State Taxation of Nonresidents’ Deferred Income: The Eroding Future of Source Taxation

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The federal government’s 1996 budget dilemmas are not only indicative of the Washington political scene but of the indecisive and fickle nature of American taxpayers who demand a federal government that spends less and imposes less taxes, but nevertheless maintains popular social programs. This struggle is not unique to the federal government but is shared, in ever-increasing numbers, by state governments and local municipalities. In a time when taxpayers are demanding more for less, states are similarly forced to be more creative in balancing revenues and expenditures. However, just when every revenue dollar is desperately needed, states are being prohibited by federal law from imposing taxes on nonresidents’ pension benefits and ignoring deferred income that is crossing state lines.

“Source taxation,” which grants states the authority to tax nonresidents on any income derived or “sourced” within the state, has been firmly established for over 75 years.1 It allows states to tax nonresidents

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1. See notes 11–14, below, and the accompanying text.
who earn money and sell property within the state. For California alone, "source taxes" bring in revenues of more than $500 million annually. Source taxation also allows states to tax former residents on deferred income or gain that was earned or accrued when that taxpayer was a resident of the state. On January 10, 1996, President Clinton signed legislation into law that bars state and local governments from imposing income taxes on specified retirement income of nonresidents. This law safeguards nonresidents receiving distributions from a wide assortment of retirement or deferred compensation plans from paying income taxes to the state where the distributions were "sourced" or earned, but where they are no longer residents. This law, effective for distributions received after December 31, 1995, is expected to cost states that enforced source taxation on nonresidents' pension before the enactment of the federal law, over $75 million annually; including $25 million for California, $9 million for New York, and $3 million for Kansas, among other states.

A majority of the states are further losing essential revenue by implicitly adopting federal taxation law which provides for the deferral of recognition of gain or income in certain instances. The most consequential of these deferral transactions, in addition to pension benefits, are replacement of principal residences, like-kind exchanges, and involuntary conversions. Although it poses no unique issues or problems when applied to taxpayers who remain residents of the state, this state conformity to federal law has different results when applied to nonresidents; for example, when a taxpayer sells his or her principal residence in the state and reinvests the gain into a new residence located in another state or enters into a like-kind exchange involving replacement property in another state. In these situations, a majority of the states that conform to the federal law, which provides for nonrecognition of that gain until the disposition of the replacement property, never impose tax on the deferral. This is primarily due to the difficulty of tracking interstate transfers of such deferred gains, resulting in the permanent loss of tax revenue on that deferred income. In light of this lost revenue, along with the new federal law affecting nonresident pensions, states must reevaluate their

3. See notes 137-140, below, and the accompanying text.
6. See note 68 and the accompanying text.
position on the source taxation of nonresident deferred income as a whole; specifically, whether conformance to federal tax law is still in their best interests from a fiscal and a policy viewpoint.

GENERAL PRINCIPLES OF STATE TAXATION OF PERSONAL INCOME

State Income Tax Schemes

A state’s power to tax income is based on two fundamental but alternative foundations: residence and source. The U.S. Supreme Court has addressed both of these alternatives. In Cohn v. Graves, the Supreme Court discussed the residence-based approach:

That the receipt of income by a resident of the territory of a taxing sovereignty is a taxable event is universally recognized. Domicile, itself, affords a basis for such taxation. Enjoyment of the privileges of residence in the state and the attendant right to invoke the protection of its laws are inseparable from the responsibility for sharing the costs of government.7

The decision in Cohn v. Graves undisputedly established the states’ power to tax residents on all worldwide income, regardless of the location from which the income is derived. As a result, states normally define what constitutes a “resident.” For most states, the definition of a resident is inextricably linked to the concept of domicile.8 Domicile itself establishes a sufficient basis for taxation.9 “Enjoyment of the privileges of residence within the state, and the attendant right to invoke the protection of its laws, are inseparable from the responsibility for sharing the costs of government.”10

The source income theory of income taxation stems from the general authority that the states have over all persons, property, and business transactions within their borders. In addition to asserting authority, the state provides protection to the persons who earn income, their property,

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8. S Goldstein, “Resident’ Taxpayers: Internal Consistency, Due Process, and State Income Taxation,” 91 Columbia L Rev 119, 120, 121, notes 11, 12 (1991). “Domicile” has a predominantly common law meaning: “the place which an individual intends to be his permanent home—the place to which he intends to return whenever he may be absent.” An individual does not lose domiciliary status by moving to a different state unless he or she intends to make the second state a permanent home. Id at 121 and n13, n14.
9. Lawrence, 286 US at 279; Cohn, 300 US at 312; Maguire v Trefry, 253 US 12, 14, 17 (1920).
10. Id.
and the activities they pursue within its jurisdiction. As previously mentioned, the authority to tax nonresidents on any income derived within the state, referred to as "source" taxation, has been firmly established for over 75 years. In *Shaffer v. Carter*, the Supreme Court articulated this source-based approach:

In our system of government, the States have general dominion, and, saving as restricted by particular provisions of the Federal Constitution, complete dominion over all persons, property, and business transactions within their borders; they assume and perform the duty of preserving and protecting all such persons, property, and business, and, in consequence, have the power normally pertaining to governments to resort to all reasonable forms of taxation in order to defray the governmental expenses. . . . That the State, from whose laws property and business and industry derive the protection and security without which production and gainful occupation would be impossible, is debarred from exacting a share of those gains in the form of income taxes for the support of the government, is a proposition so wholly inconsistent with fundamental principles as to be refuted by its mere statement. 12

The Court further stated that, just as a state may impose general income taxes upon its own residents subject to its control, "it may, as a necessary consequence, levy a duty of like character, and not more onerous in effect, upon incomes accruing to non-residents from their property or business within the State, or their occupations carried on [within the State]. . . ." 13 The source tax, therefore, can apply both in theory and practice to any type of deferred income, such as pension income, when a taxpayer who worked in a state where the employer contributed to a qualified pension plan, moves to another state upon retirement. For example, if a taxpayer earned wages and deferred pension contributions from her employer in Missouri and moved to Florida upon retirement, that taxpayer would pay income taxes to Missouri on those pension distributions. 14 In states that levy no individual income tax, such as Alaska, Florida or Nevada, continued taxation by the source state is an unwelcome reality.

From these theories of taxing jurisdiction emerge the settled constitutional principles that states generally tax residents on their worldwide income, regardless of where it was derived, and nonresidents on income

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13. Id at 52.
14. See notes 124–126, below, and the accompanying text for an explanation of what constitutes distributions from a pension or qualified retirement plan.
earned in that state. As a consequence of these settled principles, taxpayers who are domiciliaries in one state but earn income in another state encounter possible double taxation. Accordingly, most states provide tax credits in recognition of income tax paid to other states. However, in states with no individual income tax, a source-based tax will create an otherwise nonexistent tax obligation, with the accompanying tax credit having no practical effect.

Constitutional Limitations on State Taxation

The Constitution's Due Process Clause and Commerce Clause restrict states' ability to decide whose income and which sources of income may be taxed. The Due Process Clause prohibits extraterritorial taxation. The "Dormant" Commerce Clause prohibits states from discriminating against, or placing undue burdens upon, interstate commerce. Although their purposes differ, these two clauses often impose analogous restrictions on a state's authority to tax. In addition, the Supreme Court has invoked other constitutional provisions, including the Equal Protection Clause and the Privileges and Immunities Clause, as bases for limiting the states' authority to tax. A brief overview of these constitutional provisions will center on a state's ability to tax the deferred income of former residents, now nonresidents.

Due Process Clause Under the Due Process Clause, a state cannot tax an individual who has never been a resident of, or earned income in, the state. In other words, the states must have some connection to the income sought to be taxed. The general test under the Due Process Clause for taxing nonresidents was first articulated by the Supreme Court in *Wisconsin v. J.C. Penney Co.*:

[The] test is whether property was taken without due process of law, or,... whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return.

15. See note 11 at 23.
18. See note 8, above, at 127, 128.
19. US Const, Art 14, Sec 1 ("nor shall any State deprive any person of life, liberty, or property without due process of law").
Basically, this standard requires a two-prong analysis: (1) There must be “some definite link, some minimum connection between a State and the person, property, or transaction it seeks to tax”;21 and (2) even if the taxpayer has sufficient nexus to the state’s taxing jurisdiction, the measure of the tax must fairly reflect the taxpayer’s activities in the state.22 As to the second prong, the proportion of income taxed by a state must be rationally related to the services, benefits, and protections provided while the taxpayer either earned income or owned property in the state.23

In determining whether a nonresident individual is subject to state income taxation, the analysis is similar to the determination of a state’s personal jurisdiction over an individual: sufficient minimal contacts.24 The test essentially becomes one of determining whether the state has given anything to the individual for which it can ask for something in return.25 In the case of source taxation of deferred income of nonresidents,26 nonresidents will almost certainly be found to have availed themselves of the state’s protections and benefits when the taxpayer deferred either the pension income from services performed in the state or owned commercial property located in that state. Accordingly, a due process challenge to such taxation will likely fail.

**Commerce Clause** The Commerce Clause27 threatens the viability of a source tax by requiring that a state tax must not unduly burden interstate commerce. As a consequence, Congress possesses virtually unlimited power to establish uniform rules for state taxation systems affect-

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22. Moorman Mfg Co v Bair, 437 US 267, 272, 273 (1978) (“the income attributed to the State for tax purposes must be rationally related to 'values connected with the taxing State.'”); Norfolk & W. Ry. Co v Missouri State Tax Commission, 390 US 317, 325 (1968). The concept of taxing only income attributable to the state most often arises when a corporation does business in many states, but it can also arise when an individual has worked in a number of states for either a single employer or multiple employers. For instance, pension distributions from the employer(s) may be subject to tax in varying amounts in more than one state. See Klaiman, note 17 above, at 654.

