State Income Tax Treatment of Residents and Nonresidents under the Privileges and Immunities Clause
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In Lunding v. Tax Appeals Tribunal,1 a case that the Supreme Court will hear next term, the taxpayer asserts that New York State violates the Privileges and Immunities Clause of the U.S. Constitution2 by denying him an income tax deduction for alimony payments made to his former spouse. The taxpayer, Christopher Lunding, is a prosperous Connecticut resident who was practicing law in New York during the tax year at issue. Under New York law, nonresident taxpayers are permitted deductions against New York-source income only to the extent that the deductions reasonably relate to the earning of income in the state.3 No deduction is allowed for alimony payments because alimony is a personal expense unrelated to the earning of income.4 Resident taxpayers, however, are allowed deductions for certain personal expenses, including alimony. It is this difference in the treatment of residents and nonresidents that Lunding claims is impermissible under the Privileges and Immunities Clause.

The Lunding case is an important one for the states.5 As discussed in detail below, the New York taxing scheme implements normative principles of income taxation by taxing nonresidents on their net New York-source income and leaving issues of tax relief for personal expenses to their state of residence. The federal government follows the same basic arrangement in taxing residents and nonresidents,

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1 89 N.Y.2d 283, 675 N.E.2d 816, 653 N.Y.S.2d 62 (NY Ct. App., 1996), reversing 218 A.D. 2d 268, 639 N.Y.S.2d 519 (3d Dep’t 1996), cert. granted May 19, 1997, No. 96-1462. (For a summary of Lunding, see State Tax Notes, Apr. 1, 1996, p. 1022. For the full text of Lunding, see Doc 96-9526 (4 pages).)
2 U.S. Const., Art. IV, Cl. 2.
5 Obviously the case is also important to Lunding and similarly situated taxpayers for the year at issue. Its prospective importance to taxpayers in Lunding’s situation, however, may be limited. In 1991, Connecticut adopted a broad-based income tax, and in accordance with the usual practice, it taxes its residents on their worldwide income and allows a credit, subject to the normal limitations, for taxes paid to New York with respect to net income earned in New York. After 1990, therefore, a Court-imposed reduction in the New York tax on nonresident payers of alimony could inure at least in part to Connecticut.
and that arrangement is sanctioned by long-standing international custom and over 2,000 tax treaties. If states are forced by the Court to extend ability-to-pay relief to taxpayers who are not fully subject to their tax jurisdiction, they will lose a significant part of their sovereign power to design an income tax system that imposes burdens with respect to ability to pay.

Section 1, below, addresses the general system for taxing residents and nonresidents that New York has adopted and that is followed by many states and many national governments. As explained in that section, a common and appropriate system is for the source state to deny deductions for personal expenses and for the residence state to provide them.

The alimony rule complained of in Lunding was adopted by New York in 1987 as part of a major revision of its personal income tax law. Section 2, below, provides some background on the 1987 reform legislation and describes how New York treats residents and nonresidents with respect to alimony and related personal allowances. To a very large degree, the 1987 reform legislation reflects the work of the New York Tax Study Commission. In the interests of full disclosure of possible author bias, we acknowledge that we were heavily involved in the studies that helped shape the 1987 reforms through our association with the commission. One of us (Pomp) served as the director of the commission from 1982 until enactment of the reforms in 1987. The other (McIntyre) served as principal consultant to the commission on taxation of the family and low-income relief mechanisms. Neither of us is currently engaged by the state of New York.

Section 3 addresses the legal issues raised in Lunding. It begins with a discussion of the applicable New York law and then analyzes the arguments likely to be made by the parties before the Court. It concludes that the New York rule on alimony is sensible and fair, both to nonresident taxpayers and to sister states. The rule implements normative principles of tax policy, consistent with long-standing national and international practice, and it does not reflect the unprincipled grab for revenue that the Court properly criticized in Austin v. New Hampshire, the leading Privileges and Immunities income tax case decided in the modern era. Some concluding remarks are contained in Section 4.

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Lunding raises the following fundamental question: Does the Privileges and Immunities Clause require a state to extend to nonresident taxpayers who are subject to tax only on income arising within the state the same personal deductions and other related allowances that it grants to its residents, who are taxable on their worldwide income? In our view, taxpayers subject to the tax jurisdiction of a state on their worldwide income are not comparable, for purposes of judging discrimination under the Privileges and Immunities Clause, to taxpayers subject to tax on only that portion of their income arising in the state. We believe the Court should uphold the decision of the New York Court of Appeals and reject the claim of constitutional violation raised by the taxpayer.

1. Residence and Source Jurisdiction

The widely accepted practice of national governments and most state governments, including New York, is to assert income tax jurisdiction over their residents and to tax them on their worldwide income.\(^7\) This assertion of income tax jurisdiction over the taxpayer with respect to worldwide income is known as ‘residence taxation.’ The Supreme Court has long held that a state may tax individuals residing or domiciled therein on their worldwide income.\(^8\)

To achieve fairness by taxing each individual with respect to his or her ability to pay, a state should impose tax on the worldwide income of all its taxpayers. Assume, for example, that the state has three taxpayers, A, B, and C, each having total income of $100,000. A and C are state residents and B is a nonresident. A and B have $50,000 of income within the state and the same amount derived from outside the state. All of C’s income is derived from within the state. To tax each of these individuals equally, the state should subject all three of them to tax on their total income of $100,000. That result cannot be achieved, however, due to limitations on the state’s taxing jurisdiction.

