Post-Marriage Income Splitting Through the Deduction for Alimony Payments: A Reply to Professor Schoettle on *Lunding V. New York*

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This article responds to an analysis of the Lunding case by Ferdinand P. Schoettle, professor of law at the University of Minnesota Law School and another member of State Tax Notes' Advisory Board. In "Taxing Nonresidents — The 'Puzzling Failure of Economics': Christopher H. Lunding v. State of New York," which appeared in State Tax Notes, Nov. 3, 1997, p. 1119, Schoettle criticizes McIntyre and Pomp's defense of New York's position in refusing an exemption for nonresident alimony payments in Lunding, which is currently before the U.S. Supreme Court.

McIntyre and Pomp initially put forth their arguments in "State Income Tax Treatment of Residents and Nonresidents Under the Privileges and Immunities Clause," State Tax Notes, July 28, 1997, p. 245.

For coverage of arguments before the Supreme Court in the Lunding case, see State Tax Notes, Nov. 10, 1997, p. 1173.

In a recent article in State Tax Notes,[1] Professor Ferdinand P. Schoettle applied what he calls the principles of free-market economics to analyze Lunding v. New York, a case currently before the U.S. Supreme Court.[2] The issue in *Lunding* is whether New York, which grants its residents a deduction for alimony payments, has violated the U.S. Constitution by denying nonresident taxpayers earning income in New York a deduction for an apportioned share of their alimony payments.

The taxpayer and the Court have viewed the issue in *Lunding* as presenting a possible violation of the Privileges and Immunities Clause of the U.S. Constitution. As Professor

[1]Ferdinand P. Schoettle, "Taxing Nonresidents — The 'Puzzling Failure of Economics': Christopher H. Lunding v. State of New York," State Tax Notes, Nov. 3, 1997, p. 1119 (hereinafter referred to as Schoettle).

[2]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.

Schoettle implicitly concedes, the focus of his free-market analysis is on a possible violation of the Commerce Clause. Although Schoettle's Commerce Clause issue was addressed briefly in the New York courts, it was not addressed by the Supreme Court in its grant of certiorari and has not been briefed by the parties. Thus, Schoettle's article is concerned with the *Lunding* case he would like to see before the Court rather than the one that is actually under review.

In a previous article appearing in these pages, we argued that the New York treatment of alimony represents sound tax policy and should be held constitutional under the Privileges and Immunities Clause.[3] Our central argument in defense of the New York system is that it fairly implements the same principle of income splitting between former spouses that informs the New York marital income- splitting regime adopted in 1987.[4] [*1632]

As discussed in greater detail in section 1, below, the general principle under New York law, applicable to most residents and most nonresidents, is that net New York income used to pay alimony should be taxed once and only once. That principle is implemented in the most common cases by taxing the recipient of alimony when that person is a New York resident, fully subject to tax by the state, and by granting a deduction to the resident payer. When the alimony recipient is a nonresident, that person is not taxed on receipt of the alimony. The New York income out of which the alimony is presumed to be made is taxable to the nonresident payer, however, by denying the payer a deduction for that payment.

This difference in the treatment of alimony results in a difference in the tax rates applicable to the New York income out of which it presumably was paid. When the deduction is allowed, that income is removed from the tax base of the payer and included in the tax base of the recipient. The tax rate applicable to that income is the New York tax rate of the recipient. When the deduction is denied, the applicable rate is the New York tax rate of the payer. This difference in the applicable rates is justified by administrative concerns and has never been thought to create a problem under the Privileges and Immunities Clause prior to *Lunding*.

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[3]See Michael J. McIntyre and Richard D. Pomp, "State Income Tax Treatment of Residents and Nonresidents Under the Privileges and Immunities Clause," State Tax Notes, July 28, 1997, p. 245 (hereinafter referred to as McIntyre and Pomp). Professor Schoettle chides us mildly for "fail[ing] to mention the free-market issues." Schoettle, supra note 1, at 1119. His criticism strikes us as mildly unfair, as we explicitly limited ourselves in that piece to the Privileges and Immunities Clause issue before the Court. Schoettle, in his own brief discussion of the Privileges and Immunities Clause, also omits any discussion of free-market issues.

