This aggressive step, aimed at taxpayers who had been given a benefit by the U.S. Congress, was the first step in a long battle.<sup>286</sup> It is a good illustration of the lengths to which an aggressive taxing state will go to act punitively towards nonresident taxpayers.<sup>287</sup>

#### 4. *Friedsam v. State Tax Commission*

The interpretation by the Department of Taxation was challenged by a taxpayer in *Friedsam v. State Tax Commission*.<sup>288</sup> The Appellate Division of the New York Supreme Court, Third Department, which hears all appeals from the New York Tax Court, held that the New York Department of Taxation, in denying the deduction for alimony to nonresident taxpayers, violated the Privileges and Immunities Clause of the U.S. Constitution and they laced the authority to impose such a denial.<sup>289</sup> The court specifically found that "no substantial reason for the disparate treatment between residents and nonresidents exists."<sup>290</sup> This holding was generated by the absolute lack of a policy behind the New York position.<sup>291</sup> New York has never stated any policy

other itemized deductions. There was no other stated purpose behind the change. *See* Tax Reform Act § 502.

285. In addition to New York, four states limit the deduction of alimony to residents of their state: Alabama, California, West Virginia, and Wisconsin. *See* ALA. CODE § 40-18-15 (18) (1993); CAL. REV. & TAX. CODE § 17302 (West 1994); W. VA. CODE § 11-21-32(b)(4) (1995); WIS. STAT. § 71.05(6)(a)(12) (1989); *see also* ILL. COMP. STAT. ANN. chap.35 § 5-301(c)(2)(A) (West 1996); OHIO REV. CODE ANN. § 5747.20(B)(6)(Anderson 1994).

286. *See* IRC § 63. If a taxpayer was utilizing the standard deduction, because she had too few itemized deductions, the ability to treat alimony as an itemized deduction meant that no benefit would be received from the availability of the itemized deduction of alimony.

287. The California and New York Department of Taxation have consistently been described as the two most aggressive state tax authorities in the United States. *See* Prokesch, *supra* note 202, at B1; *see also* H.J. Cummins, *Cleaning Up: New York Is One of the Country's Two Most Aggressive Tax-collecting States*, NEWSDAY, Mar. 22, 1993, at 25. Describing how in December 1992 the New York Department of Taxation probably undertook the most notorious aggressive state action. During the Christmas buying season, the Department sent agents to New Jersey shopping malls, who recorded New York License plates and then notified their owners that they were subject to paying the higher New York sales taxes. *See id.*

288. 470 N.Y.S.2d 848 (App. Div. 1983), *aff'd on other grounds*, 473 N.E.2d 1181 (N.Y. 1984).

289. *See Friedsam*, 470 N.Y.S.2d at 848.

290. *Id.* at 850.

291. The legislative history of the enactment of N.Y. TAX LAW § 631(b)(6) is absolutely

supporting their position.<sup>292</sup> The dissent in *Friedsam*, suggested some policies which may exist.<sup>293</sup> This Appellate Division held that the Commission's determination supporting a disparate tax classification between resident and nonresident taxpayers is contrary to statute and tax policy of this state.<sup>294</sup>

Petitioner sought an alimony "deduction" proportional to the ratio of his New York income derived from all sources.<sup>295</sup> The amount by which petitioner reduced adjusted gross income for his alimony payment was commensurate with the income derived from New York sources, and was consistent with the reduction allowed to residents under similar circumstances.<sup>296</sup> The Appellate Division held: "in disallowing petitioner's alimony deduction the Tax Commission improperly applied section 632(a)(1) of the Tax Law."<sup>297</sup> New York Tax Law § 635 provides that nonresidents are to be allowed the same nonbusiness deductions as residents, but such deductions are to be allowed in proportion to the taxpayer's New York income to income from all sources.<sup>298</sup> The court believed that the passage of § 635 (c)(1) reflected a policy decision.<sup>299</sup> This case was appealed to the New York Court of Appeals by the Department of Taxation.<sup>300</sup>

In *Friedsam*, the New York Court of Appeals faced two issues. First, was the denial of the alimony deduction to a nonresident a constitutional application of the tax law?<sup>301</sup> And second, was the denial of the deduction within the scope of the administrative power of the Department of Taxation?<sup>302</sup> The New York Court of Appeals, refused to decide the issues.<sup>303</sup> They simply

silent.

292. *See id.*

293. *See id.* at 852 (Levine, J., dissenting). Justice Levine believed that no deduction need be allowed to a nonresident for activities "intimately connected with the State [not] of his residence." *Id.*

294. *See id.*

295. *See id.*

296. *See id.*

297. *Friedsam*, 473 N.E.2d at 1184.

298. N.Y. TAX LAW § 635.

299. *See* Joseph Hawley Murphy & Albert C. Petite, *Taxation of Nonresidents by New York State*, 12 SYRACUSE L. REV. 147, 161-2 (1960-61); *see also*, N. Y. LEGIS. SERV., INC., 1961 NEW YORK LEGISLATIVE ANNUAL 398 (1961).

300. *See Friedsam*, 473 N.E.2d at 1181.

301. *See id.* at 1182.

302. *See id.*

303. This refusal, based upon the fact that the case could be decided upon the lack of administrative authority, ultimately led to nine years of trouble for taxpayers, extended litigation in the courts and costs to both. The issue, should have been faced then. When dealing with an aggressive state agency, the court should look to grant guidance when it has a chance. To take the position that the issues do not need not be decided may be important for the U.S.

ruled that the Department of Taxation did not have the authority to deny the deduction.<sup>304</sup> Specifically, the court analyzed the section of New York Tax Law which guarantees equal tax treatment to both residents and nonresidents.<sup>305</sup> Alimony had traditionally been deemed an itemized deduction on federal income tax returns. The Court of Appeals affirmed the decision of the Appellate Division on statutory, not constitutional, grounds.<sup>306</sup>

After the decision in *Friedsam*, the legislature enacted the Tax Reform and Reduction Act of 1987<sup>307</sup> which added tax law § 631 (b)(6) to address the

Supreme Court, but in reality, a court which is the highest in a state should look to make their views known. In this case, the matter could have been dealt with in a far less costly manner. Thousands of taxpayers have been denied their rights to the deduction because of the position of the Department of Taxation. Very few will be aware of any change brought about and fewer still will be able to bring a refund action. The statute of limitations has long ago expired for most of these taxpayers. Only lawyers can afford to challenge this action. Others are denied the right because of the costs involved. This clearly shows another reason why states should not be allowed to treat nonresident taxpayers as fair game. See *supra* text accompanying note 48.

304. See *Friedsam*, 473 N.E.2d at 1184.

305. See N.Y. TAX LAW § 635(c)(1) (McKinney 1988). This section provides that nonresident taxpayers be allowed the same non-business deductions as residents, but that such deductions be allowed to nonresidents in proportion to their New York income to income from all sources. See *Murphy and Petite, supra* note 303, at 162. Section 632 of the New York Tax Law defines New York adjusted gross income for nonresidents as follows:

(a) General. The New York [adjusted gross] income of a nonresident individual shall be the sum of the net amount of items of income, gain, loss and deduction entering into his federal adjusted gross income, as defined in the laws of the United States for the taxable year, derived from or connected with New York sources . . .

...

(b) Income and deductions from New York sources. -

(1) Items of income, gain, loss and deduction derived from or connected with New York sources shall be those items attributable to: . . .

...

(B) a business, trade, profession or occupation carried on in this state.

N.Y. TAX LAW § 631 (McKinney 1988). Section 635, which deals with deductions from adjusted gross income, provides that the New York itemized deduction of a nonresident shall be the same as for a resident individual under § 615, or the total amount of the following of his deductions from federal adjusted gross income. See N.Y. TAX LAW § 635(c) & (d) (McKinney 1988). Residents are permitted to deduct from their New York adjusted gross income the itemized deductions claimed on their Federal tax returns, which includes alimony, subject to various modifications not relevant here. N.Y. TAX LAW § 615 (McKinney 1988).

306. See *Friedsam*, 473 N.E.2d at 1181.

307. See N.Y. TAX LAW § 210 (McKinney 1987) This Act was passed as a response to the 1986 Tax Reform Act passed by Congress. Imbedded within this large Act was the change

Court of Appeals' concerns, and provide express statutory authority to deny the alimony deduction to nonresidents. This action by the legislature to grant the Department of Taxation the power that it had been denied by the courts, was a typical example of the dysfunctional New York State Legislature. It was accomplished quickly, with no open debate, and no legislative history. It clearly shows the possibility of legislative abuse when there is no constituency to complain. The Department of Taxation takes a matter to the legislature, and with almost no discussion, and since it only affects nonresidents, is virtually guaranteed approval.<sup>308</sup> Nonresidents who will be affected by the change have no opportunity to complain, nor are they protected by any representation. This matter was not even the subject of a public debate.