\(^7\) In the case of the United States and a couple of other countries (e.g., the Philippines and Bulgaria), worldwide tax jurisdiction is exercised over nonresident citizens as well. The assertion of U.S. tax jurisdiction over nonresident citizens with respect to foreign-source income was upheld against constitutional challenge in Cook v. Tait, 265 U.S. 47 (1924).

\(^8\) Shaffer v. Carter, 252 U.S. 37, 57 (1920) (‘As to residents a state may, and does, exert its taxing power over their income from all sources, whether within or without the State’). The Court has explained the right of a state to tax all the income of a resident as ‘founded upon the protection afforded to the recipient of the income by the state, in his person, on his right to receive the income, and in his enjoyment of it when received,’ Lawrence v. State Tax Commission, 286 U.S. 276, 281 (1932), and on the ‘enjoyment of the privileges of residence in the state and the attendant right to invoke the protection of its laws,’ New York ex rel. Cohn v. Graves, 300 U.S. 308, 313 (1937).
For many good reasons, governments do not tax nonresidents on their worldwide income. Indeed, state governments are prohibited by constitutional doctrines from taxing nonresidents on their worldwide income. As a result, some inequality in the treatment of residents and nonresidents is inherent in any income tax that seeks to tax residents with respect to their ability to pay.

The more limited form of income tax jurisdiction exercised over nonresidents is referred to as ‘source taxation.’ The income subject to source jurisdiction may be identified by the use of ‘source rules’ or through the use of allocation and apportionment formulas. In the case of business income, many states, including New York, determine a taxpayer’s worldwide taxable income (gross income minus allowable deductions) and then apportion that taxable income under a three-factor apportionment formula. In taxing nonresident individuals on wages and other nonbusiness income, state governments typically use source rules to identify the gross income subject to tax. They frequently use apportionment or allocation formulas, however, to identify the deductions allowable in reducing gross income to taxable income.

Residence jurisdiction is grounded on the political allegiance of the resident to the government rather than on the actual receipt of any particular package of benefits. Of course most residents do receive actual benefits. An individual who is a resident of a jurisdiction typically receives certain political rights, such as the right to vote and hold office, the right to obtain various licenses and permits, and the right to participate in government programs and subsidies. A variety of other benefits also may be obtained, including access to the state’s markets and infrastructure and protection of property and liberty rights. Residents are taxable on their worldwide income as long as they remain in a position to obtain benefits from the state by retaining their status as a resident.

Source jurisdiction is not concerned with the political status of the individual. As noted above, it is grounded on a physical or economic relationship between the nonresident’s income generating activities and the taxing government. The government provides an economic and political environment that facilitates the

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9 Nonresidents who have all of their income derived from within the source state will in effect be taxed on their worldwide income. In this special case, worldwide taxation and source taxation overlap.

10 A state’s power to tax nonresidents ‘extends only to their property owned within the State and their business, trade, or profession carried on therein, and the tax is only on such income as is derived from those sources.’ Shaffer v. Carter, 25 U.S. 37, 57 (1920). More generally, the Court has prevented states from taxing nonresidents on activities that occur, or property that is located, outside their jurisdictions. See, e.g., Norfolk & W. Ry. Co. v. Mo. State Tax Commission, 390 U.S. 317 324-25 (1968); Farmers Loan & Trust Co. v. Minn., 280 U.S. 204, 210 (1930); Union Refrigerator Transit Co. v. Kentucky, 199 U.S. 194, 204 (1905).
earning of the income and in return claims a share of that income through imposition of an income tax.\textsuperscript{11}

Because it typically can tax only a portion of a nonresident’s income, a government necessarily must give limited weight to the goal of relating tax burdens to ability to pay. Primary weight is given to a variety of pragmatic considerations, such as administrative economy, protection of its residents against unfair competition, and comity with other tax jurisdictions.

In imposing taxes on nonresidents, the federal government has adopted rules that conform with international practices. Nonresidents are taxable under the Internal Revenue Code with respect to most categories of U.S.-source gross income. They are allowed deductions for the costs of earning that income, but they generally are denied deductions, allowances, and other relief measures intended to refine tax burdens to reflect ability to pay. They are frequently subject to withholding at source on U.S. dividends, royalty payments, and the like, although residents generally receive such payments free of withholding. Nonresidents generally are not allowed a tax credit for income taxes paid to foreign governments, whereas residents typically can claim a credit.\textsuperscript{12}

\textit{The International Pattern}

The approach taken by the United States in taxing nonresidents is replicated throughout the world. This pattern ends up with different rules for residents and nonresidents. International practice sanctions such differences, but only if they do not result in improper discrimination against nonresidents. What constitutes improper discrimination has been given considerable attention by national governments, most particularly in the formulation and interpretation of their income tax treaties.

\textsuperscript{11} Although the Due Process Clause protects nonresidents from overreaching by a taxing jurisdiction, the states have wide latitude in designing their income tax systems. A state is free to pursue its own fiscal policies, unembarrassed by the Constitution, if by the practical operation of a tax the state has exerted its power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society... The test is whether property was taken without due process of law, or, if paraphrase we must, 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.