23. Quill, 504 US at 308.


26. Source taxes routinely raise concerns about possible double taxation. As previously discussed, these concerns are usually addressed by most states’ grants of tax credits. Nevertheless, the Supreme Court has consistently held that the burden of double or multiple taxation does not violate due process exclusive of other factors. See Guaranty Trust Co v Virginia, 305 US 19, 23 (1938). However, the possibility of double or multiple taxation does evoke profound Commerce Clause concerns.

27. US Const, Art 1, Sec 8, Cl 3 (Congress has the power “[t]o regulate Commerce with foreign Nations, and among the several States.”).
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ing interstate commerce, including prohibiting the state taxation of nonresident income. In Complete Auto Transit, Inc. v. Brady, the Supreme Court enunciated a four-prong test to determine whether a state tax can sustain a Commerce Clause challenge. A tax will meet the restraints of the Commerce Clause if it: (1) is applied to an activity with a substantial nexus within the taxing state; (2) is fairly apportioned; (3) does not discriminate against interstate commerce; and (4) is fairly related to the services provided by the state. State source taxation of nonresidents' deferred income, such as pension plan distributions or the gain from the sale or exchange of property located in that state, generally satisfies each of the four prongs in most instances.

As to the "substantial nexus" requirement, the Court has recently drawn a distinction between the nexus required by the Commerce Clause and the nexus required by the Due Process Clause in Quill Corp. v. North Dakota. The Court observed that the Commerce Clause's "substantial nexus requirement is not, like due process' minimum contacts requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce.” As a consequence, "a corporation may have the 'minimum contacts' with a taxing state as required by the Due Process Clause, and yet lack the 'substantial nexus' with the State as required by the Commerce Clause." As applied to nonresidents’ deferred income, such as pension distributions or gains from a sale or exchange of property located in that state, substantial nexus to the source state usually exists.

As to the second prong's applicability to source taxation of nonresidents, the "fair apportionment" requirement more typically applies to a corporate taxpayer doing business in several states than a nonresident individual, except in the case of a taxpayer who has worked in a number of states for either a single employer or multiple employers. For instance, if a taxpayer worked for a single employer in multiple states or for several employers in several states, each state is entitled to tax the portion of the pension distributions earned in that state. While a state tax provision

30. Quill, note 21, 504 US at 313.
31. Id at 313.
32. In Container Corp of America v Franchise Tax Board, 463 US 159 (1983), the Court observed that the fair apportionment requirement triggers an inquiry into whether the tax is "internally and externally consistent.” The “internal consistency” requires that a tax be structured so that if every state were to impose an identical tax, no multiple taxation would result. Id at 169. A tax is "internally consistent" if a formula, when applied, results in no more than all of the income being taxed. In the context of a taxpayer who worked in several states for one employer or for several employers, as long as each state only taxes the portion of the pension contributions made while the taxpayer worked in that state, no internal consistency problems would arise. See generally Hellerstein, “Is
may fail to fairly apportion pension income according to the services rendered in-state, this flaw is not inherent in the concept of source taxation as a whole.\textsuperscript{33}

The third prong of the \textit{Complete Auto Transit} test—discrimination against interstate commerce—does not consistently affect the source taxation of nonresidents' deferred income. In addition to the interference with interstate commerce not being evident, whether a pension payment or recognition/rollover of gain across state lines constitutes interstate commerce is equally unclear.\textsuperscript{34} As discussed below, a state's employment of an in-state replacement requirement for nonrecognition of deferred gain, specifically in a like-kind exchange or involuntary conversion, raises some profound interstate commerce concerns.\textsuperscript{35}

The final prong is the fair relation of the tax to the taxpayer's activities within the state. This test ensures that a state's tax burden is not placed upon taxpayers who do not receive a benefit from services provided by the state.\textsuperscript{36} As discussed in the context of the Due Process Clause, the source taxation of nonresidents typically reflects the services, benefits, and protections provided by the state while the taxpayer was earning contributions by their employer to a pension plan or owned property located in the state.\textsuperscript{37}

**Privileges and Immunities Clause**  The Privileges and Immunities Clause states that "the Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States."\textsuperscript{38} The primary purpose behind the Privileges and Immunities Clause is to ensure fair treatment of citizens of other states. In \textit{Ward v. Maryland}, the Supreme Court explained:

\textsuperscript{33} Klaiman, note 17, above, at 657.

\textsuperscript{34} Id.

\textsuperscript{35} See notes 120 and 121, below, and the accompanying text.

\textsuperscript{36} Fernandez and Naughtin, note 32, above, at 5.

\textsuperscript{37} In Commonwealth Edison Co v Montana, 453 US 609 (1981), the Supreme Court held that the relevant inquiry under the "fairly related" test is closely connected to the nexus requirement. The inquiry, therefore, is whether the tax is reasonably related to the extent of the taxpayer's contact with the taxing state, "since it is the activities or presence of the taxpayer in the state that may properly be made to bear a just share of state tax burden." Id at 626 (quoting Western Life Stock v Bureau of Revenue, 303 US 250, 254 (1938)).

\textsuperscript{38} US Const Art IV, Sec 2, Cl 1. Note that the Privileges and Immunities Clause protects only individuals as "citizens," as compared to the Commerce Clause which provides protection to individuals and corporations.
It will be sufficient to say that the Clause plainly and unmistakenly se­
cures and protects the rights 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 . . . and to be exempt from any higher
taxes or excises than are imposed by the State upon its own citizens.39

The Clause requires only that the states treat residents and nonresidents
without unnecessary distinctions when a nonresident seeks to engage in
an essential activity or to exercise a basic right.40 In the case of pension
distributions, source taxes typically do not impose a burden on nonresi­
dents to which residents are not also subject.41 Taxpayers who remain
residents will also pay tax on their pension distributions when received.
Absent a state imposing a greater tax burden on nonresidents receiving
retirement income than residents, a source tax on pension distributions
will not solely violate the Privileges and Immunities Clause. For
instance, if the state imposes a tax on pension contributions when a tax­
payer becomes a nonresident as opposed to residents who are taxed only
when distributions are received upon retirement, the state is imposing a
greater burden on nonresident taxpayers by eliminating the benefit of de­
ferral and imposing a tax at an earlier time. The constitutionality of
source taxes on other types of deferred income in light of the Privileges
and Immunities Clause will be discussed in greater detail below.

Equal Protection Clause  The Equal Protection Clause provides
that no state will "deny to any person within its jurisdiction the equal
protection of its laws."42 Although the Supreme Court has interpreted the
Clause to prohibit the states from making unreasonable classifications,
the states nevertheless enjoy broad discretion in creating classifications
for tax purposes:

39. Ward v Maryland, 12 Wall 418 (1870); Allied Stores of Ohio, Inc v Bowers, 358 US 522, 530
(1959).
40. Krasney, note 24, above, at 409 (citing JD Varat "State 'Citizenship' and Interstate Equality,"
down license fee that discriminated against nonresidents under the Privileges and Immunities
Clause); Austin v New Hampshire, 420 US 656, 665 (1975). In Austin, the Supreme Court declared
the New Hampshire Commuters Income Tax unconstitutional because the tax treated the citizens of
New Hampshire and nonresidents unequally. The tax subjected nonresidents earning income in the
state to an income tax on earnings not taxed by the nonresidents' state, but failed to tax New
Hampshire on their income, regardless of where the income was derived. This treatment of nonresi­
dents was discriminatory and in violation of the Privileges and Immunities Clause because it only
taxed nonresidents and failed to offset this taxation with other taxes exclusively applying to citizens.
41. Kiaiman, note 17, above, at 655. Before Federal legislation enacted in 1996, all but ten states
effectively favored nonresidents by not taxing their retirement benefits. See note 132, below, and
accompanying text.
42. US Const Amend XIV, Sec 1.
Where taxation is concerned and no specific federal right, apart from equal protection, is imperiled, the States have large leeway in making classifications and drawing lines which in their judgment produce reasonable systems of taxation.\textsuperscript{43}

As opposed to the Commerce Clause, which is designed to protect commerce and to promote free trade among the states, the Equal Protection Clause protects individual taxpayer groups.\textsuperscript{44} The Equal Protection Clause is "concerned with whether a state purpose is impermissibly discriminatory."\textsuperscript{45} Equal protection analysis involves the following inquiry: "(1) Does the challenged legislation have a legitimate purpose? and (2) Was it reasonable for the lawmakers to believe that use of the challenged classification would promote that purpose?"\textsuperscript{46}

In the context of source taxation of nonresidents, if a state holds nonresidents to the same reporting requirements on deferred income as it holds residents, no equal protection claim exists. Any separate or different classification by a state must be rationally related to a legitimate state interest in order to withstand a constitutional challenge.\textsuperscript{47} However, state tax statutes that discriminate against nonresidents are vulnerable to constitutional invalidation under the Equal Protection Clause. For instance, a state tax exemption that is limited only to those taxpayers who fulfill a rigid residency requirement violates the Equal Protection Clause.\textsuperscript{48}

\textsuperscript{43} Lehnhausen \textit{v} Lake Shore Auto Parts Co, 410 US 356, 359 (1973); Allied Stores \textit{v} Bowers, 358 US 522, 526, 527 (1959), which provided:

But that clause [Equal Protection] imposes no iron rule of equality, prohibiting the flexibility and variety that are appropriate to reasonable schemes of taxation. The State may impose different specific taxes upon different trades and professions and may vary the rate of excise upon various products. It is not required to resort to close distinctions or to maintain a precise, scientific uniformity with reference to composition, use or value.


\textsuperscript{45} Metropolitan Life \textit{v} Ward, 470 US 869, 876, 877 n6 (1985).

\textsuperscript{46} Western \& Southern Life \textit{v} Ward, 470 US 869, 876, 877 n6 (1985).

\textsuperscript{47} Western \& Southern Life \textit{v} State Board of Equalization, 451 US 648, 668 (1981) (holding tax is valid if the legislature "rationally could have believed" tax would serve its objective); San Antonio Indep Sch Dist \textit{v} Rodriguez, 411 US 1, 40, 41 (1973) (requiring "some rational relationship to legitimate state purposes").