The New York system of taxation is a culmination of the most dangerous possibilities for nonresident taxpayers: an overly aggressive department of taxation, a legislature which is unlikely to give much consideration to more subtle issues of discriminatory taxation, and a court system which has clearly avowed its position that nonresidents will obtain no protection from the New York courts. The Department of Taxation was granted a free hand to tax nonresidents and can go forward unrestrained. The only available protection for these nonresident taxpayers is the application of constitutional protections by the federal courts.

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in treatment of alimony. This was the response of the Department of Taxation to its loss in the *Friedsam* case, and was accomplished with the least amount of discussion and greatest stealth possible. The change in § 631(b)(6) was included in the technical and conforming changes.

308. The lack of input by legislators, in general, and the total control of the New York legislative process by the Senate majority leader and House speaker has been well documented, and even the Governor has stated it as a given. The people who report on the New York legislature are virtually unanimous in their view that the legislature is dysfunctional. Since the possibility of a constitutional convention will not necessarily be available for at least the next twenty years, it is unlikely to change. See Elsa Brenner, *A New Constitution: Yes or No?*, N.Y. TIMES, Nov. 2, 1997, § 14 (Westchester Weekly), at 1; James Dao, *Pataki and D'Amato Back Constitutional Convention*, N.Y. TIMES, Oct. 8, 1997, at B5; *A Three Cornered Pork Barrel*, N.Y. TIMES, Sept. 24, 1997, at A26; *Albany Follies, For All The Help It Brings Long Island, The State Budget Is Still a Shameful Debacle*, NEWSDAY, Aug. 6, 1997, at A36; *Sorry Spectacle in Albany*, NEWSDAY, Aug. 5, 1997, at A8; *Albany Is A Sewer, Flush It Out Please*, NEWSDAY, Aug. 4, 1997, at A26; *209 Empty Suits, Legislators Should Reject Rubber-Stamp Role*, NEWSDAY, Aug. 3, 1997, at G1; *A Plan To Get Albany Unstuck And Ensure State Budgets On Time Year After Year*, THE BUFFALO NEWS, July 18, 1997, at 2C; *State Of Disarray, New York Is About To Set Records For Tardiness And Not Just For The Late Budget*, NEWSDAY, July 2, 1997, at A36; *Albany Budget Endgame*, N.Y. TIMES, July 1, 1997, at A20; *Is There No Limit?*, DAILY NEWS, June 30, 1997, at 26.

### 5. *The Lunding Decision in the Appellate Division*

The challenge to the legislative action came from a lawyer, Christopher Lunding. Lunding and his wife are Connecticut residents.<sup>309</sup> In 1990, Mr. Lunding, a partner in a New York City law firm, derived substantial income from his practice in New York.<sup>310</sup> On their joint New York nonresident tax return filed for the year 1990, they reported a federal adjusted gross income of \$788,210, which included an adjustment of \$108,000 for the full amount of alimony that Mr. Lunding paid that year to his former spouse, also a Connecticut resident.<sup>311</sup> On their return, petitioners adjusted their New York State gross income by 48% of the alimony payments—equaling \$51,934—which represented the percentage of Mr. Lunding's 1990 claimed New York business. Relying on Tax Law § 631 (b)(6), the Audit Division of the Department of Taxation and Finance denied the alimony deduction and recalculated petitioners' New York tax liability.<sup>312</sup> Lunding appealed the determination, alleging that § 631 (b)(6) violated the Privileges and Immunities Clause,<sup>313</sup> the Equal Protection Clause of the Fourteenth Amendment,<sup>314</sup> and the Commerce Clause.<sup>315</sup>

Under New York Tax procedure, an administrative hearing can be granted as an appeal from a determination.<sup>316</sup> In the instance of a constitutional challenge there is a procedure for a declaratory judgement.<sup>317</sup> Mr. Lunding was not aware of the labyrinth of New York tax procedure, and filed an appeal with the New York Tax Court.<sup>318</sup> This was an utterly useless proceeding, because the Tax Court judge does not have jurisdiction over constitutional issues.<sup>319</sup>

309. *See Lunding*, 675 N.E. 2d at 818.

310. *See id.*

311. *See id.*

312. *See* N.Y. TAX LAW § 631 (b)(6) is the statute which denies the deduction of alimony by nonresidents. *See* N.Y. TAX LAW § 631 (b)(6) (McKinney 1988).

313. U.S. CONST. art. IV, § 2, cl. 1.

314. U.S. CONST. amend. XIV, § 1.

315. U.S. CONST. art. I, § 8, cl. 3.

316. *See* N.Y. TAX LAW §§ 2006, 2008 (McKinney 1988).

317. *See* N.Y. C.P.L.R. 3001 (Consol. 1997).

318. *See Lunding*, 675 N.E.2d at 818.

319. It is easy to understand how a taxpayer, even an attorney, could misunderstand the appeals procedure. The New York Tax Law is a jumble. The procedural aspects make even a seasoned tax attorney confused. They differ significantly from federal tax procedure and are not well explained in many places, certainly not by the publications of the New York State Tax Department. This certainly adds to expense and the unlikely possibility of any appeals being taken. The jurisdiction of the courts is limited to very narrow instances in which the tax court has made clear errors and where there are constitutional issues. *See* David Schumde, New

The Administrative Law Judge sustained the disallowance, holding that the Tax Appeals Tribunal lacked authority to declare the statute unconstitutional. In their exception, petitioners conceded that the Tribunal's jurisdiction did not encompass their constitutional challenge but asserted that principles of collateral estoppel and *stare decisis* applied, relying on the Third Department's ruling in [*Friedsam*]. The Tribunal affirmed the decision of the A[dministrative] L[aw] J[udge], agreeing that *Friedsam* was not dispositive.<sup>320</sup>

This was based upon the fact that the legislature had changed the statute after the *Friedsam* case was decided, but before the years involved in *Lunding*.<sup>321</sup>

Thereafter, [*Lunding*] commenced an article 78 proceeding.<sup>322</sup> The Appellate Division converted the constitutional challenge into a declaratory judgement action and retained [the case] as an article 78 proceeding . . . . While recognizing both that this Court had affirmed *Friedsam* solely on statutory grounds and that the statutory provisions in the two cases are different, the Appellate Division declared the statute violative of the Privileges and Immunities Clause.<sup>323</sup>

The Commissioner of Taxation appealed as of right.<sup>324</sup> The Appellate Division upheld their previous constitutional analysis, that the application of the statute to the taxpayers was unconstitutional.<sup>325</sup> "Addressing the challenge to Tax Law § 631 (b)(6) as being violative of the Privileges and Immunities Clause because only nonresident taxpayers are denied the alimony deduction," the Appellate Division followed their decision in *Friedsam*.<sup>326</sup> *Friedsam* "addressed whether Tax Law former § 632 violated the same constitutional provision by denying the nonresident petitioner, employed in New York and living in Connecticut the income tax adjustment for alimony paid to his nonresident ex-spouse."<sup>327</sup> The court had held that "although a disparity in treatment is permitted if valid reasons exist, the Privileges and Immunities Clause proscribes such conduct as discriminatory against nonresidents 'where there is no substantial reason for the discrimination beyond the mere fact that they are citizens of other States.'"<sup>328</sup> The court rejected the stated reason that

York Practice and Procedure, chap. 38.

320. *Lunding*, 675 N.E.2d at 818.

321. *See id.*

322. An Article 78 proceeding is the method by which a taxpayer can challenge a determination of the Tax Department in the state courts. They must bring a case in the Appellate Division, Third Department, in Albany, New York. *See* N.Y. TAX LAW § 2016 (McKinney 1988).

323. *Lunding*, 675 N.E.2d at 818.

324. *See id.* (citing N.Y. C.P.L.R. 5601(b)(1) (Consol. 1997)).

325. *See Lunding*, 639 N.Y.S.2d at 521.

326. *Id.* at 520.

327. *Id.*

328. *Id.* (quoting *Golden v. Tully*, 452 N.Y.S.2d 748, *aff'd*, 449 N.E.2d 406 (N.Y.

“alimony payments are purely personal in nature and not related to income producing activities in New York to justify the disparate treatment, [and] found that the petitioner had been unconstitutionally denied the alimony deduction.”<sup>329</sup>

When confronted with the change in the tax law, the appellate division, in considering *Lunding*, found that “the addition of Tax Law § 631 (b)(6) to expressly authorize the denial of the alimony deduction to nonresidents [did] not alter or undermine [their] previous findings concerning the constitutionality of such practice or present a ‘compelling reason’ to reach a different result on the identical legal issue.”<sup>330</sup> Applying the concept that “[o]nce this Court has decided a legal issue, subsequent appeals presenting similar facts should be decided in conformity with the earlier decision under the doctrine of *stare decisis*, which recognizes that legal questions, once resolved, should not be reexamined every time they are presented.”<sup>331</sup> The Court again upheld their constitutional analysis in *Friedsam*.<sup>332</sup> The Appellate Division, in *Lunding* stated that an “examination of the legislative history behind Tax Law § 631 (b)(6) reveals no stated reason or discussion addressing the rationale underlying a denial to only nonresidents of the alimony deduction authorized by the Internal Revenue Code § 215 in proportion with their New York income.”<sup>333</sup> Again, New York State offered no compelling reason for the disparity in treatment of nonresidents as compared to residents. The Court specifically determined that

Federal policy regarding the alimony deduction recognizes that tax consequences should rightly fall upon the recipients of the alimony, not the payors and that pursuant to [the New York] statute . . . the denial of the deduction to a nonresident taxpayer ignores, *inter alia*, where the recipient resides or whether the recipient is taxed by this State.<sup>334</sup>

The Court found that “there exists no substantial reason for the disparate treatment, leaving as ‘[t]he only criterion . . . whether the payor is a resident or nonresident.”<sup>335</sup> The holding of a lack of a constitutional basis for the

1983)).