\textsuperscript{12} For the U.S. rules on the credit, see \textit{Internal Revenue Code of 1986}, sections 901 et seq. (hereinafter ‘IRC’). The point of the credit is to avoid double taxation. The residence state is assigned the burden of relieving double taxation by international practice at least in part because it is in the best position to determine whether double taxation actually has occurred and what the appropriate adjustment for it should be.
Most developed countries and many developing countries have negotiated an extensive network of bilateral treaties with their major trading partners. Those treaties are based on a model developed by the Organisation for Economic Cooperation and Development (OECD). A nearly universal feature of these treaties is a 'nondiscrimination' clause. The nondiscrimination clause in the OECD Model Treaty provides as follows:

Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected.\(^\text{13}\)

Although the language quoted above might seem to preclude most differences in the treatment of residents and nonresidents, it has not been interpreted in that broad way by the United States or its treaty partners. On the contrary, the language has been interpreted to allow significant differences in the treatment of the two groups. The commentary accompanying the Model Treaty makes explicit that 'a taxpayer who is a resident of a Contracting State and one who is not a resident of that State are not in the same circumstances.'\(^\text{14}\) Differences in collection procedures, such as withholding at source, have been accepted for decades without challenge. Also accepted are differences due to the inability of the country of source to make refined adjustments in tax burdens on account of ability to pay.

What is particularly noteworthy about the international experience is that differences in family relief measures granted to residents and nonresidents are clearly sanctioned. Article 24(3) of the Model Treaty, after guaranteeing protection to nonresidents against discrimination, provides that the nondiscrimination clause 'shall not be construed as obligating a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which [*248] it grants to its own residents' (emphasis added). The commentary to the OECD Model Treaty


\(^{14}\) OECD, Commentary on Article 24, para. 3. The commentary goes on to state: In fact, whilst the expression 'in particular with respect to residence' did not appear in the 1963 Draft Convention or in the 1977 Model Convention, the Member countries have consistently held, in applying and interpreting the expression 'in the same circumstances,' that the residence of the taxpayer must be taken into account. Id.
confirms that position. In accordance with the OECD Model Treaty and commentary, the United States, along with many other countries, provides residents with more liberal allowances for dependents than they provide to nonresidents.

Of particular relevance to Lunding is the fact that long-standing international practice sanctions granting an alimony deduction to residents and denying that deduction to nonresidents. That result is clearly reached under the language from the OECD Model Treaty quoted above. It is also the actual practice — the unchallenged practice — of the United States and many other national governments.

That the federal deduction for alimony was adopted to adjust tax burdens for the personal circumstances of the taxpayer and not to measure net income is indisputable. The deduction was introduced in 1942 in response to the high federal rates (over 90 percent) adopted after America's entry into World War II. The fear was that an individual paying alimony to a former spouse might owe a tax that was greater than the income left over after the alimony payment. According to a leading commentator, alimony was not deductible in prior years because 'plainly, such payments were not business expenses.'

The Internal Revenue Code provides that an individual may deduct alimony payments made during the taxable year. An exception is provided for nonresidents who generally may only deduct expenses that relate to earning income derived from U.S. sources and taxable by the United States. Alimony is not considered such an expense.

Although national governments that grant an alimony deduction to their residents may deny the deduction to nonresidents without violating the nondiscrimination clause of their tax treaties, they are not required to deny the deduction. Canada, for example, generally allows nonresidents to take a full, unallocated deduction for alimony payments, a rule that can lead to anomalous

15 Id. para. 4 (specifically allowing different treatment of residents and nonresidents ‘in giving relief from taxation on account of family responsibilities’) (emphasis added).
16 For the United States, see IRC sections 152(b)(3) and 873(b)(3). For discussion of family tax measures in Europe, see Ruud Sommerhalder, ‘The Taxation of Families and Individuals in Europe,’ in Chapter 7, John G. Head and Richard Krever, eds., Tax Units and the Tax Rate Scale 163-198 (1996).
18 IRC section 215.
19 IRC section 873(a) (generally allowing deductions to nonresidents ‘only if and to the extent that they are connected with income which is effectively connected with the conduct of a trade or business within the United States’). As exceptions to the general rule, IRC section 873(b) permits nonresidents to deduct certain U.S. casualty losses, an allocable share of charitable contributions, and the taxpayer’s personal exemption.
A country also may deny the deduction to both residents and nonresidents — the practice, for example, in Australia.

In the typical case, nonresidents who are denied personal deductions because the deductions do not relate to earning income in the source state are still taxed more favorably than residents because the detriment of losing those personal deductions is more than offset by the benefit of not being taxed on their worldwide income. The one exception to this general proposition is when most or all of a nonresident’s income is derived from the source country; in that situation an individual would pay higher taxes than a similarly situated resident.

Assume, for example, that N, a nonresident of Country A, has income of $50,000 derived from Country A and has losses arising in Country B of $20,000. N will be taxable in Country A on $50,000 under the tax rules of most countries, whereas a similarly situated resident taxpayer would be taxable on only $30,000 ($50,000 – $20,000). This same situation could arise under the alimony rules applicable to nonresidents under the Internal Revenue Code and under New York law. This potential for harsher treatment, however, has never been considered to constitute a violation of the Nondiscrimination Clause of U.S. tax treaties. The consensus view has been that the occasional unhappy result does not taint a statutory scheme that generally is favorable to nonresidents.

Source Taxation And Ability-to-Pay Adjustments

Source countries typically do not extend ability-to-pay adjustments to nonresidents for two reasons. First, a source country taxes nonresidents on only a slice of their income, whereas it typically taxes its own residents on their worldwide income. Second, the source country cannot prevent the nonresident’s country of

20 Canada, which employs a separate filing system, generally denies an alimony deduction to a nonresident if that individual is taxable only on dividends, interest, and other payments taxable at a flat rate through withholding at source. Nonresident individuals engaged in employment or business in Canada, however, can claim a deduction for the full amount of their alimony payments. Thus, Canada treats the alimony payments of nonresidents more favorably than their business expenses, which must be allocated between Canadian-source income and foreign-source income. ‘Non-Residents — Income Earned in Canada,’ Interpretative Bulletin IT-420R3 (Mar. 30, 1992). The result is anomalous. For example, assume that U, a nonresident, earns $50,000 in Canada and $250,000 in the United States. U pays alimony of $50,000. Because Canada allows U to deduct the entire $50,000 of alimony, U has taxable income of zero in Canada and pays no Canadian income tax.