\textsuperscript{48} Hooper \textit{v} Bernalillo County Assessor, 472 US 612 (1985). New Mexico statute granted tax exemption to Vietnam veterans who resided in the state before May 8, 1976. The Supreme Court struck down the statute as violative of the Equal Protection Clause because it favored established residents over new residents.
STATE SOURCE TAXATION OF FEDERALLY DEFERRED INCOME

State Conformity to Federal Nonrecognition Rules

Of the states that levy an income tax on individuals, a majority conform to the federal Internal Revenue Code. Accordingly, the federal nonrecognition rules which provide for the deferral of recognition of gain or income in certain instances are typically followed by conforming states. The most consequential deferral transactions involve like-kind exchanges, involuntary conversions, replacements of principal residences, and pension or deferred compensation arrangements. This conformity by states usually poses no unique issues independent of those raised in the federal context. However, that statement lacks veracity when the deferral crosses state lines. For example, if a taxpayer reinvests the gain from the sale of a former residence into a new residence located in another state or a like-kind exchange involves property in another state, two immediate issues arise: (1) When should the income be recognized? and (2) Where should the income be recognized?

Once the taxpayer to whom the deferred income or gain relates is no longer a resident, the state's ability to tax is source-based as opposed to residence-based. This source taxation of deferred income raises specific issues involving tax policy, timing, record keeping, and constitutional considerations. These issues are comparatively analyzed in the context of the following nonrecognition transactions: (1) nonrecognition of gain from the sale of a personal residence by a taxpayer who moves to another state; (2) nonrecognition of gain from the exchange of like-kind


50. Tax Management Multistate Tax Portfolios, Incorporation of Internal Revenue Code (updated as of Sep 30, 1995) [S-13, 0301-0303].

51. IRC §§ 1031, 1033, 1034, and 402. It is important to note that these deferral transactions are exceptions to the general rule that a sale or exchange of property by a taxpayer immediately triggers a taxable event for federal tax purposes. The proceeds from the sale are decreased by the taxpayer's adjusted basis in the property resulting in either a gain or loss which is normally recognized in the year of the sale. IRC § 1001(a),(c).

In addition to the deferral transactions referred to in the text, another aberration on this general rule is a one-time exclusion of gain from the sale of a principal residence up to $125,000 by a taxpayer over the age of 55. IRC § 121. Furthermore, under IRC § 1014(a), heirs are permitted to take property transferred at death with a fair market value basis as determined on the date of the decedent's death.


53. See notes 7–13, above, and the accompanying text.
property located in different states; and (3) nonrecognition of income from deferred compensation or pension arrangements if the taxpayer no longer resides in the state of her former employment. For most states, the difficulty of tracking interstate transfers of deferred gains on the sale or exchange of property ultimately results in the permanent loss of tax revenue on that deferred income. In the context of taxing the pension distributions of former residents, a newly enacted federal law eliminates the possibility of source taxation by the state or states where the taxpayer was employed at the time the deferral was permitted.

This following discussion compares federal treatment with state treatment, in the context of nonresidents, of the deferral or nonrecognition transactions. The discussion of states' treatment centers on the four categories or approaches adopted by states: (1) forgiveness of tax on the deferred gain; (2) adoption of federal treatment or "federal piggybacking"; (3) requirement of in-state replacement for nonrecognition; and (4) change in residency triggering recognition of gain.

Replacement of Principal Residence

Federal Treatment  If a taxpayer sells his or her principal residence and, within a period beginning two years before the date of the sale and ending two years after the date, purchases a new residence that he or she intends to use as the principal residence, the gain from the sale is recognized only to the extent that the "adjusted sales price" of the old residence is more than the cost of the new residence. This nonrecognition rule is an exception to the general rule that the gain from the sale of property is realized and recognized at the time of the sale. If the nonrecognition rule applies, the taxpayer may not elect to recognize the gain; in other words, application of the nonrecognition rule is mandatory. In addition, no losses are recognized without regard to Code Section 1034.

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54. The investment of proceeds from the involuntary conversion of property in similar property located in another state raises almost the same issues as like-kind exchanges.
55. See note 68, below, and the accompanying text.
56. See notes 137–140, below, and the accompanying text.
57. Smith and Hellerstein, note 52 above, at 354-359.
58. IRC § 1034(a). "Adjusted sales price" means the amount realized from the sale reduced by selling expenses including work performed on the old residence in order to assist in it sale. IRC § 1034(b)(1), (2). The "amount realized" on the sale of the old residence includes the money received and the fair market value of any property received. Treas Reg § 1.1034-1(b)(4)(ii). The deferral rule only applies with regard to the "cost" of the new residence and not its fair market value. See, e.g., Richards v Commr, TC Memo 1993-422. The cost of the new residence includes cash paid, acquisition expenses incurred such as commissions, and any indebtedness to which the property is subject whether or not assumed. Treas Reg § 1.1034-1(c)(4)(i).
59. Treas Reg § 1.1034-1(a).
This deferral of gain recognition can ultimately lead to either full or partial absolution of the deferred gain. If the taxpayer sells the new residence after reaching the age of 55, he or she may elect to exclude up to $125,000 of the gain from recognition and ultimate taxation. If the taxpayer continues to own a residence with unrecognized gain, including a previously rolled-over gain from a prior residence, the built-in gain on that residence will be totally forgiven upon his or her death.

A vast majority of the 50 states implicitly adopt these federal deferral rules by adopting federal adjusted gross income as their computational starting point for determining the state personal income tax liability. Consequently, these states generally only tax the deferred gain when the residence is sold in a federally taxed transaction. The federal rules consistently apply without regard to whether the taxpayer rolls over the gain from his or her old residence to a new residence in the same state or in another state. However, an interstate move by the taxpayer could mean that the state where the old residence was located forever loses the opportunity to ultimately collect tax revenue on that deferred gain. This potential loss similarly arises at the federal level in an international context, for example, when a United States citizen sells his or her residence in this country and purchases a new residence abroad. Although the occurrence of such transfers of deferred gain are small in comparison to interstate transactions, the same policy decisions and choices of treatment encountered by the states similarly confront the federal government. Current federal taxation law allows a taxpayer who purchases a new residence in a foreign country to defer recognition of gain from the sale of the U.S. residence.

An interstate move raises disconcerting issues for the affected states: (1) Which state should tax the deferred gain, that is, the state from which the taxpayer is leaving or the state to which the taxpayer is moving, and when should the gain be taxed? (2) Should the state of former

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60. IRC § 121.
61. IRC § 1014(e)(1). The person to whom the residence is devised by will or intestate will take a fair market value basis in the residence.
62. Smith and Hellerstein, note 52 above, at 353.
63. Id at 350 n6.
64. Rev Rul 71-495, 1971-2 CB 311. A resident alien sold his U.S. residence at a gain, returning to Norway (his country of citizenship) permanently. The ruling does not address whether the United States will ever tax the Norwegian citizen's deferred gain.

If the taxpayer is a nonresident alien individual, nonrecognition of gain is granted "only in the case of an exchange of a United States real property interest for an interest the sale of which would be subject to taxation [in the United States]." IRC § 897(e). Furthermore, IRC § 877 also applies if tax avoidance is a major purpose for expatriation by a U.S. citizen, taxing the gain on a sale or exchange of foreign replacement property as income from the U.S. source for a ten-year period. See Smith and Hellerstein, note 52, above at 350 n6.
residency, or "state A," tax the former resident upon his or her departure despite the continuance of federal deferral? Because this article centers on a state's source taxation of nonresidents, the discussion focuses on the possible courses of action for state A.

State Treatment for Nonresidents Assume the following situation exists: A Missouri resident and homeowner is selling her home located in Missouri (state A) at a gain, moving to Virginia, and reinvesting the sale proceeds in a home located in Virginia (state B), thus deferring recognition of the gain for federal tax purposes. This interstate move by the taxpayer poses a perplexing and challenging policy decision for state A: Should Missouri require the taxpayer to recognize and pay tax to Missouri on the federally deferred gain from the sale of her former Missouri residence? States basically employ one of the four following approaches to address this policy decision challenge:

1. Forgiveness of tax on the deferred gain;
2. Federal piggybacking;
3. In-state replacement; and
4. Taxable trigger.

Forgiveness of Tax on the Deferred Gain. A majority of the states inadvertently employ the easiest of the four approaches—ignoring the deferred gain upon the taxpayer's move to another state. This approach is also the simplest to administer from an enforcement and from a collection stance. Once a taxpayer moves to another state, most state tax administrative agencies lose contact with the taxpayer, who has become a nonresident. In addition, most tax agencies have no mechanism in place

65. Id.
66. The central issue for State B involves how much, if any, of the realized but unrecognized gain from the old residence can it tax upon a subsequent, federally taxed disposition of the new residence. State B's alternatives include full taxation of the recognized gain from the disposition of the new residence, exemption of previously deferred gain, and the grant of a fair market basis to the new residence upon purchase, thus exempting the new resident's former state activities from taxation ("fresh start" approach). See Smith and Hellerstein, note 52, above, for a more detailed and informative discussion on the tax policy and the constitutional considerations facing the new state.
67. See note 57, above, and the accompanying text.
68. Smith and Hellerstein, note 52, above, at 354, 355. The authors also commented in the article that their conclusion about a majority of the states' "laissez faire" attitude towards the deferred gains that leave the state with the former residents is based on the fact that no state, except North Dakota, has legislation that explicitly authorizes the taxation of the federally deferred income (upon federal recognition). The authors also added that they made informal inquiries to state tax authorities to confirm their conclusions. Id at 355, n29.

In addition, because a majority of the states do adopt the federal adjusted gross income as a starting point for state tax computation, it is difficult to track just how much income states lose by not tracking former residents that carry deferred gains or income across state lines.
to monitor the whereabouts of a former resident.\textsuperscript{69} The practicalities of developing such a monitoring system are limited, as discussed in greater detail in the context of federal piggybacking. The result is a complete ab­solution by state A of any tax on the deferred gain and a loss of revenue, which is contrary to the state’s fiscal interests. Despite the financial drawbacks of this approach to state A, the adoption of this approach raises no constitutional concerns or limitations on the state’s ability to tax.