Moreover, Professor Schoettle's analysis of the taxpayer's Privileges and Immunities Clause argument seems to concede, albeit begrudgingly, that New York has a strong case on that issue. In describing the Court's leading Privilege and Immunities Clause cases, he states that "Shaffer v. Carter tends to support New York's denying Mr. Lunding a deduction for alimony," that "[u]nfortunately for the Lundings, the Supreme Court's actions in 1985 greatly reduced the precedential value of its 1920 holding in Travis v. Yale & Towne Mfg. Co.," that "[a]s far as the Privileges and Immunities Clause precedent is concerned, state courts have great freedom in deciding whether deductions allowed to residents for income tax accounting purposes must also be allowed to nonresidents," and that "the New York Court of Appeals found adequate reasons supporting the denial of an alimony deduction to nonresidents while allowing such deduction to residents." Id. at 1122-23.

[4]As noted in our prior piece, we both were involved in the formulation of New York's marital income-splitting regime. McIntyre and Pomp, supra note 3, at 245.

In making a Commerce Clause argument on behalf of the taxpayer in *Lunding*, Professor Schoettle recognizes that the proper issue for discussion in that situation is the appropriate tax rate to apply to income used to pay alimony. In this respect, he makes a helpful contribution to the debate. Unfortunately, his discussion of rates is faulty, due to his apparent misunderstanding of some important features of the New York system. As discussed in section 2, below, the actual New York system promotes free-market values, as those values are articulated by Schoettle. Indeed, in each of the several hypotheticals that Schoettle poses to test the New York rule, the actual result reached by New York is consistent with the position he advocates.

1. Alimony, Income Splitting, and the Alleged Discrimination Against Nonresidents Under the Privileges and Immunities Clause

As we noted in our earlier article, New York adopted the alimony rule complained of in *Lunding* in 1987 as part of a major overhaul of the family taxation features of its personal income tax.[5] The most fundamental change was the replacement of its separate filing regime, which it had employed since 1919, with a marital income splitting regime. Marital income-splitting was necessarily limited to residents because both marital partners must be taxable in New York on their total income for the goals of income splitting to be fully implemented. For much the same reason, the 1987 legislation eliminated the deduction for alimony payments made by nonresident individuals.

To appreciate the policy justification for denying nonresidents a deduction for alimony, it is necessary to see how the deduction for the payer, in conjunction with the taxation of alimony to the recipient, operates as an income-splitting mechanism. As discussed below, the effectiveness of the deduction in achieving the tax policy goal of income splitting depends in part on the residence of the payer and the recipient. Because formerly married couples tend to live in the same state, the two most important patterns to discuss are when both former spouses are residents of New York and when both are nonresidents. The difference in the treatment of these two pairs of taxpayers under New York law is being challenged in *Lunding* under the Privileges and Immunities Clause. For completeness, nevertheless, it is useful to consider two additional patterns — (1) when the payer is a resident and the recipient is a nonresident and (2) when the payer is a nonresident and the recipient is a resident.

Payments of Alimony From One Resident to Another

Under New York law, the alimony deduction operates best as an income-splitting mechanism when the payer and the recipient are both resident in New York. Assume, for example, that FH is the former spouse of FW, that both are New York residents, and that FH has income of $100,000 and is paying alimony of $40,000 to FW. If FH is allowed to

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[5]See McIntyre and Pomp, supra note 3, at 249-50. For discussion of the recommendations of the New York Legislative Commission on the Modernization and Simplification of Tax Administration and the Tax Law that were the basis for those reforms, see Michael J. McIntyre, "Tax Consequences of Family Sharing Practices Under New York Law: A Critique and a Proposal for Reform," 49 Alb. L. Rev. 275 (1985). For discussion of the state legislation enacted in 1987, see Michael J. McIntyre, "Tax Justice for Family Members After New York State Tax Reform," 51 Alb. Law Rev. 789 (1987).

deduct the alimony payment of $40,000 and FW is taxable on that amount, then the obvious result is the shifting of income from FH to FW.