21 The Court has long held that the Privileges and Immunities Clause permits a nonresident to pay a higher tax under this circumstance than a resident would pay. Shaffer v. Carter, 252 U.S. 37 (1920).

22 For the most part, the provisions of U.S. tax treaties are not binding on the states. An exception is the Nondiscrimination Clause, which the states are bound to observe. See, e.g., Art. 24(6), U.S. Model Tax Treaty (1996), reproduced in Michael J. McIntyre, The International Income Tax Rules of the United States (1989, 1996), Appendix A.
residence from appropriating for itself any tax benefit ostensibly provided to the nonresident taxpayer.

As an example of the first point, assume that a country has decided to give low-income relief, such as the earned income tax credit,\(^{23}\) to resident individuals because they are poor by community standards. A nonresident who appears poor because he or she has low income sourced within the taxing jurisdiction may not be poor at all. That individual may have substantial income derived from outside the country, perhaps even sourced in a tax haven. Or that individual may be married to a nonresident taxpayer having substantial income. To properly grant low-income relief or make other refined adjustments based on ability to pay, the tax authorities in the source country must obtain detailed information on a nonresident’s worldwide income, and that information frequently is not available to them.

As an example of the second point, assume that an individual is resident in a country that does not grant an alimony deduction; assume also that he is working in a country that provides the alimony deduction to both residents and nonresidents. \(^{[*249]}\) The two countries have mirror-image tax systems aside from their treatment of alimony. Both countries tax their residents on their worldwide income and allow a foreign tax credit for income taxes paid in the source country. Under these conditions, the alimony deduction provided by the source country would reduce the amount of the foreign tax credit that the nonresident otherwise would have claimed in the country of residence, but the allowance of the deduction would not affect his overall tax liability. That liability would be set by the residence country, which would tax him on his worldwide income, computed without allowance for the alimony payment.

The types of problems illustrated above are inherent in source taxation. They are not solved by allowing nonresidents to claim an apportioned share, rather than a full share, of the family adjustments granted to residents. First of all, a rule apportioning family adjustments between income sourced within and without a taxing jurisdiction would be unprincipled because family adjustments do not relate in any rational way to particular categories of income. Secondly, the most that an apportionment rule could do would be to limit the amount of the family adjustment inappropriately granted to nonresidents. Thirdly, an apportionment rule could not operate properly in many cases because the source jurisdiction typically does not have the full information on the worldwide income of nonresident taxpayers that is needed to apportion family adjustments between income derived within and without the

\(^{23}\) IRC section 32.
jurisdiction. The Court has not required the states to grant nonresidents a proportionate share of personal deductions.

As more fully explained below, the New York rule under dispute in Lunding is very much in the mainstream. The consensus view of the federal government and its many tax treaty partners is that differential treatment of residents and nonresidents on alimony payments is grounded on principle and is not a bald discrimination against nonresidents simply because they are not residents. Most national governments are bound by their tax treaties from discriminating against nonresidents. Those governments that grant an alimony deduction to residents and deny it to nonresidents clearly believe that they are acting in accord with their treaty obligations when they do so.

2. New York’s 1987 Tax Reform Legislation

In 1987, the state of New York made the most extensive revisions of its personal income tax in its history. The 1987 reform legislation, in conjunction with federal reforms incorporated by reference into New York law, provided for a much broader tax base and much lower marginal tax rates. The set of reforms specifically enacted by New York reduced tax burdens at all income levels, with the greatest percentage relief targeted at the poor. The changes in the tax base resulting from federal reform had their heaviest impact at upper income levels, making the overall reform package quite progressive.

Complexity of the system, especially for low- and middle-income taxpayers, was reduced significantly by the 1987 tax act. To minimize complexity, the staff of the New York Tax Study Commission proposed extensive conformity with the federal income tax and ‘the elimination, to the extent feasible, of the need for information

24 An apportionment rule would presumably be based on the ratio of a nonresident’s income in the source jurisdiction to his worldwide income. In the context of state taxation, a state may have good information about the worldwide income of U.S. residents and citizens from their federal tax return. A state typically would not know the worldwide income of nonresident taxpayers who are neither U.S. residents nor U.S. citizens because such information would not be available from the federal return.

25 Jerome R. Hellerstein and Walter Hellerstein, II State Taxation, p. 20-38 (1992) (‘Shaffer and Travis support a State’s refusal to allow a nonresident a proportionate share of the various personal deductions allowed residents’). The fact that an award of alimony may be based on the amount of the payer’s income does not make the payment a deductible cost of generating that income. The Court has held that the costs of divorce are personal and do not arise in connection with a profit-seeking activity. See Gilmore, supra note 4.

26 See Albany II at 799 (Table 1).
sources independent of the Internal Revenue Service (IRS) enforcement machinery.\textsuperscript{27} The resulting reforms generally comported with that guideline.