\textit{Federal Piggybacking}. State A’s adoption of this approach requires strict adherence to the federal nonrecognition rules. Primarily, this entails that state A, like the federal government, must wait until the taxpayer sells or disposes of her replacement residence in the new state in a transaction taxable under the Internal Revenue Code.\textsuperscript{70} Although most states’ statutes are constructed in a manner that implicitly calls for federal piggybacking, most inadvertently adopt the policy of totally ignoring or forgiving the deferred gain, as previously discussed.\textsuperscript{71} North Dakota’s statute is the one example of a state that explicitly adopts the federal piggybacking approach:

\begin{quote}
Any gain or loss resulting from the sale or exchange of a principal residence in this state by a taxpayer who reinvests in another principal residence outside of this state must be treated in the same way for state income tax purposes as it is treated for federal income tax purposes.\textsuperscript{72}
\end{quote}

\footnotesize{
\textsuperscript{69} Taylor v Conta, 106 Wis 2d 321, 316 NW 2d 814 (1982); Taylor is discussed in greater detail in notes 81–86, below, and the accompanying text. In Taylor, the Wisconsin Supreme Court upheld a statute (despite its repeal in 1981 before the case was heard) that taxed the deferred gain on the sale of a Wisconsin residence when the replacement residence is located out of state despite its disparate treatment of residents and nonresidents. One of the court’s justifications for upholding the statute’s differential treatment was the administrative difficulties to both the state and nonresidents if the state were compelled to keep track of former residents until the “taxability of the ‘deferred gain’ was conclusively determined.” Id, 316 NW 2d at 825. See notes 87, 88, below, and the accompanying text for a discussion of Kuhnen v Musolf, 143 Wis 2d 134, 420 NW 2d 410 (App 1988) which revisited this statute and the discrimination issues.

\textsuperscript{70} The former state will only be able to tax the amount of the deferred gain from the sale of the residence in the former state. Any appreciation that occurs in the new state cannot be taxed by the former state; the former state is limited to “sourced” gain. See notes 11–13 above, and the accompanying text.

\textsuperscript{71} See notes 68, 69, above. In addition, the possibility still exists that the deferred gain will never be recognized for federal purposes if the taxpayer elects the lifetime exclusion of up to $125,000 of the gain under IRC § 121 or dies still owning the residence, in which case the devisee or heirs will take a fair market value basis under IRC § 1014. See notes 60, 61, above, and the accompanying text.

\textsuperscript{72} ND Cent Code § 57-38-01.13 (1995).}

The states clearly possess the constitutionally sanctioned authority to tax nonresidents upon income derived from sources within the state.\textsuperscript{73} The taxpayer's nonresidency status has no effect on state A's ability to tax the portion of the federally recognized gain with a source in state A.\textsuperscript{74} However, the administrative difficulties in adopting this approach are significant. In a tax system based on voluntary compliance, it is unlikely that former residents will know to file a nonresident return with their former state when, at some indefinite point in the future, they actually recognize gain for federal tax purposes on a disposition of the replacement residence. This reality places the burden on state A to monitor and discover the former resident's federally taxable transfer of her new residence in state B or even state C, if the taxpayer again rolls over the gain from the residence in state B to a new residence in state C. State A could employ a system of monitoring the federal income tax returns of former residents to determine if any taxable disposition of the new residence occurs.\textsuperscript{75} In addition, some states have required the posting of a bond or submission of a percentage of the consideration on the sale of the in-state residence to ensure that the deferred gain does not escape taxation upon the taxpayer's departure.\textsuperscript{76}

Although state A's employment of the federal piggybacking approach may lack efficiency and effectiveness, the approach does not discriminate against nonresidents or produce inequitable results. The taxpayer who moves interstate receives the exact same treatment as the taxpayer who moves intrastate in terms of continuing nonrecognition of gains rolled over into replacement property and the eventual encumbrance of tax if a federally taxable disposition of the new residence occurs. This similar treatment also ensures that no constitutional issues are raised.

\textsuperscript{73} See notes 11–13, above, and the accompanying text; see also New York ex rel Cohn v Graves, 300 US at 312, 313; Lawrence v State Tax Comm, 286 US at 276.

\textsuperscript{74} See Smith and Hellerstein, note 52, above, at 357. The authors make an important analogy between a former resident of state A selling a replacement residence in state B and a nonresident, having never resided in state A, selling real estate situated in state A at a gain. The nonresident's sale of real estate is treated as income by the state where the real estate is located, under the "source" tax scheme. The two fact patterns are "functionally identical" if the taxpayer moved from state A to state B, and entered state B as a new resident before she was able to sell her residence in state A. In that case, she was a nonresident at the time of realization and at the time of recognition of the gain on the sale of the state A residence. Id.

\textsuperscript{75} Id at 358. This would include monitoring federal Form 2119, "Sale of Your Home," and Schedule D, "Capital Gains" (the former resident did not engage in another Section 1034 tax-free rollover). Smith and Hellerstein also mentioned the possibility of filing a state tax lien in the new state on the replacement property.

\textsuperscript{76} See notes 93, 94, below, and the accompanying text.
Requiring In-State Replacement for Nonrecognition. State A's adoption of this approach is similar to the federal piggybacking approach, with one major difference: to continue to defer the gain, for state tax purposes, the replacement residence must be located in state A. In other words, if the taxpayer's replacement residence is in state B, the sale of her state A residence triggers realization and recognition of any built-in gain. The administration of such an approach is more efficient than having to monitor possible out-of-state future activities and ensures that state A collects its tax revenues. This in-state replacement approach is present in the statutory schemes of Alabama, Arkansas, and Hawaii. For example, Alabama's statute states:

Rollover of gain on sale of principal residence. If a taxpayer sells his principal residence and purchases a new principal residence located within Alabama and if the requirements of 26 U.S.C. § 1034 are satisfied, then the amount of gain recognized on such sale shall be computed in accordance with said 26 U.S.C. § 1034.

However, the requirement of in-state replacement raises some serious constitutional issues in addition to the equitable concerns of imposing tax burdens on interstate moves that are not likewise imposed on intrastate moves. The primary constitutional challenge falls under the Privileges and Immunities Clause, claiming that the statutory denial of nonrecognition to nonresidents is discriminatory. A decision rendered by the Wisconsin Supreme Court in Taylor v. Conta addressed the constitutionality of a state statute that employed an in-state replacement requirement for continuing nonrecognition treatment. The case was init-


79. These same constitutional concerns would be present if a statute taxed the deferred gain based solely upon a change in residency, whether or not such a change was coupled with the lack of in-state replacement property.

80. The statutes in question, on their face, explicitly discriminate only on the basis of the location of the property and not on the basis of the taxpayer's residency. See, e.g., note 63, above. However, the application of any of the above statutes have the irrefutable effect of discriminating on the basis of taxpayer's residency. See Smith and Hellerstein, note 52, below, at 366, n71.

81. The statute at issue in the case, Wis Stat § 71.05(1)(a)5, was repealed in 1981. The statute provided that: "[G]ain on the sale or exchange of a principal residence, excluded under IRC § 1034(a) [is included in income taxable in Wisconsin] if the 'new residence' referred to therein is located outside the state." In contrast, under the Wisconsin tax laws of 1976 (year at issue in the case), if the new principal residence were located in Wisconsin the gain would have been deferred under federal and Wisconsin law. Taylor v Conta, 106 Wis 2d 321, 325, 316 NW 2d 814, 817 (1982).
ated by former Wisconsin residents claiming that the taxation of the gains on the sales of their residences and denial of their moving deductions constituted impermissible discrimination against nonresidents under the Privileges and Immunities Clause. They further argued that Wisconsin residents were treated more favorably than nonresidents in that residents were permitted to defer recognition of a gain from the sale of a Wisconsin residence while nonresidents were required to immediately recognize gain.²²

In assessing their decision, the Wisconsin Supreme Court relied on the "substantial reason for the discrimination test" set forth by the U.S. Supreme Court in Toomer v. Witsell, which provides:

It [Privileges and Immunities Clause] 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. The inquiry must also, of course, be conducted with due regard for the principle that the States should have considerable leeway in analyzing local evils and in prescribing appropriate cures.³³

In light of the above test, the Wisconsin Supreme Court nevertheless found that the legislature was justified in treating residents who acquired new residences outside the state differently from those who acquired new residences within the state. First, the court stated that the legislature was concerned that, unless the gain was taxed immediately, the state would lose jurisdiction to tax the gain realized on the sale of the Wisconsin residence when the taxpayer moved out the state's borders.³⁴ Second, the court acknowledged the administrative difficulties the state encounters if required to keep track of the former residents until the "taxability of the 'deferred gain' was conclusively determined."³⁵ In light of the "substantial relationship between the problems caused by former residents for the state in achieving the state's tax objectives and the burden placed on non-residents," the court concluded that the Privileges and

²². Taylor, 316 NW 2d at 817.
³⁴. Obviously, the state does not lose its jurisdiction to tax the deferred gain because the seller leaves the state. The source of the deferred gain was in Wisconsin and thus creates the constitutional basis for Wisconsin's taxation of any future federal recognition of that gain. See notes, above, 11–13 and the accompanying text.
³⁵. Taylor, 316 NW 2d at 825.
Immunities Clause was not violated by denying nonrecognition treatment to nonresidents. 86

The constitutionality of the statute questioned in Taylor v. Conta was revisited by a Wisconsin intermediate appellate court six years later. 87 In Kuhnen v. Musolf, the appellate court, although stating it was bound by the decision in Taylor, nevertheless found that the statute was unconstitutional under the Privileges and Immunities Clause. The court concluded that very few Wisconsin residents ever paid a tax on the deferred gain because of eventual qualification for the exclusion under Code Section 121 and, thus, the denial of nonrecognition for nonresidents constituted a "migration or exit tax, payable almost exclusively by the nonresident and at rates higher than his or her resident counterpart." 88