When income is shifted between former spouses and both former spouses are New York residents, the income out of which the alimony is presumed to be paid ends up being taxed at the tax rate of the recipient rather than the tax rate of the payer. This result is desirable in a state that has adopted the tax principle that income is properly taxable to the person who enjoys the consumption and savings that it finances. Marital income splitting for New York residents was adopted by New York in 1987 to implement that principle. The application of that principle to former spouses is a logical extension of the marital income-splitting rule.

The fundamental point to note is that the deduction for alimony in the above example does not change the amount of income taxable by New York. New York taxes the same $100,000 of income that it would have taxed if no alimony payment had been made. What is changed is the rate at which that income is taxed. Given the graduated rate structure of New York, the tax rate on that income is reduced, assuming, as would be typical, that the recipient of the alimony is in a lower tax bracket than the payer.

Alimony Payments Between Nonresidents

When both former spouses are nonresidents, which is the situation in *Lunding*, New York denies an alimony deduction [*1633] to the payer and exempts the recipient of the alimony payment from New York tax. The result is that the income presumed to be deflected to the alimony recipient is taxed once and only once by New York. The tax is formally imposed on the payer through the increased tax that results from the denial of the deduction.[6]

In theory, New York could grant a deduction for alimony to the nonresident payer and tax that amount to the nonresident recipient. By adopting that approach, New York presumably could avoid having to confront the Privileges and Immunities Clause issue presented in *Lunding*. It would still end up taxing 100 percent of the New York source income out of which the alimony is presumed to be paid. Leaving aside constitutional issues, that approach is less desirable than the approach actually followed by New York because of the administrative problems that would arise in taxing the nonresident recipients of alimony payments. Those alimony recipients typically do not file a New York tax return. In practice, therefore, New York would need to establish an information reporting system or some type of withholding system to collect its tax, thereby turning thousands of ordinary individuals paying alimony into reporting or collecting agents for the tax department.

New York's current system, which denies a deduction to a nonresident payer and exempts the nonresident recipient, is firmly grounded on tax principles. An alternative system that would grant the deduction to a nonresident payer and would tax the

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[6]Some of the burden of that tax, however, is likely to be shifted to the recipient because tax burdens imposed on alimony payments are usually taken into account in setting the level of such payments.

nonresident recipient also would be justified on tax policy grounds, notwithstanding the administrative problems it would pose. Both systems recognize that a state should tax income used to pay alimony once and only once. In sharp contrast, the system argued for by the taxpayer in *Lunding* is unprincipled, for it would allow some portion of the New York income used to pay alimony to escape New York taxation entirely.

To illustrate the defect in the system proposed by the taxpayer in *Lunding*, assume that FH and FW in the above example are both nonresidents. FH earns his entire income of $100,000 from New York sources. As a nonresident, FW is not taxable by New York on the alimony payment of $40,000 received from FH. If the deduction for alimony were to be granted to FH, therefore, New York would collect tax on only $60,000 of income, notwithstanding that FH and FW have together derived $100,000 of income from New York sources.[7]

As noted above, the Court's constitutional jurisprudence would allow New York to impose tax on a nonresident individual receiving an alimony payment that was paid out of income properly traceable to New York sources. By imposing that tax and granting the payer a deduction, the state would have an easy statutory fix if the Court were to decide *Lunding* against it. If it is constitutional to tax a nonresident recipient of alimony directly, however, it should also be constitutional to do so indirectly by denying an alimony deduction to the person making the payment. We do not believe that the Privileges and Immunities Clause should be interpreted so as to elevate form over substance.

We believe that the Court also should be reluctant to push New York to adopt that statutory fix of taxing nonresident recipients because by doing so it would create significant risks of double taxation. Nearly all states, including New York, tax their residents on alimony payments received. If New York were to tax nonresident recipients of alimony payments on a source basis and the residence state also were to impose its tax on those payments, the alimony recipient would be subject to double taxation unless relief were granted by the residence state through a tax credit. The residence state, however, may not be obligated under the Court's constitutional jurisprudence to grant a tax credit in these circumstances.