A major focus of the 1987 reform was the redesign of family taxation rules to take account of the impact on ability to pay of sharing practices within the family. New York replaced its separate filing system for marital partners, which it had adopted in 1919, with a joint filing regime that provided for nearly full marital income splitting.\textsuperscript{28} In effect, each spouse became taxable on an equal share of the total income of their marital partnership.\textsuperscript{29}

To obtain the benefits of marital income splitting, both marital partners must be taxable in New York on their worldwide income, they must file a federal joint return, and at least one of the spouses must be a resident of New York.\textsuperscript{30} A resident taxpayer having a nonresident spouse is eligible for income splitting only if the nonresident spouse elects to be taxable as a resident.\textsuperscript{31} These limitations on income splitting are comparable to the limitations contained in the Internal Revenue Code.\textsuperscript{32}

New York has long granted the benefits of income splitting to resident former spouses by allowing the payer of alimony to exclude the payment from taxable income and by requiring the recipient of alimony to report the payment as income. This result is achieved by using federal adjusted gross income as the [*250] starting point in defining New York taxable income.\textsuperscript{33} Under the Internal Revenue Code, alimony payments are deducted from the income of the payer\textsuperscript{34} and added to the income of the payee.\textsuperscript{35}

\textsuperscript{27} Albany II at 793; Albany I at 340.
\textsuperscript{28} Tax Reform and Reduction Act of 1987, section 29(b)(2), 1987 N.Y. Laws at 94 (imposing joint filing requirement) (amending N.Y. Tax Law section 611(b)(2)). As adopted in 1987, the tax brackets of the rate schedule for married persons filing jointly were not exactly double the width of the brackets for single persons, but the departure from full splitting was minor. Subsequent legislation provided for full income splitting.
\textsuperscript{29} For full discussion of how income splitting ends up taxing each individual spouse on his or her share of their marital income, see Albany I at 281.
\textsuperscript{30} N.Y. Tax Law section 611(b)(2); N.Y. Tax Regs. section 111.2(d)(2).
\textsuperscript{31} N.Y. Tax Law section 611(b)(4); N.Y. Tax Regs. section 111.2(d)(1).
\textsuperscript{32} IRC section 6013(a)(1). Nonresident aliens married to a U.S. citizen or resident may file a joint return by electing to be taxable on their worldwide income. IRC section 6013(g).
\textsuperscript{33} N.Y. Tax Law, section 612(a).
\textsuperscript{34} IRC sections 215 (granting deduction) and 62(a)(10) (allowing deduction ‘above the line’ — i.e., against gross income).
\textsuperscript{35} IRC section 71.
New York’s Treatment of Alimony

Prior to the 1987 reforms, New York allowed nonresident taxpayers making alimony payments to a former spouse to take an allocable portion of the alimony deduction claimed on their federal tax return. The amount of the deduction was computed by multiplying the federal deduction by a fraction, the numerator of which was New York-source income and the denominator of which was federal adjusted gross income.

New York law did not expressly mandate that result. Indeed, the New York tax authorities had interpreted a general statutory rule limiting the deductions of nonresidents to deductions ‘derived from or connected with New York sources’ as prohibiting a deduction for personal expenses such as alimony. In interpreting pre-1987 law, however, the New York Court of Appeals held that nonresidents were allowed a deduction for an allocable portion of their alimony expenses under general statutory language promising tax parity between residents and nonresidents. The 1987 legislation overturned prior law, as interpreted by the New York courts, by specifically providing that nonresidents could not deduct alimony payments in determining New York-source income.

No specific legislative history is available that explains the legislative decision to deny nonresidents an alimony deduction. The Legislature appears to have concluded, nevertheless, that alimony payments should not be treated as comparable to costs of earning income and therefore should not be deductible by nonresidents, who are taxable only on their New York-source income. By reversing the result reached by the New York courts, the Legislature reaffirmed its position that alimony is a personal expense and that the responsibility for adjusting tax burdens to take account of that expense should fall on the state of residence and not on the state of

37 Matter of Friedsam v. State Tax Commission, 64 NY2d 76, 473 NE2d 1181, 484 NYS2d 807 (1984), aff'g result in 98 AD2d 26, 470 NYS2d 848 (NY Sup. Ct., App. Div., 3d Dept 1983). The New York Appeals Court held that the deduction was allowable under N.Y. Tax Law section 635(c)(1), which it interpreted as allowing nonresidents to deduct an apportionable share of the nonbusiness deductions granted to residents. Id. at 82. The lower court had held that denial of the alimony deduction violated the Privileges and Immunities Clause. Because of its reading of the N.Y. tax statute, the Court of Appeals did not reach the constitutional issue.
38 N.Y. Tax Law section 631(b)(6). The 1987 legislation modified the taxation of nonresidents generally by taxing them at the average tax rate that would have been applicable to them if all of their income had been derived from New York sources. That result is achieved by requiring nonresident taxpayers initially to compute their New York tax liability as if they were New York residents. The tax so determined is then multiplied by a fraction, the numerator of which is New York source income and the denominator of which is federal adjusted gross income. N.Y. Tax Law section 601(e).
source. Just as the 1987 reform followed the federal lead in denying marital income-splitting benefits to nonresidents, it followed the federal rule in denying nonresidents an alimony deduction.\textsuperscript{39}

Whatever its specific intent, the New York Legislature reached a sensible result in denying the alimony deduction to nonresidents. The tax policy goal of an alimony deduction is to tax income used to pay alimony to the beneficiary and not to the earner of the income. Because the beneficiary is usually in a lower tax bracket than the earner, that shift in the tax burden typically results in a lowering of the overall tax burden on the former couple. That shifting of burdens is similar to the result achieved through marital income splitting. By eliminating the deduction for nonresident payers of alimony in 1987, New York generally conformed the income-splitting rules applicable to broken marriages with the newly adopted income-splitting rules applicable to intact marriages.