329. *Id.* at 520-21 (quoting *Friedman*, 470 N.Y.S.2d at 848) (internal quotes omitted).

330. *Lunding*, 639 N.Y.S.2d at 521 (citing *Dufel v. Green*, 603 N.Y.S.2d 624 (App.Div.

1993)).

331. *Id.* (emphasis added).

332. *See id.*

333. *Id.*; see also Senator Warren M. Anderson, *Memorandum of Senator Warren M. Anderson*, IN NEW YORK STATE LEGISLATIVE ANNUAL 58-59 (1997); Governor Mario M. Cuomo, *Annual Message State of New York*, IN NEW YORK STATE LEGISLATIVE ANNUAL (1987).

334. *Lunding*, 639 N.Y.S.2d at 521 (citations omitted).

335. *Id.* (quoting *Friedsam*, 470 N.Y.S.2d at 848).

discrimination led to the ultimate conclusion: “[W]ithout more, there results a constitutional violation.”<sup>336</sup> This is exactly the analysis which is required by the “treaty” analysis of the Privileges and Immunities Clause. The states should not discriminate against nonresident citizens. And, in cases where the state presents no rationale for the discrimination, it should not be upheld. The courts here are left to speculate as to the New York legislative intent.

## VI. NEW YORK COURT OF APPEALS DECIDES *LUNDING*

The *Lunding* case and the continuing saga went forward again to the New York Court of Appeals.<sup>337</sup> The court of appeals upheld the New York statute in an opinion which is flawed in many ways.

The court of appeals began “with the familiar proposition that statutes—the enactments of a co-equal branch of government—enjoy a presumption of constitutionality. Moreover, ‘in taxation, even more than in other fields, legislatures possess the greatest freedom in classification.’”<sup>338</sup> This type of declaration, avowing a cavalier attitude towards taxpayers, has been a common belief of courts. It may be a leading reason why our tax system is so inhospitable to taxpayers.<sup>339</sup> The courts are the place where taxpayers can

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336. *Id.*

337. See *Lunding v. Tax Appeals Tribunal*, 675 N.E.2d 816 (N.Y. 1997). [hereinafter *Lunding II*]. It is very interesting to note that all of the people who have challenged the alimony deduction denial, in *Friedsam*, *Lunding* and in the Oregon case of *Wood* were attorneys. This is not mere coincidence. The appeals process is so time consuming and costly, with so little hope for success, that only an attorney can afford to make the case for himself. In fact, in *Lunding*, the taxpayer appeared in the U.S. Supreme Court for himself. See Linda Greenhouse, *Alimony Case, in Supreme Court, Could Alter New York's Tax Law*, N.Y. TIMES, Nov. 6, 1997, at B1. This indicates that it is unlikely that a taxpayer who is not an attorney could ever hope to succeed with the process. The amount of state tax involved would not justify the great expense that the state is willing to put the taxpayer through. Under New York state Tax Law, any appeal to the Courts must be made in Albany, New York, thereby increasing the difficulty and expense to challenge a constitutional issue. See N.Y. TAX LAW § 2016 (McKinney 1988). All of the requirements make any challenge, difficult, costly and very unlikely.

338. *Lunding II*, 675 N.E.2d at 816 (quoting *Austin v. New Hampshire*, 420 U.S. 656, 661-62 (1975)).

339. The lack of protection for taxpayers has manifested itself in what is perceived to be an out of control Internal Revenue Service. If the courts had provided protection for the taxpayers, this may have been avoided. The truth is that the IRS is much fairer and better run than the New York Department of Taxation. But, it is now clear that the New York courts will not provide any protection from administrative abuses by this agency. See David S. Broder, *Shaking Up The IRS*, WASH. POST, Oct. 21, 1997, at A19; George Guttman, *Overtaxed, The Internal Revenue Service No Longer Meets Anyone's Expectations*, SAN DIEGO UNION-TRIBUNE, Oct. 19, 1997, at G-1; Hugh R. Morley, *Rothman Cites Examples of Abuse by IRS*, BERGEN COUNTY REC., Oct. 17, 1997, at L2; *IRS Restructuring—Where does it go From Here?*,



receive protection from offending administrative agencies. A failure to provide that protection will lead to an agency which has little care for fairness in dealing with taxpayers. After all, if the courts are cavalier and hold the agency to a low standard, what would compel the agency to be fair. Courts must begin to understand their role in dealing with aggressive tax agencies. There has been an utter lack of that protection in recent times. Courts too often cite platitudes about how the legislature has a free reign. This ignores the lack of understanding and caring which exists in the legislature. This is most critical when dealing with nonresident citizens.

The *Lunding II* court noted that the Privileges and Immunities Clause entitles the "Citizens of each State . . . to all Privileges and Immunities of Citizens in the several States."<sup>340</sup> They further stated that the clause "was intended to create a national economic union and establish a norm of comity between [the] States. The Clause in essence ensures that citizens of State A may do business in State B on terms of substantial equality with the citizens of that State."<sup>341</sup> Having stated that proposition, the court went on to dismantle it.

The court relied on "two seminal decisions on State income taxation of nonresidents under the Privileges and Immunities Clause—*Shaffer v. Carter* and *Travis v. Yale and Towne Manufacturing Co.*"<sup>342</sup> The *Lunding II* court noted that in *Shaffer* and *Travis* the Supreme Court had

established that limiting taxation of nonresidents to their in-State income was a sufficient justification for similarly limiting their deductions to expenses derived from sources producing that in-State income. Further, the Court made clear that in testing the constitutionality of a tax law, a court should put aside "theoretical distinctions" and look to "the practical effect and operation" of the scheme.<sup>343</sup>

The *Lunding II* court further noted that

. . . in *Shaffer* the Court upheld a provision of the Oklahoma income tax law that taxed nonresidents' income derived from local property and business and limited their deductions to losses related to these in-State activities, where Oklahoma also taxed all income of its own citizens. Similarly in *Travis*, the Court considered a New York Statutory provision limiting a nonresident's income tax deductions to such as 'are connected with income arising from sources within the state.' In upholding the provision the Court noted that 'there is no constitutional discrimination against citizens of other States in confining the deduction of expenses, losses, etc., in the case

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77 TAX NOTES 509 (1997); Sheryl Stratton, *IRS Suspends Four District-Level Managers*, 77 TAX NOTES 8 (Oct. 6, 1997); George Guttman, *Evaluating the IRS: The Senate Finance Hearings in Retrospect*, 77 TAX NOTES 13, (Oct. 6, 1997).

340. *Lunding II*, 675 N.E.2d at 819 (internal quotes omitted).

341. *Id.* (citations omitted).

342. *Id.* (citations omitted).

343. *Id.* (quoting *Shaffer v. Carter*, 252 U.S. 37, 56 (1920)).

of nonresident taxpayers, to such as are connected with income arising from sources within the taxing State, likewise is settled by [*Shaffer*]. The *Travis* Court, however, considered an additional provision of the Tax Law that disallowed nonresidents any personal exemptions and found this an unreasonable discrimination because New York's proffered hope of reciprocity did not justify the statute's discriminatory effect.<sup>344</sup>

This analysis is flawed in that it fails to consider the fact that the *Travis* Court was not dealing with deductions for personal expenses, but was merely stating theoretical possibilities, which did not exist at that time. The other major flaw in this reliance is that tax law, unlike other areas of law, is a fast moving area and the cases cited were considered more than seventy-five years ago, arising shortly after the first income tax law was adopted in the United States. A decision in the present atmosphere should rely more heavily on a reasoned discussion of what would best serve society today. To rely on these old, outdated cases is generally unacceptable. In fact, *Shaffer* has no relevance to the issue in *Lunding*.<sup>345</sup>

The *Lunding II* court did discuss a more recent federal case. They analyzed the Supreme Court holding in *Austin v. New Hampshire*.<sup>346</sup> In *Austin*, the Supreme Court

invalidated New Hampshire's commuters' income tax where it determined that 'the tax falls exclusively on the income of nonresidents; and it is not offset even approximately by other taxes imposed upon residents alone.' Indeed, the practical effect of the tax scheme in *Austin* was that New Hampshire taxed only the income of nonresidents working in the State, whereas its own residents paid no income tax whatsoever.<sup>347</sup>

This case has very little relevance to the *Lunding* facts. In fact, it stands for a valid reason for finding the New York statute to be unconstitutional. The New York statute falls more heavily upon nonresidents. A nonresident who earns all of his income in New York would pay a higher tax than a resident of New York who has the same alimony expense.