The Court has never articulated in detail when a state is required to give a credit for income taxes paid to a sister state. In the tax literature and in the international community, however, the traditional rule is that the residence state ought to bear the burden for relieving double taxation by granting a credit for income taxes imposed by the source state. Application of this traditional rule would not eliminate the risk of double taxation in the case of alimony because the source of alimony income is unclear. Under the federal rule, alimony income has its source in the state of residence of the payer,[8] which would not be

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[7]In the example, all of the nonresident's income was sourced in New York. That case is atypical. In *Lunding*, for example, less than half of the nonresident payer's income was taxable by New York. If the New York alimony rules are fair to the nonresident taxpayer in the example, they are fair, a fortiori, to nonresident taxpayers subject to tax in New York on only a fraction of their income.

[8]Manning v. Com'r, 614 F.2d 815 (1st Cir. 1980); Warwick Housden v. Com'r, TC Memo 1992-91, 63 T.C.M. 2063 (1992). See Michael J. McIntyre, The International Income Tax Rules of the United States, section 3/A3d (1989 with current updates).

New York in the case of a nonresident payer. A state adopting this source rule would not grant a credit to its residents for the New York tax paid on their receipt of alimony. A state may, however, choose to adopt other source rules, which might mitigate any double taxation.[9]

The Court is hardly in a position to draft a detailed set of unique source rules for the states under the guise of interpreting the Privileges and Immunities Clause. Yet a decision for Mr. Lunding would implicitly be imposing a source rule for alimony on the states. If the Court requires that Lunding be allowed to deduct an apportioned share of his alimony payment against his New York income, the state would be entitled to tax the recipient on the ground that the alimony has its source in New York. Why the Court would want to stretch its powers [*1634] under the Privileges and Immunities Clause to impose a controversial source rule on the states is difficult to understand.[10]

In summary, the New York rule of denying a deduction for alimony payments between nonresidents results in the full taxation of New York-source income out of which the alimony is presumed to be paid. The same amount of income is taxable by New York when the alimony payments are made between residents. Thus there is no discrimination under New York law in the rules defining taxable income between a pair of formerly married individuals who are New York residents and an equivalent pair of former spouses who are nonresidents.

Alimony Payments Between a Resident and a Nonresident

The above discussion has focused on alimony payers and recipients when both are residents of New York or when both are nonresidents, as is the case of Mr. Lunding and his former spouse. New York policymakers could plausibly have believed that these two situations account for the overwhelming majority of former spouses with New York ties who are receiving or paying alimony. Two other situations can arise, however, that merit some discussion. Neither of these situations would properly invoke the Privileges and Immunities Clause because they do not entail a systematic discrimination against nonresident individuals.

In the first of these situations, the payer is a resident of New York and the recipient is a nonresident. Under certain normative tax principles, New York's alimony rules are too generous to former spouses in this situation because the payer receives an alimony deduction and the recipient is not taxable on the alimony payment. Thus the income shifted from the resident to the nonresident recipient is not subject to New York tax at all.

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[9]For example, a competing-source rule would treat the alimony as being sourced proportionately in the states in which the payer earned his or her income.

[10]An analogy may be drawn between the source of alimony payments and the source of interest payments. In both cases, the obligation to make the payment is incurred under the reasonable expectation that the obligor will be earning sufficient income in the future to meet that obligation. The legal obligation must be met, nevertheless, even if the obligor fails to earn the expected future income. Because of the weak linkage between interest and any particular gross income item, the international community has generally assigned the source of interest income to the country of residence of the obligor. The comparable linkage is significantly weaker in the case of alimony.

The seemingly too-generous treatment of a resident payer and nonresident recipient will be mitigated by the treatment of the recipient in his or her state of residence, assuming that the resident state imposes an income tax comparable to the New York tax. As discussed above, nearly all states would tax the alimony recipient, thereby removing some or all of the benefit the former spouses would obtain from the New York rule. New York's too-generous treatment of the recipient thus inures primarily to the benefit of that individual's state of residence.