When both the payer and payee of alimony are residents of the state, allowing a deduction to the payer and taxing the payee achieves a result comparable to marital income splitting. The income out of which the alimony is paid is taxed to the former spouse at the rate appropriate to that spouse's standard of living. When the payer and the payee are both nonresidents, however, that result cannot be achieved. Moreover, to prevent an unwarranted loss of revenue, a state cannot give the deduction to a nonresident payer when the payee is also a nonresident who will not be taxable on the receipt of the alimony. The best a state can do under these circumstances is to deny the deduction to the payer of the alimony and exempt the payee. This approach parallels the approach reached in the case of gifts, which are nondeductible to the payer and exempt to the payee. It is also the result achieved with respect to entertainment expenses when, for example, the employer is denied an otherwise legitimate deduction in whole or in part in order to implicitly tax an employee on the consumption benefits of the entertainment.

At first blush, it might appear that a legislature concerned about revenue should be reluctant to give a deduction for alimony paid by residents when the recipient is a nonresident, due to the practical problems that would arise in subjecting the recipient to taxation. In the typical case, however, that concern for revenue would be misguided. Whatever revenue a state might lose by granting an alimony deduction for payments to nonresidents would be picked up from taxing its own residents on receipt of alimony from a nonresident former spouse. Assuming that the inflows and outflows of alimony payments are in rough balance, a significant revenue loss is unlikely to materialize.

\textsuperscript{39} See IRC section 873. For discussion of the federal rule, see section 1, above.
The New York and federal rules on alimony differ from the marital income-splitting rules in that marital income splitting [*251] is available only if both spouses are taxable as residents, whereas resident payers of alimony are allowed to split income with a former spouse even if that spouse is a nonresident. This difference, however, makes good policy sense. In the case of marital income splitting, the residence state cannot give the appropriate level of relief unless both spouses are subject to its residence jurisdiction. It is clearly feasible, however, for the residence jurisdiction to give the appropriate level of relief to resident individuals making alimony payments whether or not the recipient is a resident.

Although the New York Legislature did not articulate its reasons for limiting the alimony deduction to residents, the resulting arrangement achieves fairness, promotes comity with other taxing jurisdictions, avoids complex problems of administration, coordinates the alimony rules with the marital income-splitting rules, and denies to nonresidents a deduction that is not a cost of generating their New York-source income. A tax rule that achieves all of these worthy goals deserves applause. At a minimum, it should be treated as a reasonable exercise of legislative prerogatives.

3. Analysis of Legal Arguments Under Privileges and Immunities Clause

The principal taxpayer in Lunding was a partner in a New York City law firm and a resident of Connecticut. In 1990, he paid alimony to his former spouse of $108,000. On their joint New York nonresident tax return for 1990, Lunding and his current wife reported federal adjusted gross income of $788,210, which reflects a deduction of $108,000 for the full amount of the alimony paid. Lunding apportioned approximately 48 percent of his partnership income to New York sources.40

In computing his New York-source income, Lunding did not claim the full deduction for alimony payments that is available to New York residents. Instead, he apportioned the deduction between New York and other sources, using the same apportionment percentage used to apportion his partnership income to New York. As a result, Lunding contended that approximately 48 percent of his alimony payment ($51,934) should be allowed as a deduction from New York-source income.

As discussed in section 2, above, the alimony deduction that Lunding claimed on his New York nonresident tax return is explicitly denied under New York law. Lunding contends, however, that the provision of the New York law denying that deduction violates the Privileges and Immunities Clause of the U.S. Constitution. On audit, the New York tax authorities redetermined Lunding’s New York tax liability under the

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applicable statute and successfully defended their assessment in the New York Court of Appeals.

Implicit Concessions of Taxpayer

By claiming only an apportioned deduction for alimony payments, Lunding has conceded that New York may treat residents and nonresidents differently with respect to the alimony deduction without violating the Privileges and Immunities Clause. Residents, after all, get a deduction for the full amount of their alimony payments without apportionment. Lunding’s claim appears to be that some differences in treatment are justifiable, but that those differences must satisfy some unarticulated standard of appropriateness. In effect, Lunding is arguing that if resident taxpayers are allowed a deduction for some type of personal expenditure, then the state is required under the Privileges and Immunities Clause to provide an apportioned deduction for such an expenditure to nonresidents.\footnote{That reading of the Privileges and Immunities Clause goes well beyond established precedents.\footnote{See supra note 25.}}

In addition, Lunding implicitly concedes, as he must, that New York can grant residents a full deduction for their business expenses while requiring nonresidents to deduct only those business expenses attributable to generating their New York-source income. Allowing nonresidents to deduct only expenses associated with their N.Y.-source income is simply a specific application of a more general rule, applicable to all taxpayers, including residents, that expenses incurred to earn income are not deductible unless they relate to income subject to current taxation. New York residents, for example, are denied a New York deduction for expenses incurred in obtaining income paid on U.S. Treasury bonds because such income is exempt from tax under New York law.\footnote{N.Y. Tax Law section 612(b)(5).}

Lunding would not help his case, however, by arguing for an unapportioned alimony deduction. For that argument to prevail, the Court would need to hold that a state must exempt nonresident individuals from its income tax whenever those individuals are making alimony payments in excess of their income derived within the state. For example, assume that N is a resident of Connecticut. He earns $100,000 from practicing law in New York and earns an additional $200,000 from sources outside New York. N pays alimony of $108,000 to a former spouse. Under New York law, residents are permitted to deduct the full amount of their alimony payments. If

\footnote{New York also allows residents, but not nonresidents, to claim their itemized personal deductions. Distinguishing the itemized personal deductions from alimony is difficult — indeed, at one time both federal and New York law treated alimony as an itemized personal deduction. Consequently, Lunding is implicitly arguing that the Privileges and Immunities Clause requires that nonresidents also be allowed to deduct an apportionable share of their itemized deductions.}
New York is required under the Privileges and Immunities Clause to grant N the same deduction, then N will not have any New York-source [*252] taxable income and will not pay any New York tax. Such an inappropriate result should not be required under the Constitution.