The court of appeals stated that as a result of their analysis of *Shaffer*, *Travis* and *Austin*; "the Privileges and Immunities Clause does not mandate absolute equality in tax treatment."<sup>348</sup> Relying on another U.S. Supreme Court

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344. *Id.* at 819-20 (quoting *Travis v. Yale & Towne Mfg. Co.*, 252 U.S. 60, 73, 75-76 (1920)).

345. See discussion in Sec. V.

346. 420 U.S. 656 (1975).

347. *Lunding II*, 675 N.E.2d 386 (quoting *Austin*, 420 U.S. at 665). *But see*, *Spencer v. South Carolina Tax Commission*, 316 S.E.2d 386 (S.C. 1985). *Aff'd by an equally divided court*, 471 U.S. 82 (1985) (stating that reciprocity between States is insufficient justification for disallowance of alimony deduction).

348. *Lunding II*, 675 N.E.2d at 820.

case, *Toomer v. Witsell*,<sup>349</sup> the court concluded “[r]ather, disparity in tax treatment between residents and nonresidents is permissible ‘in the many situations where there are perfectly valid independent reasons for it.’”<sup>350</sup> The test which the court derived from those cases was that “the Clause is not violated where (i) there is a substantial reason for the difference in treatment; and (ii) the discrimination practiced against nonresidents bears a substantial relationship to the State’s objective.”<sup>351</sup> In fact, most of the courts that have applied these tests have determined that it applies only when the nonresidents are the peculiar source of the evil at which the statute is aimed.<sup>352</sup> There is no evidence of evil in this case.<sup>353</sup> All of the cases cited by the court of appeals in defense of their holding shed very little light upon the *Lunding* situation. *Toomer* involved discriminatory shrimp fishing rules, some involving discriminatory taxes on nonresident fishermen.<sup>354</sup> The court of appeals, in *Lunding II*, did not address any evil at which the New York discrimination was aimed. In *Spencer v. South Carolina Tax Commission*,<sup>355</sup> the Supreme Court of South Carolina held that a statute which denied personal deductions to nonresidents was violative of the Privileges and Immunities Clause. They believed that the clause “was intended to prevent retaliation and to promote federalism.”<sup>356</sup>

The *Lunding II* court went on to expound on how well settled the issue was in New York. “In [New York] the propriety of disallowing deductions to nonresidents for personal expense unrelated to New York income-producing sources was definitively addressed in *Matter of Goodwin v. State Tax Comm’n*.”<sup>357</sup> This statement and reliance upon *Goodwin* presents the most troubling aspect of the *Lunding II* decision.

This reliance upon *Goodwin* is a clear example of what happens when a court, without sufficient information, blindly relies on what appears to be “common law.” This reliance on a case which was not overturned by the courts, but was overturned by the governments and legislature of the states involved, shows exactly where common law can fail the populace. *Goodwin* caused a commission to be created and an agreement was reached between the

349. 334 U.S. 385 (1948).

350. *Lunding II*, 675 N.E.2d at 820 (quoting *Toomer*, 334 U.S. at 396).

351. *Lunding II*, 675 N.E.2d at 820 (quoting Supreme Court of N.H. v. Piper, 470 U.S. 274, 284 (1985)).

352. See *Toomer*, 334 U.S. 385 (1948); See *Spencer*, 316 S.E.2d 386 (S.C. 1985).

353. See *Lunding II*, 675 N.E.2d at 818.

354. See *Toomer*, 334 U.S. at 403.

355. 316 S.E.2d 38 (S.C. 1985), *aff’d by an equally divided court*, 471 U.S. 82 (1985).

See *supra* note 364.

356. *Spencer*, 316 S.E.2d at 388.

357. 286 A.D. 694 (1955).

states. But, the court of appeals, in *Lunding II*, merely relies upon the holding of *Goodwin* while completely ignoring the later history.

In *Goodwin*,

[t]he petitioner, a lawyer residing in New Jersey and practicing in New York City, challenged New York's disallowance of deductions he claimed for his New Jersey real estate taxes, interest payments, medical expenses and life insurance premiums.<sup>358</sup> In upholding the challenged disallowance, the Appellate Division gave three independent reasons to support the statute, two of which are [relevant] here.

First, New York residents—unlike nonresidents—were subject to the burden of taxation on their worldwide income regardless of source and therefore were entitled to the offsetting benefit of full deductions. Second, the court found it reasonable to disallow the deductions because they were personal expenses of the taxpayer and therefore 'clearly a part of the petitioner's personal activities in his home State. . . . If these expenditures are to be allowed as deductions at all, they should be allowed by the State of the taxpayer's residence.' [The] *Goodwin* [court] justified the disparity on the basis that deductions for certain personal expenses reflected acceptable State policy 'to give aid or encouragement of the character embodied in the tax deductions to its own residents' where the policies were linked to residence, and in such instances the State was not 'constitutionally required to extend similar aid or encouragement to the residents of other States.'<sup>359</sup>

It seems that this analysis was driven by an adherence to the privileges and immunities theories of Brainerd Currie which were discussed above.<sup>360</sup> It must be noted that most of these theories, that states must only look after their own citizens and not care for citizens of other states, have been clearly refuted in the period since the 1950s.<sup>361</sup>

In *Goodwin*, under the theories applicable at the time, the court believed that if they found unconstitutional, the portion of the New York tax law which denies these personal deductions to nonresidents, that they would then have to strike down the entire tax law which applied to nonresidents.<sup>362</sup> This created added pressure to uphold the statute based upon the *Travis* case. In addition, the court felt that *Travis* had answered this exact question.

After *Goodwin*, the appellate division in *Golden v. Tully*<sup>363</sup> considered a privileges and immunities challenge to New York's policy of granting a moving expenses deduction to residents while denying it to nonresidents. Only

358. At the period in question, New York State had enacted a law which denied deduction of itemized federal amounts to nonresidents. See N.Y. TAX LAW § 360 (McKinney 1919).

359. *Lunding II*, 675 N.E.2d at 820 (quoting *Goodwin v. State Tax Comm'n*, 146 N.Y.S.2d at 172 (App.Div. 1955)) (citations omitted).

360. See *supra* note 164.

361. See Laycock, *supra* note 122, at 433-36.

362. See *Goodwin*, 146 N.Y.S.2d at 174.

363. 449 N.E.2d 406 (N.Y. 1983).

nonresidence was the explanation for the disallowance.<sup>364</sup> The appellate division struck down the discriminatory statute, and was affirmed by the court of appeals. In fact, most other states allow the nonresidents to deduct a proportional amount of personal deductions.<sup>365</sup>

New York stands out again as the prime violator of the Privileges and Immunities Clause and the type of protective spirit which the clause was meant to protect against. In fact, New York has a specific statutory provision which is meant to do the same thing.<sup>366</sup> There have been a few other states which have denied the deduction of personal expenses to nonresidents.<sup>367</sup> The most common treatment by states has been the proportional allowance of the personal deductions to nonresidents.<sup>368</sup>

The court of appeals, in *Lunding II* went further

Now applying well-established principles to the facts before us, we conclude there is no violation of the Privileges and Immunities Clause. The disparate tax treatment of alimony paid by a nonresident is fully justified in light of the disparate treatment of income: nonresidents are taxed only on income earned in New York, while residents are taxed on all income earned from whatever sources. Focusing on the practical effect and operation of the challenged tax it is clear that the advantage granted residents is offset by the additional burden of being taxed on all sources of income.<sup>369</sup>

But, the nonresidents receive far less governmental services from New York. The point that the court did not discuss is that the nonresidents earning their living in New York are not placing a greater burden on the use of governmental services in New York than are residents. They are, however, under these facts, being taxed at a greater level than are residents. The most important single point is that these nonresidents are paying more tax than residents who are similarly situated.

The next portion of the *Lunding II* decision is also very troubling. The court states, "Indeed, unlike *Travis* and *Shaffer*, nonresidents are not denied all benefit of the alimony deduction since they can claim the full amount of such payments in computing the hypothetical tax liability 'as if a resident' under Tax Law § 601 (e)."<sup>370</sup> Tax Law § 601 (e) provides that the nonresident's tax

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364. See *Golden*, 449 N.E.2d at 406.

365. See, e.g., DEL CODE ANN. tit. 30 § 1126 (repealed by Del. Laws, c. 86 § 7 (1987)); HAW. REV. STAT. § 235-5(c) (1993); OKLA. STAT. ANN. tit. 68, § 2362(4) (West 1997).

366. See N.Y. TAX LAW § 635 (McKinney 1997).

367. See *Davis v. Franchise Tax Bd.*, 71 Cal. App. 3d 998 (Cal. Ct. App. 1977); *Stiles v. Currie*, 118 S.E.2d 4298 (N.C. 1961).