The conflicting decisions regarding the Wisconsin statute reveal the constitutional vulnerabilities to which statutes with in-state replacement requirements are subject. The loss of the deferral to nonresidents effects a substantial burden that is not similarly borne by residents. Residents are less likely to ever pay any tax on a similar deferred gain because of the probable occurrence of events where total forgiveness of the gain is granted. 89 It is highly unlikely that any statute denying nonrecognition to nonresidents without similar treatment to residents would endure constitutional scrutiny. The purpose of the Privileges and Immunities Clause is to preclude this kind of disparate treatment, which is devoid of any compelling independent reasons. 90

A Commerce Clause argument can also be advanced against requiring in-state replacement of principal residences. By limiting the tax advantages of interstate residence replacements, a state can effectively discourage and, thus, discriminate against interstate commerce; principally, the mortgage market and the mobility of labor between the states. The Commerce Clause argument, however, is not as strong in the context of principal residences because the nature of the investment involves personal as opposed to business property. 91

Change in Residency Status Triggers Recognition of Gain. Several states either currently employ or have employed varying types of positions that make a taxpayer's change in residency a taxable event. Hawaii adopts a variation of the in-state replacement approach

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86. Id at 829.
88. Id, 420 NW 2d at 407.
89. See notes 60, 61, above, and the accompanying text.
91. Smith and Hellerstein, note 52 above, at 394, 395.
discussed above by making the lack of an in-state replacement along with a change in residency a trigger for gain recognition:

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

(1) A taxpayer who purchases a replacement residence which is located within the State; [or]

(2) A taxpayer who is a resident of the State, taxable upon the taxpayer's entire income, computed without regard to source within the State; . . . .92

In Vermont, if a nonresident sells or exchanges real property located in Vermont, the buyer or transferee is statutorily required to withhold and remit to the state 2.5 percent of the consideration paid for the transfer. The transferee becomes personally liable for the amount if he or she fails to withhold the amount.93 However, in the context of the interstate replacement of a principal residence, this statute is only effective when a taxpayer sells her former residence after he or she has left Vermont and has established residency in another state. The statute does not functionally apply when the property is sold before the taxpayer leaves Vermont and then subsequently rolls over the gain into a new principal residence in the other state.

When the resident status of an individual changed from a resident to nonresident, New York previously required the individual to accrue and report on the final resident income tax return, certain items of income, gain, loss or deduction, unless a bond or other acceptable security was filed along with the final return with the Tax Department. By filing the bond, the taxpayer was agreeing to report the accruable amounts on future New York State nonresident income tax returns as if a change of resident status had not occurred.94

93. The statute referred to is entitled "Withholding on sales or exchanges of real estate," and reads:
(a) General rule. Except as otherwise provided in this section, in the case of any sale or exchange of real property located in Vermont by a nonresident of Vermont, the transferee shall be required to withhold and transmit to the commissioner within 30 days of such sale or transfer, a withholding tax equal to 2 1/2 percent of the consideration paid for the transfer. Any transferee who fails to withhold such amount shall be personally liable for the amount of such tax.

94. NY Tax Law § 654(c)(1),(4) (McKinney 1987), repealed by L1987, ch 28 § 88 (effective Jan 1, 1988, applicable to taxable years beginning after 1987).
As discussed in the context of states' in-state replacement requirements, the effect of these statutes is to discriminate on the basis of residency, which is a probable violation of the Privileges and Immunities Clause. By denying nonrecognition to these nonresidents or requiring a portion of the consideration received without regard to whether there is another out-of-state replacement, these statutes are imposing unequal treatment on nonresidents, which is most likely unconstitutional.95

**Like-Kind Exchanges and Involuntary Conversions**

**Federal Treatment** In addition to the replacement of principal residences, the Internal Revenue Code grants similar nonrecognition treatment to like-kind exchanges and involuntary conversions of property. Similar justifications for allowing deferral are shared by all of these transactions: a continuity of the taxpayer's investment; the failure of the transaction, in most cases, to not generate cash with which to pay the tax; and the acquisition of new property that basically performs the same function as the old property.96 The treatment of like-kind exchanges and involuntary conversions on the federal level is similar in the underlying rationale and the benefits conferred. In addition, as in the case of replacement of principal residences, the possibility for total absolution or forgiveness of the gain is possible in certain instances.97 Despite these similarities, the statutory requirements differ for like-kind exchanges and involuntary conversions.

**Like-Kind Exchanges.** No gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in a trade or business or for investment.98 Besides receipt of the exchanged property, if the taxpayer additionally receives cash or other nonlike-kind property ("boot"), he or she must recognize gain to the extent

95. See notes 38–41, above, and the accompanying text.
97. See note 61, above, and the accompanying text.
98. IRC § 1031(a). The nonrecognition provision does not apply to exchanges of stocks, bonds, notes, other securities or evidences of debt or interest, partnership interests, and certificates of trusts or beneficial interests. IRC § 1031(a)(2). The section further requires that the property to be received in the exchange must be identified within 45 days and transferred within 180 days after the date on which the taxpayer transfers the property relinquished in the exchange. IRC § 1031(a)(3).
The exchange must involve property of "like-kind," which refers to the nature or character of the property and not to its grade or quality. One kind or class of property may not be exchanged for property of a different kind or class. Thus, real property can only be exchanged for real property, not real property for personal property, and vice versa. Treas Reg § 1.1031(a)-1(b).
of the cash and the fair market value of the other property.99 A sale of
one property and reinvestment of the proceeds in other “like-kind” prop-
erty is not an exchange that qualifies for nonrecognition under the
Internal Revenue Code. To qualify, the sale and purchase must be inter-
dependent.100 In addition, a special rule applies to like-kind exchanges
between related parties.101

Involuntary Conversions. The receipt of insurance or other compen-
sation for property involuntarily or compulsorily converted102 normally
results in a taxable gain if the amount received exceeds the adjusted basis
of the property in the taxpayer’s hands. However, an owner of property
involuntarily converted is able to defer the tax on all or part of the gain
resulting from the involuntary conversion by electing to replace the prop-
erty within a specified period, commonly two or three years.103 For this
nonrecognition rule to be applicable, it is essential that the replacement
property be “similar or related in service or use” to the replaced prop-
erty.104 The nonrecognition rule does not apply to condemnation losses.
Unlike like-kind exchanges which are limited to properties held for in-

99. IRC § 1031(b). Furthermore, the taxpayer will take a carryover basis in the replacement prop-
terty to ensure that the deferred gain will be properly recognized in any future taxable disposition.
The carryover basis is adjusted for any gain or loss recognized by the taxpayer in the exchange and
for the value of any other property received or transferred by the taxpayer in the exchange. IRC
§ 1031(d).
100. Anderson v Commr, TC Memo. 1985-205; Young v Commr, TC Memo 1985-221; D’Onofrio
v Commr, TC Memo 1983-632.
101. In the case of exchanges between related parties, nonrecognition is not accorded if either the
property transferred or the property received is disposed of within two years of the exchange. IRC
§ 1031(f).
102. The property must be “compulsorily or involuntarily” converted as a result of its “destruction
in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof.”
IRC § 1033(a). “Destruction” encompasses all cases of physical destruction by violent and external
means such as storm and flood losses, collision, and other applications of unusual force. Under the
“threat or imminence thereof” component, the party, usually a government entity, seeking the sale
must have the legal power to condemn or requisition and must make the threat of condemnation be
known, or there must be a known imminence of such condemnation. Forest City Chevrolet v
103. The replacement period for real property held for productive use in a trade or business or for
investment ends three years after the close of the first taxable year in which any part of the conver-
sion gain is realized. IRC § 1033(g)(4). For all other involuntarily or compulsorily converted prop-
erty, the replacement period ends two years after the close of that taxable year. IRC § 1033(a)(2)(B).
To avoid recognizing gain, the taxpayer must invest all of the proceeds from the conversion in
the replacement property. The gain is computed by subtracting the cost of the replacement property
from the proceeds realized on the conversion. IRC § 1033(a)(2)(A). The replacement property’s basis
comprises its cost less the amount of any unrecognized gain. IRC § 1033(b).
104. IRC § 1033(a)(1). The “similar use” rule is essentially a functional test in which the end use
of the replacement property must be substantially similar, as opposed to identical, to the use of the
replaced property. Lynchburg Natl Bank & Trust Co v Commr, 20 TC 670 (1953), affd 208 F 2d 757
(4th Cir 1953).
vestment or for use in a trade or business, involuntary conversions can include property used by the taxpayer for personal purposes. Because the issues involved with property held for personal purposes are similar to those discussed in the context of the replacement of principal residences, the following discussion focuses on the involuntary conversion of property held for productive use in a trade or business or for investment.