**Differential Treatment Of Alimony Payments Appropriate**

Clearly New York is permitted under the Privileges and Immunities Clause to make reasonable distinctions between residents and nonresidents in fashioning its rules on the deductibility of alimony payments. As the Court stated in Toomer v. Witsell, that clause 'does not preclude disparity of treatment in the many situations where there are perfectly valid independent reasons for it.' The issue to be decided in a privileges and immunities case is 'whether such reasons do exist and whether the degree of discrimination bears a close relation to them.'

The Court has long held that the Privileges and Immunities Clause does not require states to grant residents and nonresidents the same package of deductions. As early as 1920, in Shaffer v. Carter, the Court upheld an Oklahoma statute that allowed resident individuals to deduct their worldwide losses but allowed nonresidents to deduct only those losses incurred within the state. The Court understood that the difference in treatment of losses 'is only such as arises naturally from the extent of the jurisdiction of the State in the two classes of cases, and cannot be regarded as an unfriendly or reasonable discrimination.' In Travis v. Yale & Towne Mfg. Co., a companion case to Shaffer, the Court, relying on Shaffer, stated that 'there is no unconstitutional discrimination against citizens of other states in confining the deduction of expenses, losses, etc., in the case of non-resident taxpayers, to such as are connected with income arising from sources within the taxing state.' Applying the lessons of those two cases, the New York Court of Appeals in Lunding concluded that 'limiting taxation of nonresidents to their in-State income was

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44 Canada permits nonresidents engaged in business in Canada to claim a full, unapportioned alimony deduction, with the anomalous result illustrated in the text above. See supra note 20.
45 334 U.S. 385 (1948).
46 Id. at 396.
47 Id. In one of its most recent privileges and immunities cases, the Court restated this view, holding that the clause is not violated if a substantial reason exists for the difference in treatment between residents and nonresidents and the discrimination bears a substantial relationship to the state's objectives. Supreme Court of New Hampshire v. Piper, 470 U.S. 274, 284 (1985).
48 252 U.S. 37 (1920).
49 Shaffer v. Carter, 252 U.S. 37, 57 (1920).
50 252 U.S. 60 (1920).
51 Id. at 75-76 (1920).
a sufficient justification for similarly limiting their deductions to expenses derived from sources producing that in-State income.\textsuperscript{52}

The taxpayer’s basic complaint in Lunding is that the New York tax statute treats alimony expenses differently from business expenses, notwithstanding that alimony payments do not constitute an expense of generating New York-source income. In effect, New York follows the common international practice and allocates the alimony expenses of nonresidents to their state of residence. In contrast, nonresidents must show that an expense relates to earning income in New York in order to claim that expense as a deduction in computing their New York-source income. That a taxing statute can distinguish between business expenses and personal expenses should go without saying. Every income tax statute ever written makes that distinction.\textsuperscript{53} For the taxpayer to make out a case of prohibited discrimination in Lunding, he must demonstrate that New York’s rule requiring nonresidents to allocate the alimony deduction wholly to their state of residence is unreasonable.

In fact, the New York rule on alimony reflects sound tax policy. As discussed in detail in Section 2, above, an alimony deduction is an income-splitting mechanism, designed to implement a refined concept of ability to pay. It was adopted in 1987 as part of a comprehensive reform package that introduced joint filing and marital income splitting to New York. For both intact and broken marriages, New York chose to limit income splitting to individuals taxable as residents on their worldwide income. That decision did not discriminate unfairly against nonresidents. On the contrary, it simply prevents many nonresidents from enjoying an unwarranted windfall.

\textsuperscript{52} 89 NY2d at 288, 675 NE2d at 819, 653 NYS2d at 65. Travis also held, improperly in our view, that it was unconstitutional for a state to limit personal exemptions to only its residents. In any event, Travis can be distinguished. A personal exemption can be viewed as part of a state’s rate schedule. In effect, the state is providing a zero bracket or zero rate for amounts not in excess of the personal exemption. A personal exemption that was limited to only residents would have the effect of taxing them under a more favorable rate schedule than that which applied to nonresidents. If the exemption were set at a high enough level, a state could exempt a majority of its residents.

Described in this manner, Travis is consistent with Austin v. New Hampshire, 420 U.S. 656 (1975). Austin struck down under the Privileges and Immunities Clause a New Hampshire income tax that had the practical effect of applying only to nonresidents. If a state could limit its personal exemptions to only residents, it could approximate the prohibited result in Austin.

The personal exemption rules applicable to nonresidents that have been adopted by the federal government are consistent with the Court’s position in Travis. The federal government generally denies nonresidents the exemptions for dependents, which are intended to adjust for the taxpayer’s family circumstances, but permits nonresidents to claim a personal exemption, which functions as a zero tax bracket. See IRC section 873(b)(3).