368. See *Kuhnen v. Musolf*, 420 N.W.2d 401 (Wis. Ct. App. 1988); *Barney v. State Tax Assessor*, 490 A.2d 233 (Me. 1985); *Taylor v. Conta*, 316 N.W.2d 814 (Wis. 1981).

369. *Lunding v. Tax Appeals Tribunal*, 675 N.E.2d 816, 821 (N.Y. 1996).

370. *Lunding II*, 675 N.E.2d at 821 (emphasis added).

is computed as if the person were a resident.<sup>371</sup> This includes any deductions allowed to a resident, including alimony. This tax is then multiplied by the "New York Source Fraction" to compute the taxpayer's tax liability. The "New York Source Fraction" is the individual's federal adjusted gross income as the denominator and the numerator being the individual's New York source income.<sup>372</sup> In the case where a nonresident taxpayer had all of their earnings in New York, and paid alimony, the resulting fraction would be greater than one.<sup>373</sup> The nonresident taxpayer receives no benefit from this computation other than allocating the New York portion of the tax.<sup>374</sup> The court states that the effect of the application of § 601(e) is "nonresidents are not denied all benefit of the alimony deduction since they can claim the full amount of such payments in computing hypothetical tax liability 'as if a resident' under Tax Law § 601(e)."<sup>375</sup> This statement is true in some instances, and the effect is generally very small. The only effect that the alimony deduction has is on the denominator of the equation. It does not in any way decrease the tax of the nonresident. This shows a profound misunderstanding by the court in its analysis.

371. This allocation of deductions and exemptions has been approved as rational and fair by many courts. See *Reynolds Metals Co. v. Martin*, 107 S.W.2d 252, 263 (Ky. Spec. Ct. App. 1937); *Barney v. State Tax Assessor*, 490 A.2d 223 (Me. 1985); *Lung v. O'Chesky*, 617 P.2d 1317 (N.M. 1980).

372. See *Brady v. State of New York*, 607 N.E. 2d 1060, (N.Y. 1992), *cert. denied*. 509 U.S. 905 (1993)

373. See N.Y. TAX LAW § 631(a)(McKinney 1987). New York source income would be all of the income of the taxpayer. Likewise, all of the income would be included in federal adjusted gross income. But, federal adjusted gross income would have been reduced by the amount of the alimony payment. This would result in a fraction greater than one. This increased fraction would result in a modification of the amount computer "as if a resident" to an amount virtually identical with the full tax on the nonresident without any reduction for alimony payments. When the alimony paid by a nonresident is a large proportion of the payor's income, the use of this calculation does provide some small amelioration. At higher levels of income, and where the alimony paid is a small percentage of income, the benefit is very small. It is not a rational adjustment. This analysis would be similar for nonresident income percentages.

374. See *id.* New York measures source income of a nonresident as: the sum of the net amount of items of income, gain, loss, and deduction entering into his federal adjusted gross income, as defined in the laws of the United States for the taxable year, derived from or connected with New York sources, including:

- (1) his distributive share of partnership income, gain, loss and deduction . . .
- (2) items of income, gain, loss and deduction derived from or connected with New York sources shall be those items attributable to . . .
  - (B) a Business trade, profession or occupation carried on in this state . . .

*Id.*

375. *Lunding II*, 675 N.E.2d at 821.

This is an example of what can occur when a complex tax statute is analyzed by a court without the guidance of a tax expert. The taxpayer was not a tax lawyer. The assistant attorney general was not a tax attorney, and the court had no such expertise. However, the numerator of the fraction (referred to as the "apportionment percentage")—the nonresident's New York source income—, has under the Internal Revenue Code been reduced by any alimony payments.<sup>376</sup> Since the alimony deduction is not connected with either of these figures, it has no effect upon the determination of the tax figure. The use of this provision to explain the court's decision makes no sense. The court is grasping at an issue which has no relevance to the case. The purpose of the fraction referred to is simple, it is a method whereby nonresidents are made to pay New York tax at the higher marginal rate which applies to all of their income. If the marginal tax rate on New York income were applied to only New York income, some taxpayers could be in a lower marginal tax bracket. The court points to a provision which has the effect of raising taxes on most nonresidents, but has a coincidental minimal ameliorating effect in this case, as being a factor in the fairness of the tax treatment of these nonresidents. It appears to be stretching an issue to its limits. The court of appeals held that the disallowance is substantially justified by the fact that petitioner's alimony payments are — not unlike the expenditures for life insurance, out-of-state property taxes and medical treatment at issue in *Goodwin* — wholly linked to personal activities outside the state. They believed there is nothing to "warrant the petitioner's shifting the allowance for these expenditures, which are intimately connected with the state of his residence, to New York state."<sup>377</sup> The court felt that there can be no serious argument that petitioners' alimony deductions are legitimate business expenses. Thus, they held that "the approximate equality of tax treatment required by the Constitution is satisfied, and greater fine-tuning in this tax scheme is not constitutionally mandated."<sup>378</sup> This analysis fails to look to the proper issue. The issue is not whether alimony is a business expense, but whether it is related to the New York income.

The taxpayers argued that the silence of TRARA's legislative history as to the substantial reasons behind the treatment of nonresidents' alimony deductions preordained its unconstitutionality. Although there is no legislative history, the Department of Taxation has made their motives clear, they have grabbed an opportunity, created by a liberalization of federal law, to increase the taxation of a nonresident taxpayer. The court believed that there were

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376. See I.R.C. § 215 (1986).

377. *Goodwin v. State Tax Comm'n*, 146 N.Y.S.2d 172, 180 (App. Div. 1955).

378. *Lunding II*, 675 N.E.2d at 821.

substantial reasons for the disparity in tax treatment, and that these reasons were apparent on the face of the statutory scheme. Thus, the absence of a statement at the time of enactment was not a sufficient reason to invalidate the statute. What the New York court found to be apparent on the face of the statute was not so apparent to the Oregon Supreme Court. They found that there was a connection between generating income in one state and payment of alimony in another.<sup>379</sup> It is inconceivable that the court would not discuss the differing opinion in the Oregon case.

The court of appeals also found against *Lunding* under the Equal Protection and Commerce Clauses. They stated

Nothing in the Fourteenth Amendment prevents the States from imposing unequal taxation on nonresidents, so long as the inequality is rationally related to the furtherance of a legitimate State interest. Here, New York's treatment of alimony deductions is rationally related to its substantial policy of taxing only those gains realized and losses incurred by a nonresident in New York, while taxing residents on all income from whatever sources. Further, the challenged treatment is rationally related to its policy of limiting a nonresident's deductions to those attributable to income-producing activities in New York. Even if this matter concerning alimony payments were deemed to involve interstate commerce, petitioners' Commerce Clause claim would ultimately fail for the same reason.<sup>380</sup>

This belief that the alimony payment is not related to the New York income producing activities is severely flawed. The amount of the alimony payment was determined with consideration of the New York income producing activities. It is clearly related to the New York activities. The belief also contradicts a recent holding by the Supreme Court of Oregon.<sup>381</sup> The spouse was an "economic partner" of the taxpayer during the time of the marriage.<sup>382</sup> In this "economic partnership," certain rights were generated. Those rights included the right to an alimony payment after the termination of the marriage. The determination of that alimony payment was integrally related to the earning of income in New York by the "economic partnership." Therefore, when at a later date the alimony payment is made from New York generated income, it is related to the New York income production. But, even beyond this argument, and the determination in *Lunding*, the New York Court

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379. See *Wood v. Department of Revenue*, 749 P.2d 1169 (Or. 1988). See *infra* notes 399-428 and accompanying text.

380. *Lunding II*, 675 N.E.2d at 821-22 (citations omitted).

381. See *Wood*, 749 P.2d at 1169.

382. Most courts have treated marriage as an economic partnership, but specifically, the New York Court of Appeals in a series of opinions has characterized marriage as an economic partnership. See *Dejesus v. Dejesus*, 687 N.E.2d 1319 (N.Y. 1997); *Hartog v. Hartog*, 647 N.E.2d 749 (N.Y. 1995); *McSparron v. McSparron*, N.E.2d 745 (N.Y. 1995).



of Appeals is applying a test which is outdated, incorrect and divisive to the taxation of nonresidents.

The reliance by the New York Court of Appeals on the *Goodwin* case shows the mean spiritedness and cavalier attitude that state courts have taken in their failure to protect nonresident taxpayers. It is the strongest argument for litigating such issues in the federal court of the nonresident taxpayer's domicile. This reliance upon *Goodwin* shows a clear lack of sympathy for nonresidents. The *Goodwin* case stands as an ill considered beacon of ignorance and the capabilities of states for an all out war on nonresidents. We are now reaping the results of such thinking. The adoption by the *Lunding* court of that opinion shows an interest in going to a contentious position against the alien taxpayer, the nonresident. It manifests itself in the increasing legislative attacks on nonresidents. This is resulting in exactly the type of treatment of nonresidents from which the Privileges and Immunities Clause was meant to protect against. The New York Court of Appeals has quite aggressively told nonresidents that the New York legislature has a free hand to abuse them.