In the second situation, the payer of alimony is a nonresident and the recipient is a resident. Here the New York rules are insufficiently generous under normative tax policy criteria because they deny the payer an alimony deduction and also tax the recipient of the alimony payment. The New York rules may be viewed as subjecting the former spouses to a tentative double tax on income used to pay alimony in this situation.

The insufficiently generous treatment of former spouses in this second situation is likely to be mitigated or eliminated by the harmonization of the New York rules with the tax rules of most sister states. All states imposing an income tax give a credit to their residents for taxes paid to sister states on income that is treated as arising in those states. Thus the tentative double tax on the former spouses will be eliminated, in whole or in part, when the state of residence gives the alimony payer a credit for the New York tax. Accordingly, New York's insufficiently generous treatment of the payer is unlikely to affect substantially his or her after-tax position; its primary effect will be on the amount of taxes collected by the payer's state of residence.[11]

Rather than relying on widely accepted principles of comity to solve the equity problem in the second situation, involving a nonresident payer and a resident recipient, New York might attempt to give relief directly by allowing nonresidents making alimony payments to New York residents to take the deduction. That rule, of course, would not help Mr. Lunding, who pays alimony to a nonresident and who suffers no hardship from the current New York rule. It would give appropriate relief, however, to that presumably small number of nonresident alimony payers whose former spouses reside in New York.

The apparently simple solution suggested above is anything but simple in practice. The suggested rule would work acceptably well only if most nonresident payers of alimony could be expected to know the residency of the alimony recipient. In fact, they often would not. Residency is one of the most litigated issues in a state income tax, oftentimes turning on factors of which the payer may have no knowledge and which may change from year to year. In a contentious divorce, the payer may know only the mailing address of the

[11]If payers were to receive a deduction for the payment of alimony in calculating their New York taxable income, their New York taxes would be less than what they are under current law; such a reduction in New York taxes would reduce the credit they would otherwise receive against the income tax in their state of residence. Consequently, although the deduction would reduce their New York income taxes, it would increase the income taxes paid in their state of residence. Thus a decision by New York to allow or disallow an alimony deduction is likely to have its primary effect on the way the tax base is shared between New York and the state of residence of the payer and to have relatively little effect on the tax burdens imposed on those payers, unless of course the payer is resident in one of the handful of states that does not have a personal income tax.

recipient, which is not terribly relevant in determining residency. The New York tax department, moreover, would face problems of administration in determining whether a nonresident alimony payer was entitled to the deduction. In auditing individual taxpayers, the department depends very heavily on information received from the federal tax authorities. The state residency of taxpayers is of no interest to federal authorities, and that information does not appear on a taxpayer's federal tax return.[12] [*1635]

In theory, New York could adopt a rule that was neutral toward resident and nonresident payers of alimony by denying the alimony deduction to all New York taxpayers, whether resident or nonresident, whenever the alimony payments were made to a nonresident former spouse. This rule would present formidable administrative problems because it would require payers of alimony to know the state of residency of the recipient. As noted above, that information is often not available to them or to the tax department.

The hypothetical replacement rule described above would not be neutral on its face with respect to resident and nonresident recipients of alimony. Nonresident recipients of alimony can fairly claim that they would be affected adversely by the rule because they are likely to bear some or all of the tax burden imposed on the payer with respect to alimony payments.[13] Whether nonresident alimony recipients would receive support in the courts for a constitutional challenge to that rule is unknown. In our view, the tax policy arguments that can be advanced in its favor are significantly less persuasive than the arguments offered above in defense of the current New York rule.