State Treatment for Nonresidents  As discussed in the replacement of principal residences, a majority of the states employ the federal adjusted gross income amount as the computational starting point for state tax purposes, thus implicitly adopting the federal like-kind and involuntary conversion rules.\textsuperscript{105} In addition, as with principal residence replacements, complex state taxation issues and policy choices arise when such transactions have an interstate component. Similar issues and policy choices also arise at the federal level in regard to international transactions. However, as with principal residences, no territorial restrictions are placed on nonrecognition of gain arising from like-kind exchanges.\textsuperscript{106}

One major difference exists between sales of principal residences and like-kind exchanges and involuntary conversions: the issue of the taxpayer's residency.\textsuperscript{107} If a taxpayer sells her principal residence in state A and rolls over the gain into a new principal residence located in state B, the taxpayer is no longer a "resident" of state A. However, this necessary residency shift does not exist in the out-of-state replacements of like-kind and involuntarily converted property. A resident of state A may exchange investment property located in that state for investment property located in state B while remaining a resident of state A.\textsuperscript{108} Another difference between like-kind exchanges and involuntary conversions, and the replacement of principal residences, is that the former two transactions can also be engaged in by corporate taxpayers. However, for purposes of state source taxation of nonresidents, the discussion is limited to individual taxpayers. With these differences in mind, the approaches employed by states to deal with the out-of-state replacements of like-kind and involuntarily converted property, nevertheless, basically mirror those discussed in the context of principal residences, with the exception of a change in residency status which has been incorporated into discussion of the remaining three approaches.\textsuperscript{109}

\textsuperscript{105} See note 50, above, and the accompanying text.
\textsuperscript{106} Rev Rul 68-363, 1968-2 CB 336. Exchange of a ranch in United States for a ranch in a foreign country was eligible for nonrecognition of gain. See note 64, above, for limitations on the allowance of nonrecognition.
\textsuperscript{107} Smith and Hellerstein, note 52, above, at 380, 381.
\textsuperscript{108} Id.
\textsuperscript{109} See note 57, above, and the accompanying text.
Forgiveness of Tax on the Deferred Gain. As previously stated, a majority of the states inadvertently employ the easiest of the four approaches, that is, ignoring the deferred gain by failing to impose a tax when the taxpayer disposes of the replacement property located in another state. The important distinction from principal residences is that in the context of like-kind exchanges and involuntary exchanges, the residency of the taxpayer does not necessarily change. Therefore, a taxpayer who replaces state A property for state B property may remain a state A resident at the time of a federally taxed disposition of the state B property. As a resident of state A, the recognition of gain on the state B property is taxed by state A under the residency, not source taxation, scheme.\textsuperscript{110} Alternatively, the owner of the state A property may have never been a resident of state A (has always been a nonresident) and, thus, any disposition of state A property is taxed as income derived from in-state sources.\textsuperscript{111} In this situation, the taxable event is not in any way related to a change in the property owner’s residency. As previously noted, the constitutionality of any state imposition of tax under this approach would not be questioned.

Federal Piggybacking. As discussed in the context of principal residences, an adoption of this method causes states, like the federal government, to wait until the taxpayer eventually sells or disposes of her replacement residence in the new state in a transaction taxable under the Internal Revenue Code. If the taxpayer is still a resident of state A, an annual income tax return will be filed reporting income not derived from sources within the state, including a taxable disposition of out-of-state replacement property. However, state A commonly has no way of determining which resident taxpayers with tax-deferred replacement property located outside the state will continue to be residents as long as the replacement property is owned.\textsuperscript{112} If the taxpayer subsequently becomes a nonresident, the same problems of keeping track of the replacement property, as with replacements of principal residences, still arise. For example, suppose a resident of state A exchanges property held for investment in state A for like-kind property in state B. Any gain inherent in the state A property is transferred without recognition to the state B property. If the taxpayer subsequently becomes a resident of another state, state A must track any transactions on the replacement property,

\textsuperscript{110} See notes 7–10, above, and the accompanying text; Smith and Hellerstein, note 52, above, at 381, 382.
\textsuperscript{111} Id.
\textsuperscript{112} Smith and Hellerstein, note 52 above, at 383, 384.
since the taxpayer is no longer a resident and presumably will not be annually filing tax returns with state A.

If the taxpayer is no longer a state resident, the same enforcement and collection problems discussed in the context of principal residences arise with the taxable disposition of out-of-state replacement property. Despite state A’s authority to tax the deferred gain from property originally located in state A, the same administrative burdens of needing to monitor such dispositions of nonresidents, like the taxpayers’ federal tax returns, render the federal piggybacking as ineffective, in most instances, as ignoring the gain all together. However, as previously discussed, despite this approach’s administrative difficulties when applied to nonresidents, the similar treatment of in-state and out-of-state replacements ensures that no constitutional issues are raised.

Requirement of In-State Replacement for Nonrecognition. Statutory language employing an in-state replacement requirement for nonrecognition in like-kind exchanges and involuntary conversions is present in the statutory schemes of Georgia, Oregon, and South Carolina.113 For example, Oregon’s current statute provides:

(1) Where laws relating to taxes imposed upon or measured by net income make provision for deferral of tax recognition of gain upon the voluntary or involuntary conversion or exchange of tangible personal property, the provisions shall be limited to those conversions or exchanges where or to the extent that:

(a) The property voluntarily or involuntarily converted or exchanged and the property newly acquired by the taxpayer both have a situs within the jurisdiction of the State of Oregon.

(b) The property voluntarily or involuntarily converted or exchanged has a situs outside the jurisdiction of the State of Oregon.114

As with replacements of principal residences, the failure to make an in-state replacement causes the taxpayer to immediately recognize any gain from the exchange or the involuntary conversion at the time of realization. However, the major difference between interstate replacement of

113. Ga Code Ann § 48-7-27(b)(6) (Michie 1996); see note 77, above, for further discussion on Georgia’s in-state replacement requirement; Or Rev Stat § 314.290(1)(a),(b) (1995); SC Code Ann. § 12-6-1120(3) (1995) (like-kind exchanges only). (For taxable years beginning before 1996, see § 12-7-430(b)(5)).

114. Or Rev Stat § 314.290(1)(a), (b) (1995). South Carolina’s statute, which explicitly applies only to like-kind exchanges, similarly provides:
   The exclusion permitted by IRC § 1031 is not permitted for the sale or exchange of real estate located in this state unless the real estate received in the exchange is located in this state.

residences and interstate replacements for property exchanged or invol­
unently converted is that the in-state replacement requirement as to the
latter two transactions is not based on the taxpayer’s residency. The two
taxpayers treated unequally may both be residents with one replacing in­
state and the other out-of-state; both may be nonresidents; or a nonresi­
dent with in-state replacement and a resident with an out-of-state re­
placement.115

As with principal residences, the in-state replacement requirement
raises some serious constitutional issues and inefficiencies in the treat­
ment of different taxpayers. The constitutionality of such a requirement,
as contained in the Oregon statute quoted above, was addressed by the
Oregon Supreme Court in Wilson v. Department of Revenue.116 The court
held that the statutory provision allowing for deferral of tax recognition
only for like-kind property acquired within the state did not violate the
state constitutional guarantees against denial of equal privileges and im­
munities, and equal protection, and did not violate interstate com­
merce.117 The court held that the statute had neither a discriminatory pur­
pose nor effect. Unlike other cases where the statutes were invalidated
under the Commerce Clause because of the statute’s discriminatory pur­
pose,118 the Oregon statute’s legislative history, explained the court, re­
vealed that the statute’s purpose was other than keeping investment and
business opportunities in the state. Rather, the court found the following
purpose for the statute:

The statute was enacted in recognition of the difficulties in collecting de­
ferred taxes if the property owner leaves the state after having exchanged
Oregon property for out-of-state property. In such a case, the taxable event
might well not be discovered. Even if discovery occurred, the Oregon tax
collector would encounter the added burden of locating the taxpayer and
enforcing liability. The state should not be required to monitor each tax­
payer who might convert his or her investment from Oregon property to
out-of-state property.119

The Oregon Supreme Court’s analysis is questionable and raises
serious Commerce Clause concerns. By limiting deferral of gain for only
in-state replacements, Oregon is imposing a substantial burden and disin-

115. Smith and Hellerstein, note 52 above, at 385.
118. The court found the Supreme Court decision in Boston Stock Exchange v State Tax Commn,
429 US 318 (1977), to be a case on point. In Boston Stock Exchange, the Supreme Court held that
the Commerce Clause prohibited New York from imposing higher stock transfer rates on transfer of
securities through out-of-state exchanges than on transfers through in-state exchanges.
119. Id, 302 Or at 136, 727 P 2d at 619.
centive on out-of-state investment. The burden can be substantial in its
effect, since it falls on residents and nonresidents alike who own property
in the state and enter into an exchange for out-of-state property. Consequently, this treatment amounts to a penalty being imposed on in­
terstate transactions that is not imposed on intrastate transactions and, thus, clearly violates the third prong of the Complete Auto Transit test:
a tax must not discriminate against interstate commerce.

Statutes similar to Oregon’s (requiring in-state replacement for nonrecognition of like-kind exchanges and involuntary conversions) in­
erently possess other constitutional vulnerabilities, which vary somewhat from those discussed in the replacement of principal residences. This variance is mainly due to the inherent residency aspects of interstate replacement of principal residences, which evokes the Privileges and Immunities Clause. As mentioned in the Commerce Clause analysis above, the burden of taxation on out-of-state replacement falls as equally on residents as nonresidents. Because of the increased likelihood that residents will eventually pay tax on the deferred gain, enforcement on nonresidents is not seen as discriminatory as in the case of principal resi­
dences. Accordingly, the Privileges and Immunities Clause has less im­
pact in the context of like-kind exchanges and involuntary conversions.

Finally, the Equal Protection Clause, which only requires that the
state’s classification for tax purposes be “rationally related” to a legiti­
mate state purpose, does not likely pose a serious threat in the context of exchanges and conversions. As espoused in Wilson, a state’s justification of protecting the state from loss of revenue and administrative bur­
dens of collecting tax in a subsequent sale would probably endure equal protection scrutiny.

120. See notes 29, above, and the accompanying text.
121. Smith and Hellerstein, note 52 above, at 394, 395. The authors concluded that “imposing greater tax burdens on out-of-state than on in-state investments plainly discriminates against inter­
state commerce.” They similarly commented that the Wilson court did not give enough weight to the value of deferral and gave too much weight to the state’s justification for the discriminatory taxation of out-of-state investments by holding that the state’s interest in efficient tax administration out­
weighed the national interest in preserving “tax-neutral” decision making. Id (citing Boston Stock
Exchange, 429 US at 331).
122. The only instance in which total forgiveness may be granted in exchanges and conversions is
the death of the taxpayer, resulting in a step-up in basis to fair market value. IRC § 1014(a). The
$125,000 exclusion of gain for taxpayers over 55 under IRC § 121 is not applicable to like-kind
exchanges and involuntary conversions. See notes 60, 61, above, and the accompanying text.
123. Western & Southern Life Ins Co, 451 US at 668.
Pension or Retirement Income

Federal Treatment Under federal taxation rules, a qualified retirement plan receives employer contributions which are invested and ultimately paid out to participating employees, usually upon retirement. The employer is entitled to a deduction for contributions in the tax year in which they are made. When an employer makes a contribution for the benefit of an employee to a qualified plan, the employee does not include the contribution in his or her individual income unless a contribution is distributed in that year. Furthermore, a plan benefit is not taxable to the employee when it is "made available" to the individual, unless there is an actual distribution. An employee is only taxed on benefits under a qualified retirement plan in the tax year in which those benefits are actually distributed to and received by the individual.