A. *Wood v. Department of Revenue*<sup>383</sup>

In 1988, the Oregon Supreme Court decided an issue identical to the one faced in New York in the *Lunding* case.<sup>384</sup> It is surprising to the point of dismay that the New York Court of Appeals, in *Lunding II*, although decided eight years later, did not even mention the Oregon case. It would seem that a court which is overruling a lower court in its own state, and ruling on a federal constitutional issue would attempt to distinguish, or at least mention the opposite ruling of a state supreme court in another state. Since the New York Court of Appeals relied so heavily upon a lower court in New York, in the *Goodwin* decision, it appears as though the court is completely discounting the Oregon court. This would appear to be an act of elitism which cannot be justified. The only other possible explanation is that the New York Court of Appeals was unaware of the Oregon decision in *Wood*. If such is the case, then it appears to be an unacceptable act of negligence. Since the taxpayer in *Lunding* was not a tax attorney, it could be that he did not present the case to the court. In a case involving a *pro se* taxpayer, it would be expected that the office of the Attorney General would have some duty to present the case to the court. Being a case in the highest court of the state of Oregon, there is no rational explanation for the New York court to have ignored it. It is another

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383. 749 P.2d 1169 (Or. 1988).

384. See *Wood*, 749 P.2d at 1169.

indiction of the lack of fairness that can be expected by a nonresident in litigating a tax issue before the courts of the taxing state.

The issue in the *Wood* case was "whether the disallowance of a deduction for alimony to nonresidents of Oregon, when contrasted with the allowance of a deduction for alimony to residents of Oregon . . . violate[d] the Privileges and Immunities Clause of the United States Constitution."<sup>385</sup> No Oregon constitutional issue was raised.<sup>386</sup> The Oregon Tax Court ruled against *Wood* on the constitutional question.<sup>387</sup> The Oregon Supreme Court held that the Oregon statute disallowing a deduction for alimony to nonresidents "violated plaintiffs' claimed federal constitutional rights" and reversed the Oregon Tax Court.<sup>388</sup>

Erskine B. Wood practiced law as a partner in a Portland firm. Wood resided in Vancouver, Washington, and filed Oregon nonresident personal income tax returns on his income earned in Oregon.<sup>389</sup> "During the years in question . . . Wood made substantial alimony payments to two former wives, who paid Oregon income tax on the alimony received."<sup>390</sup> Wood paid \$80,113 of alimony to these former wives who both resided in Oregon.<sup>391</sup> "The parties further stipulated that . . . Wood's present and future Oregon law practice income was a major factor considered in determining the amount of alimony that was agreed upon in the divorce decrees."<sup>392</sup>

The Oregon court explained the law for the tax years at issue, "ORS 316.127(1)(a) did not permit a nonresident a deduction from Oregon income for alimony because the alimony was not a 'deduction' in arriving at federal adjusted gross income."<sup>393</sup> The narrow question before the Oregon court was "whether the distinction between the tax treatment of alimony payments of residents and nonresidents is an unconstitutional infringement on plaintiffs' rights under the federal Privileges and Immunities Clause."<sup>394</sup>

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385. *Wood*, 749 P.2d at 1169 (citing OR. REV. STAT. § 316.127(1)(A)(1995))(footnote and citation omitted).

386. *See id.*

387. *See Wood v. Department of Revenue*, 10 Or. Tax 374 (1987).

388. *See id.*

389.

390. *Id.*

391. *See id.* at 1169, n.2.

392. *Id.*

393. *Wood*, 749 P.2d at 1170 (footnote omitted).

394. *Id.* *See* OR. REV. STAT. § 316.127 (1981). Oregon's statute provides:

(1)The adjusted gross income of a nonresident derived from sources within this state is the sum of the following:

(a)The net income of items of income, gain, loss and deduction entering into his federal adjusted income that are derived from or connected with sources in this state

## The court further explained the federal and state law concerning alimony deductions

From 1942 until the passage of the federal 1976 Tax Reform Act, all taxpayers were allowed to claim alimony as an itemized deduction on their federal tax returns. The 1942 Act provided that in computing net income there shall be allowable as deductions alimony or separate maintenance payments made during the taxable year. Since the adoption of Oregon's Personal Income Tax Act of 1969, the express intent of the legislature has been that Oregon tax law will conform to federal tax law insofar as possible. As part of the attempt to parallel federal tax law, Oregon residents and nonresidents are allowed to take itemized deductions from adjusted gross income on their Oregon tax returns similar to federal deductions.

In 1976, Congress passed the Tax Reform Act and made alimony an adjustment, one of the items used to determine adjusted gross income, rather than an itemized deduction subtracted after adjusted gross income is calculated. This change allowed alimony-paying federal and Oregon resident taxpayers to take a full deduction for alimony without itemizing deductions and still take the benefit of the standard deduction. Some nonresident Oregon taxpayers were harmed by this change because, while Oregon deductions are substantially the same as federal deductions, nonresidents who paid Oregon income tax for the years in question could not use the same adjustments to determine adjusted gross income. Oregon tax law allowed nonresidents to adjust their income derived from sources within this state only if the adjustments were attributable to the ownership or disposition of real or tangible personal property in Oregon or attributable to a business, trade, profession or occupation carried on in Oregon.<sup>395</sup>

The court assumed that Wood's income as a partner in his Portland law firm had no relationship or attribution to his alimony payments.<sup>396</sup>

The court noted that over 100 years ago the United States Supreme Court said

[B]ut, it should not be forgotten that the people of the several states live under one common constitution, which was ordained to establish justice, and which, with the laws of Congress, . . . is the supreme law of the land; and that the supreme law requires equality of burden, and forbids discrimination in state taxation when the power is applied to the citizens of other states. Inequality of burden, . . . was one of

including (A) his distributive share of partnership income and deductions and (B) his share of estate or trust income and deduction; and . . .

(2) Items of income, gain, loss and deduction derived from or connected with sources within this state are those items attributable to:

(a) The ownership or disposition of any interest in real or tangible personal property in this state; and (b) A business, trade, profession or occupation carried on in this state.

*Wood* 749 P.2d at 1170, n.3 (quoting OR. REV. STAT. § 316.127 (1981)).

395. *Wood*, 749 P.2d at 1170 (footnote and citations omitted); see also OR. REV. STAT. § 316.048 (1995).

396. See *Wood*, 749 P.2d at 1170.

the grievances of the citizens under the Confederation; and the new constitution was adopted, among other things, to remedy those defects in the prior system.<sup>397</sup>

Additionally the court noted that the Supreme Court has also held:

Like many other constitutional provisions, the privileges and immunities clause is not an absolute. It does bar discrimination against citizens of other States where there is no *substantial reason* for the discrimination beyond the mere fact that they are citizens of other States. But it does not preclude disparity of treatment in the many situations where there are perfectly valid independent reasons for it. Thus the inquiry in each case must be concerned with whether such reasons do exist and whether the degree of discrimination bears a close relation to them.<sup>398</sup>

Further, the Oregon Court noted that the U.S. Supreme Court had recently restated this principle: "The [Privileges and Immunities] Clause does not preclude discrimination against nonresidents where: (i) there is a substantial reason for the difference in treatment; and (ii) the discrimination practices against nonresidents bears a substantial relationship to the State's objective."<sup>399</sup>

The tax department argued that there are substantial reasons for the denial to nonresidents of a deduction for alimony. The department asserted

- (a) Nonresidents are only taxed on their Oregon source income, and alimony expenditures are not connected with Oregon source income;
- (b) Residence has an obvious connection with the allowance for the alimony deduction, because the alimony obligation arises from activities in the state of residence, which is the locus of the marriage; and
- (c) The statute denying deductions for alimony was originally intended to deny nonresidents those deductions for expenses associated with non-Oregon source income.<sup>400</sup>

This was the same argument made by the New York Department of Taxation in *Lunding II*. Because of a change in the federal tax law, the Oregon statute denied to nonresidents the deduction for alimony, even though alimony is not associated with the generation of non-Oregon source income.

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397. *Id.* at 1171 (quoting *Ward v. Maryland*, 79 U.S. (12 Wall.) 418, 431 (1870)).

398. *Id.* (quoting *Toomer v. Witsell*, 334 U.S. 385, 396 (1948)).

399. *Id.* (quoting *Supreme Ct. of N.H. v. Piper*, 470 U.S. 274, 284, (1985)) (alteration in original); see also *United Bldg. & Constr. Trades Council v. Mayor of Camden*, 465 U.S. 208, 222 (1984).

400. *Wood*, 749 P.2d at 1171.