\textsuperscript{53} See, e.g., IRC section 162(a) (ordinary and necessary trade or business expenses deductible); IRC section 262(a) (no deduction for personal living or family expenses). Indeed, a taxing statute that failed to make the distinction could hardly be called an ‘income’ tax.
comparable to the windfall they would get by claiming losses arising outside New York against their in-state income.\textsuperscript{54}

In the traditional privileges and immunities case, the taxpayer claims that he or she is similarly situated with some or all resident individuals yet is being denied, for no good reason, a benefit that those residents enjoy.\textsuperscript{55} The taxpayer in Lunding, however, cannot fairly make that claim.\textsuperscript{[*253]}

New York taxes Lunding and his spouse only on their New York-source income, whereas New York residents are taxable on their worldwide income. A New York resident earning Lunding’s income and making the same alimony payments would gladly trade tax shoes with Lunding. As discussed above, Lunding’s federal adjusted gross income was approximately $788,000 in 1990, less than half of which was derived from New York sources. After adding back the alimony deduction, as required under the allegedly discriminatory New York statute, Lunding’s New York-source income was slightly more than $400,000. A similarly situated New York resident would have been taxable on $788,000. That outcome does not have the appearance of discrimination against Lunding.

4. Conclusion

The taxpayer in Lunding asserts that New York’s decision to allocate the entire deduction for alimony to the taxpayer’s state of residence puts it in violation of the Privileges and Immunities Clause of the U.S. Constitution. The complained-of rule, which was adopted fairly recently by New York, has been a feature of the federal income tax since World War II. It has never been considered to be a discriminatory rule in the international context. Although nonresident taxpayers traditionally have not been shy in asserting that provisions of the Internal Revenue Code violate the Nondiscrimination Clause of their country’s tax treaty with the United States, they have not attempted to challenge the U.S. or New York rule that limits the alimony deduction to residents. They have good reason for not mounting that challenge. A denial of the deduction to nonresidents is clearly sanctioned by international custom and by the OECD’s authoritative interpretation of the nondiscrimination clause.

New York is not ‘penalizing the citizens of other States by subjecting them to heavier taxation merely because they are such citizens.’\textsuperscript{56} On the contrary, New York residents typically incur a higher tax burden than equal-income nonresidents under

\textsuperscript{54} The Court prevented that windfall from occurring in Shaffer v. Carter, 252 U.S. 37 (1920).

\textsuperscript{55} For a collection of privileges and immunity cases with commentary, see Richard D. Pomp and Oliver Oldman, State & Local Taxation, Chapter 4 (2d edition, 1997).

\textsuperscript{56} Toomer v. Witsell, 334 U.S. 385, 408 (concurring opinion).
the New York personal income tax. As demonstrated above, New York can fairly claim to have a 'substantial reason for the discrimination against nonresidents beyond the mere fact that they are citizens of other States.'\textsuperscript{57} The New York rule complained of prevents nonresident taxpayers from emasculating the New York income tax base by taking deductions for personal expenditures that have no substantial relationship to their New York-source income.

In its recent opinion in Oklahoma Tax Commission v. Jefferson Lines,\textsuperscript{58} the Court displayed a sophisticated sensitivity to the benefits of looking to the structural features of the tax being challenged in judging whether the taxing state has overreached unconstitutionally.\textsuperscript{59} In that case, the Court concluded that a sales tax on bus tickets, although equivalent in its economic effects to an unconstitutional gross receipts tax on interstate bus transportation, nonetheless passed constitutional muster. Central to the holding of the Court was its judgment that the retail sales tax in question presented no significant risk of double taxation, whereas a gross receipts tax almost invariably presents such risks.

The issue raised in Lunding under the Privileges and Immunities Clause differs significantly from the Commerce Clause issue raised in Jefferson Lines.\textsuperscript{60} The need for a structural analysis of the challenged statute, however, is the same. A personal income tax that applies to residents with respect to their worldwide income and to nonresidents with respect to their income derived within the taxing jurisdiction necessarily includes features that treat residents and nonresidents differently. Those differences, viewed in isolation, may appear as discriminatory, for nonresidents generally are not allowed to claim certain personal deductions available to residents. In the context of the statute in which they are embedded, however, those differences are not discriminatory in intent or in their primary effects. On the contrary, they implement normative policy goals that are important to the states.


\textsuperscript{58} 115 S. Ct. 1331 (1995). (For a summary of the Supreme Court's decision in Jefferson Lines, see State Tax Notes, Apr. 10, 1995, p. 1503; for the full text of the decision, see 95 STN 64-218.)


\textsuperscript{60} There is, however, one significant similarity. The issue in Jefferson Lines was how a state sales tax should be apportioned. Lunding can be viewed as raising an apportionment issue in the context of New York's personal income tax. The typical approach of the states in apportioning personal income tax revenues is for the residence state to tax its residents on their worldwide income and to grant them a credit for the income taxes that they have paid to source states. That approach has the effect of fairly apportioning income between the residence state and the source state in the case of an individual earning income outside his or her state of residence.
The New York rules on the alimony deduction implement the policy goal of taxing nonresidents on their net gains from conducting economic activity in the source state while leaving ability-to-pay adjustments for family and marital circumstances to the state of residence. The source state, which typically taxes only a slice of the income of nonresidents, is not in a position to make refined adjustments for a nonresident’s ability to pay, which is a function of an individual’s worldwide income. Nor should the source state be required by constitutional mandate to allow a nonresident to take deductions for personal expenditures unrelated to economic activities conducted within its borders. The result achieved under New York law is consistent with the practice of many states and many national governments. That eminently sensible result should not be held to violate the Privileges and Immunities Clause.