The only difference between the hypothetical replacement rule and the current New York rule is in the treatment of resident payers of alimony. New York currently allows resident payers to deduct alimony payments to nonresidents, whereas the replacement rule would not allow the deduction. As discussed in detail above, the current New York rule is far simpler to administer than the hypothetical replacement, and it harmonizes better with the alimony rules of sister states. Nonresident alimony recipients would be treated unfairly under the replacement rule if they were taxable on the receipt of alimony in their state of residence and also paid indirectly some or all of the New York tax imposed on the payer. This implicit double taxation would occur most frequently when the payer was a New York resident because nonresident payers typically would receive a credit in their state of residence for the New York tax, whereas New York residents obviously would not get a credit.[14]

[12]One of the stated goals of New York's 1987 reform was to eliminate, to the extent feasible, the need for information sources independent of the Internal Revenue Service enforcement machinery. See Michael J. McIntyre, "Tax Justice for Family Members After New York State Tax Reform," 51 Alb. Law Rev. 789 (1987) at 793.

[13]See supra, note 6.

[14]By giving a credit to resident payers for their New York taxes paid with respect to New York income used to pay alimony, New York would effectively convert the hypothetical replacement rule into the current New York rule.

Lack of Systematic Bias

Under the Court's long-standing constitutional jurisprudence, a tax rule is not suspect under the Privileges and Immunity Clause simply because a nonresident happens to be denied a tax benefit enjoyed by certain other taxpayers. The burden on the taxpayer making a case under that clause is to show that some identifiable class of nonresident individuals is systematically disadvantaged under the challenged rule.[15] Certainly no proof of such systematic bias was offered by the taxpayer in *Lunding*.

Nor could the taxpayer in the *Lunding* case make that proof. Because New York's alimony rules implement the goal of income splitting, they should be evaluated for tax policy purposes and for constitutional purposes by reference to the combined tax consequences to the payer of alimony and the recipient. As discussed above, the New York system gets the correct tax policy result when both the payer and the recipient are New York residents and when both individuals are nonresidents. These cases are far and away the most important ones.

The New York system typically gets reasonable results when one of the parties to the alimony transaction is a resident and the other is a nonresident. Those latter results may be less than ideal, but the too-generous and insufficiently generous results sometimes achieved are typically ameliorated by the comparable tax rules of other states. Most importantly from the perspective of the Privileges and Immunities Clause, those results are not biased against any identifiable class of nonresidents. The potential bias is against certain pairs of former spouses, one a resident and the other a nonresident.

Notwithstanding the lack of systematic bias, a question legitimately arises as to whether New York obtains an unfair share of tax revenue from the interplay of its alimony deduction rules with the comparable rules of other states. The answer is clearly no, on the reasonable assumption that the inflows and outflows of alimony payments among the states are approximately in balance. The revenue loss from the too-generous treatment in one situation is washed out by the insufficiently generous treatment in the other situation.[16]

In any event, the question of whether the New York alimony rules result in a fair sharing of revenue among the states is not an issue properly addressed under the Privileges and Immunities Clause. As Professor Schoettle suggests, that issue is best addressed under the Commerce Clause. To that issue we now turn.

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[15]A nonresident taxpayer who believes that a state statute discriminates against him but is unable to show that it disadvantages an identifiable class of nonresidents may assert a violation of the Equal Protection Clause. To defeat an Equal Protection Clause challenge, however, a state need only show a rational basis for its statute. The taxpayer did in fact raise an Equal Protection Clause argument in the case below, but that argument has been treated properly as a makeweight.

[16]The too-generous treatment of former spouses in situation (1) is not corrected if the state of residence of the alimony recipient does not impose an income tax. Similarly, the insufficiently generous treatment in situation (2) is not corrected if the state of residence of the payer of alimony does not impose an income tax. These cases of potential unfairness are fairly minor. No conceivable set of alimony deduction rules could eliminate all potential problems of this nature, given the diversity of state income tax rules.

2. Professor Schoettle's Free-Market Principles And the Commerce Clause

In principle, a state can violate the U.S. Constitution by discriminating against nonresidents in its rules for defining taxable income or in its tax rate rules.[17] Discriminatory tax base [*1636] rules adversely affecting nonresident individuals are clearly suspect under the Court's Privileges and Immunities Clause jurisprudence.[18] The Court has never confronted a case in which a state taxing statute imposed overtly discriminatory income tax rates on nonresidents.[19] We have little doubt, nevertheless, that such a state statute would be stuck down. For example, the Court would surely overturn under the Privileges and Immunities Clause a state statute that taxed residents at 10 percent and nonresidents at 20 percent. In practice, however, this type of overt rate discrimination simply does not occur in income tax statutes.