As previously discussed in the context of principal residences, like-kind exchanges, and involuntary conversions, these federal rules consistently apply without regard to the residency of the taxpayer, taxing the distributions in the year or years in which they are received. However, if an employee works in state A where her employer contributes to a qualified retirement plan in that state and the employee moves to state B, state A has to take affirmative steps to collect tax on those deferred contributions.

124. Deferred compensation can generally be divided into two principal classes—qualified employee retirement plans and nonqualified arrangements. "Qualified plans" such as qualified pension, profit-sharing, and stock bonus plans, have three major characteristics: (1) The employee is not taxed when the benefits are earned but only when they are received; (2) the employer can deduct contributions to funded plans currently; and (3) earnings on funded plans are not subject to tax as realized but only when distributed to the beneficiaries. Bittker and MJ McMahon Jr, Federal Income Taxation of Individuals, § 37 at 37-1 (1988). Each plan must meet certain requirements to be "qualified," including a definite and written plan, adequately communicated and for the exclusive benefit of the employees, and fulfillment of certain minimum funding, participation, and coverage rules as well as nondiscrimination rules. Federal Tax Coordinator 2d (New York: RIA, Dec 29, 1994), ¶ 5102-5116.

"Nonqualified plans" are subject to less-detailed statutory rules; the employee may or may not be taxed currently, and the employer is ordinarily entitled to deduct contributions, payments, or benefits only when they are taxed to the employee. This restriction on the employer is effective even if the employer's method of accounting otherwise permits or requires the employer's liability to be deducted when the benefits are earned and the liability to pay becomes fixed and determinable. Bittker & McMahon at 37-2; IRC §§ 404(a), 404(b) (1996).

125. IRC § 402(a)(1). Before its amendment in 1981, IRC § 402 provided that amounts held in a qualified plan were taxable when actually paid, distributed, or "made available." For example, if an employee reaches age 62 and is entitled to receive plan distributions, he or she is not automatically taxed because he or she could have elected to receive a distribution. Rather, the employee must elect to receive and actually receive those distributions in order to be taxed in that year. See Clayton v United States, 33 Fed Cl 628 (1995).

126. Distributions from any type of qualified pension or deferred compensation arrangement that are received by the taxpayer are referred to as pension or retirement income.
State Treatment for Nonresidents  As previously discussed, most states' existing income tax statutes implicitly provide for taxation of federally deferred income earned from sources within the state when that income is federally recognized. This statement holds true even if the taxpayer is no longer a resident of that state in the year of recognition. As applied to the pension income of nonresidents, a state only has the authority to tax that portion of the pension income that arose from or in connection with services or other activities performed in the state. Consequently, most states view pension income as "simply deferred income or compensation for services performed at an earlier point in time."

A federal law enacted in 1996 prohibits states from imposing income taxes on specified retirement income of nonresidents. Before this federal law, state taxation of nonresident pension or retirement income was limited to a relatively small group of states: Arizona, California, Kansas, Louisiana, Massachusetts (taxed nonqualified pension and retirement benefits only), Michigan (taxed nonqualified pension and retirement benefits only), Minnesota (excluded annuities and the first $20,000 for retirement income per year), Oregon, Vermont (taxed nonqualified pension and retirement benefits only), and Wisconsin (taxed nonqualified pension and retirement benefits only). Furthermore, only several of these states had any substantial program or system in place to enforce tax compliance by nonresidents on annuity payments from qualified retirement plans. Consequently, before the 1996 federal law, a majority of the states did not have specific statutory provisions or established practices of taxing nonresidents on pension income earned in

128. See Shaffer v Carter, notes 11-13, above, and the accompanying text.
129. "Hearings," note 11, above, at 54 n2 (statement of HT Duncan). Mr. Duncan further commented that, although the Supreme Court has not directly addressed this issue, the Court's ruling in Davis v Michigan Department of the Treasury, 109 S Ct 1500 (1989) (intergovernmental immunity) and 4 USC 111 (preventing a state from taxing federal pensions to a greater degree than they do state and local pensions), supports the state interpretation that pensions are deferred income paid for services performed previously.
130. See notes 137-140, below, and the accompanying text.
133. See "Hearings," note 11, above, at 55 (statement of HT Duncan), which listed California, as of 1994, as the only state that had any program in place to enforce compliance of nonresidents. An earlier survey in 1991 also listed New York and Vermont as having systems in place to pursue nonresidents who received pensions generated within the state. See Kaiman, note 17, above, at 647 n4, citing Hearings before Subcommittee on Taxation of the Committee on Finance, 102d Cong 1st Sess 265 (1991) (statement of HT Duncan).
the state. The nonresidents were either taxed on the pension income in their state of residency or, if their state of residency had no income tax, escaped state taxation all together.

The most aggressive state in taxing nonresident pensions before the enactment of the 1996 federal law was California. California’s current personal income tax statute, which has not yet been altered in response to the 1996 federal law, provides:

When the status of a taxpayer changes from resident to nonresident, or from nonresident to resident, there shall be included in determining income from sources within or without this state, as the case may be, income and deductions accrued prior to the change of status even though not otherwise includable in respect of the period prior to that change, but the taxation or deduction of items accrued prior to the change of status shall not be affected by the change. 134

By advancing the time of recognition of accrued but deferred compensation, California denies the continuation of tax deferral to departing taxpayers and retains it for those taxpayers remaining in the state. 135 Although it raises concerns of unequal treatment under the Privileges and Immunities Clause, such treatment most likely sustains constitutional scrutiny since residents and nonresidents pay the tax. Furthermore, the 1996 federal law provides a substantial reason for the differing treatment of nonresidents as to the timing of tax imposition. 136

FEDERAL LEGISLATIVE DEVELOPMENTS AND TAX POLICY CONSIDERATIONS

Federal Legislation

On January 10, 1996, President Clinton signed legislation into law that bars state and local governments, the District of Columbia, and U.S.

134. Cal Rev & Tax Code § 17554 (West 1996). The statute dealing with the general imposition of tax, specifically the provision applying to nonresidents, states:

There shall be imposed for each taxable year upon the entire taxable income of every nonresident or part-year resident which is derived from sources in this state, except the head of a household as defined in Section 17042, a tax which shall be equal to the tax computed under subdivision (a) as if the nonresident or part-year resident were a resident multiplied by the ratio of California adjusted gross income to total adjusted gross income from all sources. . . .

Cal Rev & Tax Code § 17041(b) (West 1996).


136 Id.
possessions from imposing income taxes on specified retirement income of nonresidents or nondomiciliaries. The enactment of Public Law No. 104-95 applies to any amounts of income received after December 31, 1995. The 1996 law safeguards nonresidents or nondomiciliaries receiving distributions from a wide assortment of qualified and nonqualified retirement or deferred compensation plans from paying income taxes to the state where the distributions were sourced or earned, but where they are no longer residents. “Nonresident” or “nondomiciliary” status is determined under the law of the state or jurisdiction involved.

Income protected by the 1996 law includes distributions from: (1) qualified Section 401(a) retirement plans exempt from federal income tax under Code Section 501(a); (2) simplified employee pensions (SEPs); (3) Section 403(a) annuity plans; (4) Section 403(b) annuity contracts; (5) individual retirement accounts (IRAs) as described in Code Section 7701(a)(37); (6) an eligible deferred compensation plan as defined in Code Section 457; (7) Section 414(d) governmental plans; (8) trusts described in Code Section 501(c)(18); and (9) nonqualified deferred compensation plans, programs or arrangements described in Code Section 3121(v)(2)(C). Payments that are not covered under the statute and, thus, still subject to a state source tax include stock options, restructured stock plans, severance plans, unemployment benefits, and distributions from nonqualified plans if they constitute a lump-sum distribution or “quick payout.”

The reactions to the enactment of the 1996 law have been mixed. Advocates, including states like Florida and Nevada which impose no income tax, hail the legislation as a “triumph for tax fairness” and an end to “taxation without representation.” Some employers view the 1996 law favorably; specifically, protecting them from becoming the “record keepers for the states” that are trying to tax across state lines. To the contrary, many state governments view the 1996 law as a federal intrusion into their taxing authority and feel the issue should be dealt with at the

138. Id; see 4 USC § 114(a) (1996).
139 To be protected by state source taxation, nonqualified plan distributions must be made in substantially equal installments, no less frequently than annually, over the lifetime of the beneficiary or over a period of at least ten years. The new law also protects payments received after the termination of employment under a plan or arrangement maintained solely to provide benefits for employees in excess of limitations on contributions or benefits in the Internal Revenue Code on qualified retirement plans. Id; see 4 USC § 114(b)(1)(I)-(II) (1996).
141. Wright, note 4, below, 51-56.
142. Statements of The Honorable Barbara Vucanovich, Congresswoman from Nevada, and The Honorable Harry Reid, Senator from Nevada, respectively; 23 Pension & Benefits Reporter (BNA).
143. Id (quoting news release of American Payroll Association).
The enactment of this controversial federal law triggers tax policy considerations and puts into question the viability of state source taxation of nonresidents’ deferred income as a whole.