## The Supreme Court of Oregon held

The so-called reasons simply do not track. It is no reason for disparity to claim that the income and alimony expenditures are not related to Oregon income, or to claim that the out-of-state character of the obligation and the plaintiff's residence justify such a distinction. Neither does the original intent of the Oregon legislation to 'deny nonresidents those deductions for expenses associated with non-Oregon source income' provide any substantial reasons for the unequal tax treatment, because, at the department admits, the present denial does not correspond to the original intent of the legislation.<sup>401</sup>

The State of Oregon conceded that the original intent of ORS § 316.127 was to deny nonresidents deductions for expenses associated with non-Oregon source income, and not to deny nonresidents adjustments for alimony payments.<sup>402</sup> The court concluded that there are less restrictive means to achieve the original intent of the statute. "The state could achieve its original intent and come closer to its stated policy of compatibility with the federal tax law by, for example, stating that federal adjustments will be allowed unless those adjustments are items of income, gain, loss or deduction derived from non-Oregon source income."<sup>403</sup>

The court emphasized that "[w]hen considering nonresident taxpayer challenges under the Privileges and Immunities Clause, courts must look to the practical effect of the taxing scheme, applying a 'rule of substantial equality of treatment for the citizens of the taxing state and nonresident taxpayers.'<sup>404</sup> The court pointed out that the state agrees that "[t]he practical effect of Oregon's taxing scheme is to allow a resident to deduct alimony when calculating his adjusted gross income, and to deny that deduction to a nonresident."<sup>405</sup> The State attempted to justify this disparity by arguing: "[a]lthough a resident is taxable by Oregon on the resident's entire income from whatever source, a nonresident is taxable by Oregon on his Oregon source income only. Thus, the denial of the alimony deduction does not subject the nonresident to a higher tax than that imposed on a resident."<sup>406</sup> This argument was rejected by the court. "No matter how the tax is calculated, the practical effect is still to discriminate against nonresident taxpayers for no articulable substantial reason. The disallowance of the deduction subjects

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401. *Id.* at 1171-72. The Oregon court pointed out that in *Piper*, the Supreme Court noted that "[i]n deciding whether the discrimination bears a close or substantial relationship to the State's objection, the Court has considered the availability of less restrictive means." *Id.* at 1172, n.5.

402. *Id.* at 1172, n.5.

403. *Id.*

404. *Id.* at 1172 (quoting *Austin v. New Hampshire*, 420 U.S. 656, 665 (1975)).

405. *Wood*, 749 P.2d at 1172.

406. *Id.*

nonresidents to a higher tax relevant to alimony than imposed on residents.<sup>407</sup> The Oregon court found the federal law as expressed in *Travis v. Yale & Towne Manufacturing Co.*,<sup>408</sup> as dispositive of the case.

In *Travis*, the United States Supreme Court held that a personal exemption that discriminated on the basis of residency was unconstitutional discrimination against nonresidents, stating

In the concrete, the particular discrimination is upon citizens of Connecticut and New Jersey, neither of which states has an income tax law . . . residents and citizens of those states, go daily from their homes to the city and earn their livelihood there. They pursue their several occupations side by side with residents of the state of New York,—in effect competing with them as to wages, salaries, and other terms of employment. Whether they must pay a tax upon the first \$1,000 or \$2,000 of income, while their associates and competitors who reside in New York do not, makes a substantial difference. Under the circumstances as disclose, we are unable to find adequate ground for the discrimination, and are constrained to hold that it is an unwarranted denial to the citizens of Connecticut and New Jersey of the privileges and immunities enjoyed by citizens of New York.<sup>409</sup>

The 1920 *Travis* decision was approved relatively recently in *Austin v. New Hampshire*,<sup>410</sup> which cited *Travis* extensively, commenting: "The New York tax on residents and non-residents' income at issue in *Travis* could not be sustained when its actual effect was considered. The tax there granted personal exemptions to each resident taxpayer but it made no similar provision for non-residents."<sup>411</sup>

The Oregon court noted in *Wood* that the "actual effect of the department's interpretation is to grant a personal exemption (adjustment) for alimony to residents, but no similar provision for nonresidents. Because nonresidents cannot adjust their income to account for alimony payments, nonresidents pay tax on a relatively larger portion of gross income than do residents."<sup>412</sup>

The court further explained that the Supreme Court's 1975 decision in *Austin*, "warned that because nonresidents are not represented in the taxing state's legislature, the Court has a 'heightened concern for the integrity of the Privileges and Immunities Clause.'<sup>413</sup> *Austin* mandates rigorous scrutiny of

407. *Id.*

408. 252 U.S. 60 (1920).

409. *Wood*, 749 P.2d at 1172 (quoting *Travis*, 252 U.S. at 80).

410. 420 U.S. 656 (1975).

411. *Wood*, 749 P.2d at 1172 (quoting *Austin*, 420 U.S. at 664-65).

412. *Id.* at 1173.

413. *Id.* at 1174 (quoting *Austin*, 420 U.S. at 663).

state taxing schemes that burden nonresidents.<sup>414</sup> The Supreme Court has said that states may legislate different treatment for residents and nonresidents when there is a strong reason of policy and a rational basis for the difference.<sup>415</sup> However, the court concluded here that there is no substantial reason or rational basis for the difference. The alimony deduction in *Wood* was denied purely on the basis of nonresidence.<sup>416</sup>

Clearly, the decision of the New York Court of Appeals in *Lunding* is at odds with the Oregon court's decision. The only difference appears to be that the recipients of the alimony were residents of Oregon in the *Wood* case, while in *Lunding*, the recipient spouse was not a resident of New York. But, certainly there are many instances in which those set of facts exist in New York, Connecticut and New Jersey. The New York tax treatment of alimony is a broad based discrimination aimed only at nonresidents.

The courts have espoused two views of the deduction of "personal expenses" by nonresidents from another states income tax computation. In the *Lunding*, *Berry* and *Goodwin* cases, the three courts espoused the view that such expenses related to the nonresidents personal life and not related to the production of income in the taxing state are not to be allowed as deductions. This theory seems to be a reading of the Supreme Court's language in *Travis*. But, the language in *Travis* was written in 1919, before any concept of personal deductions existed, and is based on language which does not relate to the holding in the case.

The second view, espoused in *Wood* and *Austin* is that the denial of these personal deductions is merely a method for the taxing state to generate higher taxes from nonresidents. This is a facial discrimination against the nonresidents.

## B. Alimony

It is interesting that neither the New York court in *Lunding*, nor the Oregon court in *Wood* looked at the reasoning behind the granting of a deduction for alimony paid to a former spouse. Everyone supposes that this is somehow related to an income or compensatory scheme. There are two important points to be made here. First, the federal deduction for alimony is based simply upon fairness concepts. There is no hint that it has to do with compensation. The deduction was adopted in the Revenue Act of 1942<sup>417</sup> as a mitigation to effect a vast increase in the income tax rates. The tax rates were

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414. *Id.*

415. *See id.* (quoting *Allied Stores of Ohio, Inc. v. Bowers*, 358 U.S. 522 (1959)).

416. *See Wood*, 749 P.2d at 1174.

417. *See Revenue Act of 1942*, ch. 619, 56 Stat. 753 (1942).

increased by a huge margin to pay for the war effort. It was recognized that some people could be required to pay in excess of 100% of their income in the form of alimony and income taxes. The solution was to allow a deduction for alimony paid. The cost was that the recipient would include the alimony into income. There were no compensatory thoughts involved. The second point is that alimony is directly related to the income stream of the payor. The most significant aspect of the determination of the amount of alimony to be paid is the payor's income stream. Where does this come from in the case of a person who is earning money in another state. It comes from that other state. The money which has been generated to support a spouse and will continue to be generated to support the now ex-spouse is coming from the same source state. If the connection exists before the divorce, it continues to exist after the divorce. If in fact the marriage is an economic partnership,<sup>418</sup> then the amounts received by the spouse paying alimony, are the proceeds from this economic partnership received in the taxing state. To view the alimony payments as having no relationship with the state in which the monies used for the payment are earned in disingenuous at best. Alimony is based upon the earnings of the payor spouse in both Connecticut and New Jersey.<sup>419</sup> The alimony received by the recipient spouse is a portion of the earnings earned by the payor spouse.

Another significant problem with the New York statute is that it does not distinguish between alimony payments made by a nonresident taxpayer to a resident of New York. In this instance, New York state is taxing the same income twice, with no relief for either party. In a metropolitan area as integrated as New York, Connecticut and New Jersey, there can be many instances of this occurrence. Under these circumstances, the tax is punitive and unjustifiable in any case. For this reason alone, the New York statute is unconstitutional because it treats these persons in a manner which places a greater tax on a nonresident merely by reason of their nonresident status.

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418. Most courts have treated marriage as an economic partnership, but specifically, the New York Court of Appeals in a series of opinions has characterized marriage as an economic partnership. See *Dejesus v. Dejesus*, 687 N.E.2d 1319 (N.Y. 1997); *Hartog v. Hartog*, 647 N.E.2d 749 (N.Y. 1995); *McSparron v. McSparron* 662 N.E.2d 745 (N.Y. 1995).