As discussed above, the alimony rules adopted by New York in 1987 and under challenge in *Lunding* result in a differential in the rates of tax imposed on pairs of resident former spouses and pairs of nonresident former spouses. An appropriate question for the Court in *Lunding*, which we addressed in section 1, above, is whether the rate differences systematically give an advantage to resident individuals at the expense of nonresidents. We concluded that there is no systematic bias against nonresidents under the New York rules. As a result, we do not believe that the New York alimony rules should be viewed as suspect under the Privileges and Immunities Clause.

Professor Schoettle, in his recent article, has urged the Court to use the *Lunding* case to address a quite different tax rate issue. In Schoettle's view, the Court can appropriately use *Lunding* to infuse free-trade values into the Commerce Clause. Schoettle does not assert that the New York alimony rules under challenge in *Lunding* actually violate the Commerce Clause.[20] Nor does he provide any specific guidance to the Court as to how *Lunding* should

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[17]For a taxonomy of tax rules and how they affect tax liabilities, see Michael J. McIntyre, "What Should Be Redistributed in a Redistributive Income Tax? Retrospective Comments on the Carter Commission Report," in The Quest for Tax Reform: The Royal Commission on Taxation Twenty Years Later (W. Neil Brooks, ed.), Carswell, Toronto 1988.

[18]See, e.g. Austin v. New Hampshire, 420 U.S. 656 (1975) (New Hampshire income tax held unconstitutional because it applied to the New Hampshire wage income of nonresidents and excluded the wage income of residents).

[19]The Court has been quick to strike down discriminatory license or privilege fees on nonresidents. See, e.g., Mullaney v. Anderson, 342 U.S. 415 (1952) (striking down higher fees for nonresident fishermen); Toomer v. Witsell, 334 U.S. 385 (1948) (striking down a higher license fee for shrimp fishing boats owned by nonresidents); Chalker v. Birmingham & N.W. Ry., 249 U.S. 522 (1919) (invalidating higher fees on construction firms having their principal offices out-of-state).

[20]Professor Schoettle does assert that he would grant nonresidents an apportioned share of the "personal itemized deductions" available to residents. Schoettle, supra note 1, at 1127. Schoettle apparently classifies alimony as a personal deduction for purposes of that statement. His reasoning for allowing such deductions is that they "seem a cost of doing business in New York." Schoettle's unusual aesthetic judgment on this point is not based on his free-trade values or on any articulated constitutional principles.

New York generally treats personal itemized deductions the way it treats alimony. That is, it allows the nonresident taxpayer a deduction for them in computing his New York taxable income (T). Unlike alimony, however, personal itemized deductions are not allowed as a deduction from federal adjusted gross income (A). And New York does not allow the deduction in computing New York source net income (N). The basic formula for computing New York tax is $T/A \times N$. See infra, note 22. Thus if a nonresident individual would be analyzed under the Commerce Clause. He contents himself with laying out "the basic ideas of free trade" and applying a free-trade analysis to a series of hypothetical cases that resemble the *Lunding* case in some respects.

Without endorsing Professor Schoettle's analytical framework or his constitutional jurisprudence, we do embrace two of his key propositions. First, we agree that the question of how the states should tax nonresidents on their in-state income to achieve a fair allocation of tax revenue among the states is best answered by reference to Commerce Clause values rather than to the values implicit in the Privileges and Immunities Clause. Second, we concur with Professor Schoettle in giving significant weight to free-trade values in deciding whether a state has overreached in its taxation of nonresidents. For reasons presented below, we conclude that New York has set its tax rates in a way that satisfies Schoettle's free-trade values and that results in a fair sharing of tax revenues among the several states, notwithstanding some statements of Schoettle to the contrary.