**Tax Policy Considerations Raised by the Federal Legislation**

During Congressional hearings considering federal intervention into state source taxation of nonresidents’ pension or retirement benefits, both sides of the dispute raised some important and interesting policy considerations. The first policy argument advanced by the advocates for the legislation is that source taxation of nonresident pension income constituted “taxation without representation.” One of the sponsors of the legislation explained:

Today, many retirees are forced to pay taxes to states where they do not reside. The retirees pay taxes on pension drawn in the state where they spent their working years, despite the fact that they no longer live in that state . . . this is taxation without representation. Retirees are no longer participating in the state’s medical assistance programs or senior centers, nor do they use the roads or public parks that these taxes are helping to fund. Most importantly, they are not allowed to vote in their former state of residence—yet they still pay taxes to these states.145

This argument is frequently refuted with the statement that the nonresidents received benefits from the taxing state while they were earning their pension income.146 However, in rebuttal, proponents of the legislation submitted the following scenario:

Consider two similar retirees. One decides to remain in the state where the pension was earned and the other moves to another state. The resident pays taxes, but continues to receive benefits from the state, can vote, petition, and otherwise be represented by the government of that state. The nonresident pays taxes, but receives nothing. Didn’t the retiree who remained in the state also get benefits while they were earning their pension? *Isn’t this discrimination? How can this be equal treatment?*147

The taxation without representation argument lacks merits and validity. Source taxation satisfies due process since the nonresident had the rights and privileges of residence while she earned the income, which was generated by the performance of services within the state.148 Even

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144. Comments of HT Duncan, Executive Director, Federation of Tax Administrators, 10 *State Tax Notes* 184 (Jan 15, 1996).
146. See note 148, below, and the accompanying text.
though the tax is assessed after the former resident moves to another state and is no longer receiving benefits from the state where the pension was earned, that state nevertheless provided the person with ample benefits while the income was being earned in the state. 149 More importantly, by taxing former residents when pension benefits are received, the state "is simply recovering revenues that were lost earlier due to the State's policy decision to permit deferral of recognition. The State could have taxed the pension rights prior to retirement when they were earned." 150

Another policy consideration submitted by proponents of the legislation is the fact that employers and plan administrators do not possess the records necessary to allocate retirement benefits among states if the taxpayer worked in more than one state before retirement. States do not currently have any agreement setting forth a uniform method or practice for allocating pension contributions among states where the taxpayer was employed. 151 In addition, most employers and plan administrators do not possess the records necessary to allocate each payment or distribution between compensation for services and investment earnings. 152 Since most retirement plans allow for rollovers from other plans, employers and plan administrators argued that, if the legislation was not enacted, they would have to account for these allocations not only for their own plans but for benefits earned under the plans of prior employers. 153

Source taxation does raise the practical difficulties of allocating income among several states where the taxpayer was employed or allocating pension distributions between the deferred compensation and investment portions. These difficulties were readily admitted by most witnesses at the Congressional hearings who testified against federal intervention into states' source taxation of nonresident pension income. 154 However,

150. Id.
151. "Hearings," note 11, above, at 59 (statement of RJ Johnson, Director of Benefits Planning, Motorola). See also "Hearings," at 83 (statement of the American Payroll Association, emphasizing the large and burdensome administrative costs to employers and plan administrators of tracking and allocating pensions based on the employee's residence when the services were performed and applying a myriad of state withholding laws to these computations).
152. The fact that pension distributions include a deferred compensation component and an investment earnings or income component creates practical complications for state source taxation of nonresident pension or retirement income. While states clearly possess the power to tax deferred income from services performed by nonresidents in the state as well as investment income earned by residents, they do not possess the power to tax investment income earned by nonresidents unless it has an in-state source. See Molter v Department of Treasury, 505 NW 2d 244 (Mich 1993) (former resident not taxable on interest accrued on contributions to qualified deferred compensation plan). See also "Hearings," note 11, above, at 27 (statement of JC Smith).
the opponents of the federal legislation argued that no sound theoretical basis existed for depriving the state of the right to tax income earned in that state.155 In fact, they warned that states may react to the legislation by amending laws to abolish the adoption of federal deferral rules and accelerate the recognition of the deferred income for state tax purposes.156

Finally, proponents of the federal legislation argued that source taxation subjects many taxpayers to possible multiple taxation on the same retirement income. Even though states with income taxes provide credits for residents who earn income in other states, the proponents argued that tax credits do not work effectively because the states using source taxation have not agreed on a uniform method or practice for allocating pension distributions among the states in which a taxpayer worked.157

While the states do not have an agreed-upon uniform method for allocating pension distributions among the states in which the taxpayer worked, the tax credit itself has not failed, in most instances, to prevent double or multiple taxation. All states that impose an income tax currently provide credits for residents who earned income from sources in other states.158 States do use different formulas for calculating the credit, which sometimes is less than the tax paid to the source state.159 However, the widespread availability of the tax credit substantially resolves any problems that might arise between any number of states taxing an individual’s pension distributions.

Equity and efficiency considerations require states that tax the pensions of continuing residents to also tax the pensions of its former residents. If an individual taxpayer’s personal choice about where to retire affects state tax consequences for pension income already earned, equity and fairness are offended.160 If the state income tax system causes a taxpayer to alter his or her behavior, tax neutrality and efficiency are similarly violated. Consequently, if nonresidents are not similarly taxed, both of these concepts are offended in that retirees who remain in the state bear a tax not similarly borne by former residents.161

Finally, the 1996 federal law has some practical effects that could be detrimental to states. The federal law’s prohibition on states’ source taxation of nonresident pension or retirement income will result in the

155. Hellerstein and Smith, note 127, above, at 223.
156. See "Hearings," note 11, above, at 27 (statement of JC Smith), and 75 (statement of G Goldberg, Director, California Franchise Tax Board); Hellerstein and Smith, note 127, above, at 228.
157. Id at 61; "Hearings" (statement of RESIST).
159. Id.
161. Id at 22, 26.
loss of tax revenue.\textsuperscript{162} The elimination of source taxation of nonresidents’ pension income by Congress disturbs the fundamental principle that a state may tax all income derived from sources within the state and invites further federal intrusions on states’ taxing authority.\textsuperscript{163} Furthermore, this federal intervention is as likely to cause harm as it is to alleviate it by “creating” areas of nonconformity with federal tax, increasing complexity of state and federal taxes for taxpayers and employers, and frustrating stated U.S. retirement policy.\textsuperscript{164} The 1996 federal law invites substantial abuses in that residents will now be motivated to move to another state or structure their current compensation as retirement income, particularly because of the legislation’s inclusion of nonqualified plans in its protective coverage.\textsuperscript{165} In addition, the 1996 federal law possibly constitutes an “unfunded mandate” in violation of federal law.\textsuperscript{166}

CONCLUSION

A majority of the policy considerations raised in the federal legislation pertaining to the taxation of nonresidents’ retirement or pension income can be applied to state source taxation of other types of deferred income discussed in this article: gains on sales of principal residences, like-kind exchanges, and involuntary conversions. The practical difficulties and burdens of employers and plan administrators in allocating pension distributions among states can be similarly analogized to states’ difficulties in tracking future taxable dispositions of replacement properties containing deferred gains. Furthermore, the concepts of equity and efficiency play an equally important role in states’ treatment of nonresidents

\textsuperscript{162} California estimated that the loss to its treasury from the federal legislation barring state source taxation of nonresident retirement or pension income will be an estimated $25 million annually. See “Hearings,” note 11, above, at 75 (statement of GH Goldberg).
\textsuperscript{163} Further intrusion by Congress into states’ taxing authority is currently being proposed by Representative Christopher C. Cox (R-Calif) and Senator Ron Wyden (D-Ore). The two congressmen announced plans on January 7, 1997 to introduce legislation preventing states and localities from imposing any “new” taxes, which possibly could include sales and use taxes, on Internet access or services until a comprehensive national approach to taxation of electronic commerce is developed. In response, state government and tax organizations regard the proposed federal preemption of state and local taxes as an unfunded mandate on the states. See A Bennett, “Cox, Wyden to Introduce Legislation to Stop New State, Local Internet Taxes,” \textit{5 Daily Tax Report (BNA)} G-5 (Jan 18, 1997).
\textsuperscript{165} Klaiman, note 17, above, at 667, 668; “Hearings,” note 11, above, at 56 (statement of HT Duncan).
\textsuperscript{166} Id at 76, for further discussion on whether the enacted legislation violates Unfunded Mandates Act of 1995; see also “Hearings,” note 11, above, at 57 (statement of HT Duncan).
for all types of deferred income. Although the possibility of federal intervention into any of these other areas is probably nonexistent, the federal prohibition on state source taxation on pension or retirement income only further erodes most states’ source taxation of nonresident deferred income, which was already near extinction from the adoption of federal deferral rules and practical difficulties in enforcing compliance.

States’ alternatives for stopping the erosion of their authority, both legally and practically, to source tax nonresident deferred income, are somewhat limited and extreme in nature. In the context of pension distributions, states can eliminate the employers’ deductions for initial contributions and tax employees at the time the contributions are made on their behalf. This would ensure equal treatment regardless of whether the employee remains a state resident and would further protect the states’ revenues. In addition, states could tax gains on sales of principal residences, like-kind exchanges, and involuntary conversions at the time the gain is realized and not allow deferral, ensuring equal treatment for residents and nonresidents alike. However, this departure from federal deferral rules would mean additional administrative and enforcement costs. Alternatively, the states could eliminate tax altogether on deferred pension contributions and gains from residence exchanges and conversions for residents and nonresidents. They could also tax any deferral of income or gain upon a change in the taxpayer’s residency, ensuring that any previously allowed deferral is taxed before the taxpayer becomes a nonresident. However, this final alternative, as previously discussed, raises serious constitutional concerns.

Accordingly, the states’ alternatives to stop the erosion of revenues from lack of taxation of nonresident deferred income are not attractive from the perspective of losing further revenue, incurring additional administrative and enforcement costs, or risking constitutional violations. Perhaps the states’ gravest and most immediate concern is the federal intrusion and limitation on their taxing authority at a time when every state is searching for new creative means in which to raise revenues.

167. States’ elimination of deferral on pension or deferred compensation contributions may violate provisions of the Employee Retirement Social Security Act (ERISA). In enacting ERISA, Congress intended to make the regulation of pension and retirement plans solely a federal concern. ERISA includes broad exemption provisions whereby federal law will supersede “any and all state laws insofar as they may now or hereafter relate to any employee benefit plan” under the Act. [29 USC § 1144(a)] The application of this preemption provision has been the subject of extensive case law and is beyond the scope of this article.