419. Compare N.J. STAT. ANN. § 2A:34-23; *Gugliotta v. Gugliotta*, 388 A.2d 1338 (N.J. Super Ct. Ch. Div. 1978), *aff'd*, 395 A.2d 901 (1978); *O'Neill v. O'Neill*, 12 A.2d 839 (N.J. 1940); *Mahoney v. Mahoney*, 453 A.2d 527 (N.J. Sup. Ct. 1982), with CONN. GEN. STAT. § 46b-82 (1995); *Vandal v. Vandal*, 626 A.2d 784 (Conn. App. Ct. 1993); *Silver v. Silver*, 365 A.2d 1188 (1976).



VII. *LUNDING* IN THE SUPREME COURT

On January 21, 1998, the U.S. Supreme Court issued its opinion in the *Lunding* case.<sup>420</sup> The Court reversed the decision of the New York Court of Appeals.<sup>421</sup> The most substantial rationale for the reversal was the Supreme Court's belief that New York had not shown a "substantial justification" for the discrimination.<sup>422</sup> The Court again stated its test as one requiring that a state must show: (1) there is a substantial reason for the difference in tax treatment of nonresidents, and (2) the discrimination practiced against nonresidents bears a substantial relationship to the state's objective.<sup>423</sup> In applying the Privileges and Immunities Clause of the United States Constitution, the Court held that New York had not adequately justified the discriminatory treatment of nonresident individuals. The Court stated that they granted certiorari to *Lunding* because the New York Court of Appeals case was in direct conflict with *Wood*, and in tension with *Spencer*.<sup>424</sup>

The *Lunding* court restated their belief in the purpose of the Privileges and Immunities Clause as: "placing the citizens of each State upon the same footing with the citizens of other States, so far as the advantages resulting from those States are concerned."<sup>425</sup> They restated other issues with respect to the Clause as to the protection from unequal taxation afforded to nonresidents of a state. They recognized that "absolute equality is impracticable."<sup>426</sup> The Court also restates its rule in this area of one of "substantial equality of treatment."<sup>427</sup>

The specific areas of the Court's holding, and their discussion of the reasons for overturning the New York Court of Appeals were the following:

(1) There was no substantial reason for the difference in treatment of New York nonresidents;<sup>428</sup>

(2) The court of appeals failed to take into account the history of the tax statute, specifically the fact that the state tax statutes were completely rewritten many years after *Goodwin*;<sup>429</sup>

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420. See *Lunding v. New York Tax Tribunal*, 522 U.S. 287 (1998).

421. See *Lunding*, 118 S. Ct. at 752.

422. See *id.* at 773.

423. See *id.* at 772-73.

424. See *id.* at 773.

425. *Id.* at 773 (quoting *Paul v. Virginia*, 75 U.S. 168 (1869)).

426. See *Lunding*, 118 S.Ct at 774.

427. *Id.* at 774.

428. See *id.* at 777.

429. See *id.*

(3) The court of appeals was wrong in believing that the "as if" computation applied to nonresident New York taxpayers could alleviate the denial of the alimony deduction;<sup>430</sup> and

(4) In relying on the belief that "there can be no serious argument that petitioners' alimony deductions are legitimate business expenses," the court of appeals applied an incorrect test for constitutional legitimacy.<sup>431</sup>

Ultimately, the Court concluded that requiring nonresidents to pay more tax than similarly situated residents, solely on the basis of whether or not nonresidents are liable for alimony payments, violates the rule of "substantial equality of treatment," described first by the Supreme Court in *Travis*. The test which the Supreme Court applies is that any tax provision imposing discriminatory treatment on nonresident individuals "must be reasonable in effect and based on a substantial justification other than the fact of nonresidence."<sup>432</sup>

The "substantial justification" test remains murky. It would seem impossible to have a "substantial justification." In virtually every case, the single reason for the difference in taxation of nonresidents has been to collect more taxes from a group who cannot effectively complain. The discriminations practiced are based solely on a motive to raise taxes on nonresidents. The act of finding a rationale does not rise to a "substantial" justification. If a person makes most or all of their income in one state, and lives in another state, there can exist no justification for taxing that person higher than the person residing in the taxing state. The economic dislocation is not justifiable.

The three judges dissenting in *Lunding* adopted the reasoning of the New York Court of Appeals, stating that alimony payments are "surely a personal matter."<sup>433</sup> Under this analysis, the judges would not allow nonresidents any deductions for matters not related to generating income in the taxing state. This line of thinking appears to allow virtually all discrimination against nonresidents. It would allow states to deny all "personal" deductions for nonresidents. Ultimately, this would allow states to increase the tax burden on nonresidents. Furthermore, it would significantly increase the cost of traveling across state lines to obtain employment, and would result in increased economic costs and dislocations. The dissent trivialized these results. In fact, the argument was made that the resulting tax increase to some taxpayers was

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430. See *id.* at 771 (The Supreme court pointed out that this exact calculation can create a fraction in excess of 100%, thereby requiring the nonresident to pay more tax than the resident taxpayer).

431. See *Lunding*, 118 S. Ct. at 781-82.

432. *Id.* at 782.

433. *Id.* at 783 (Ginsburg, J., dissenting).

insignificant.<sup>434</sup> This again, reflects the cavalier attitude that many courts have taken towards discriminatory taxation.

Clearly, the New York Court of Appeals issued a very flawed opinion in *Lunding*. This opinion illuminates the lack of consideration given to nonresidents. It shows a lack of consideration given to the decisions of the supreme courts of other states such as the *Wood* decision. It illustrates how an inattentive legislature can create a statute which is clearly unconstitutional, yet is given a presumption of constitutionality, without giving any consideration or explanation for its discriminatory policy.<sup>435</sup> The Court gave no consideration to the history of the statutes. The whole saga cost the State large sums to litigate. And, a substantial number of taxpayers were left with no remedy for the unconstitutional position taken by the legislature since 1987. The statute of limitations only allows refunds for taxable years beginning in 1994 and later.<sup>436</sup>

#### CONCLUSION

Legislatures, in search of new revenue sources, and extremely wary of unruly constituents, have turned their taxing power towards the helpless, the non-constituent. The resulting taxes are becoming more discriminatory and aggressive. The non-constituents generally cannot wield the necessary economic power to force the repeal of these taxes. Legislatures have no interest in protecting a class of people who cannot vote against them. The state courts have shown a shocking indifference to the plight of the nonresident taxpayer. The resulting taxes threaten the economic well being of interstate commerce. The threat is greatest to the increasing number of people who commute to another state to seek employment. But, it also exists for those individuals and businesses who travel to another state to carry on business and must rent cars and hotel rooms. In addition, travelers to another state will be subject to discriminatory taxes aimed at nonresidents. The Constitution provides adequate remedies in the privileges and immunities clause and the equal protection clause. It is up to the federal courts to provide the constitutional protection for the nonresident taxpayers. It appears that the state courts are unlikely to provide protection to nonresidents. The most likely success will be to avoid the traditional route of appeal through the state courts, and go directly to the federal courts with a constitutional challenge. The Supreme Court's decision in *Lunding* provides an opportunity to expand upon

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434. See *id.* at 754 (Ginsberg, J., dissenting).

435. See James Dao, "Rank and File of Albany Chafing at Their Bit Parts," N.Y. TIMES, Jan. 3, 1998, at A1 (describing the inattentiveness given by the legislature to legislative matters).

436. N.Y. TAX LAW § § 681(c), 683(a), 687(a)(McKinney 1987).

the "substantial justification requirement." The clearest argument should be that there can never be a substantial justification for the discriminatory tax.

It seems that the purpose of the Privileges and Immunities Clause was to ensure that other states treated nonresidents fairly, that these nonresidents receive the same protection afforded a resident. In addition, the Clause is meant to guarantee the ability of a citizen of the United States to seek his or her earnings in any state without interference from one state. The types of trade barriers common in trade amongst countries are to be avoided between states. The courts must be vigilant in protecting citizens from these increased costs imposed on nonresidents by some states. The reality is that subterfuge and complexity, either with knowledge or by operation, are used to conceal the discriminatory taxes to the greatest extent possible. The federal courts appear to be the only place that a citizen can gain protection from discriminatory state taxation. The state courts have been protective of their statutes. What is occurring now is exactly what the Constitution sought to prevent—the beginning of trade wars, in the form of taxation, by individual states against the citizens of other states.

There is adequate history and movement in the interpretation of the Privileges and Immunities Clause to support a stronger stance against facial discrimination by one state against the citizens of another state. In addition, the possible economic dislocations, inefficiencies and disincentives possible in discriminatory taxing schemes should be avoided. The courts need to apply a more broadly based test of discrimination with respect to taxation of nonresidents by any state. If the practical effect of a tax is to discriminate substantially against a broad based class of nonresidents, and if it has no specific rationale, designed to attack a peculiar source of evil, which explains its discrimination, then it should be struck down. The specific rationale could only be some specific matter of increased state expenses generated by the class of taxpayers upon whom the tax is imposed. There have been very few instances in which a state enacted a discriminatory tax with any other purpose than to tax non-constituents at higher rates. The reasons attached to construction of facilities break down to selfish reasoning of the taxing state.