In explicating the implications of his free-trade approach to interpreting the Commerce Clause, Professor Schoettle has described what he considers to be the appropriate free-trade result in a series of hypothetical cases, only some of which relate directly to New York's alimony deduction. Those hypotheticals relevant to the Commerce Clause issue implicit in *Lunding* are discussed below. Schoettle strongly implies that several of his hypotheticals distill certain provisions of New York law that are relevant to the *Lunding* case. As noted below, Schoettle appears to have misunderstood some aspects of the contested New York statute.

Setting the Appropriate Tax Rate on Nonresidents

Professor Schoettle employs the following example to illustrate the free-trade issues that arise in designing an appropriate rate structure applicable to nonresident individuals when resident individuals are subject to graduated tax rates. Consider A, a resident of Connecticut, who has total income of $100,000. A earns $50,000 in New York, the source state, and $50,000 in Connecticut. B, a resident of New York who is a competitor of A's, also has total income of $100,000, all of which is earned in New York.[21]

New York taxes residents such as B under a graduated rate structure. The issue that forms the heart of Professor Schoettle's Commerce Clause analysis is how to tax A, who is taxable on only a portion of his income, in a way that gives A no competitive advantage or disadvantage with respect to B. A has an obvious interest in not being taxed more harshly than B, and B has an obvious interest in being taxed no less favorably than A. New York's approach is to maintain equity between A and B by taxing A at the same average rate of tax that applies to B.

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have worldwide taxable income of $30,000 before the deduction for personal itemized deductions and had itemized deductions of $30,000, he would not pay any income tax to New York because his taxable income computed as if he were a New York resident (T) would be zero ($30,000 minus $30,000).

[21]This example is based on Schoettle, supra note 1, at 1126.

New York implements this approach by having a nonresident first calculate the amount of tax that he would be required to pay if he were a New York resident. In calculating this tentative New York tax, the nonresident taxpayer computes his New York taxable income, claiming all the deductions that he would be allowed if he were a resident, including a deduction for any alimony paid. Next, the nonresident divides that tentative New York tax by the amount of his federal adjusted gross income, calculated as if he were a resident. In making that calculation, the nonresident again is allowed a deduction for any alimony paid. The resulting fraction is the average tax rate that would apply to a New York resident having the equivalent amount of federal adjusted gross income. The nonresident [*1637] individual then multiplies the average rate so computed by the amount of his New York source net income, computed without an allowance for alimony payments.[22]

As explained above, New York takes into account a nonresident individual's total income in determining the rate at which that individual will be taxed. Professor Schoettle contends that the New York approach is consistent with free-market values. Indeed, he argues that a contrary approach — taxing the nonresident individual's net New York-source income as if it were the taxpayer's total worldwide income -- would violate those values. We concur. We obviously do not concur, however, with Schoettle's unstated but apparent belief that *Lunding* should be decided for the taxpayer. As explained below, the state's position in that case is entirely consistent with the free-trade values that Schoettle endorses.

Proper Treatment Of Out-of-State Losses

In defending the constitutionality of its taxing statute, New York has relied in part on dicta in the Court's opinion in Shaffer v. Carter.[23] According to Shaffer, a state is permitted to tax nonresident taxpayers on their in-state income without allowing them a deduction for losses arising outside the state, notwithstanding that resident taxpayers are allowed a deduction for such losses. The Court stated that position as follows:

> As to nonresidents, the jurisdiction [of the source state] 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. Hence there is no obligation to accord to them a deduction by reason of losses elsewhere incurred.[24]

[22]This average tax rate is sometimes referred to in tax parlance as the effective tax rate. There is no standard method, however, for measuring effective tax rates. Of course the New York taxing statute does not make reference to the concept of an effective tax rate.
In the interests of clarity, our description above is a paraphrase of the literal language of the New York statute. Under the statute, the taxpayer is directed to divide his New York-source net income (N) by his federal adjusted gross income (A) and then multiply the result by the taxable income that he would report if he were a New York resident (T). That implicit statutory formula, $N/A \times T$, is equivalent to the formula in the text above, which is $T/A \times N$. The latter formula simply makes clear what we understand to be the objective of the New York statute.

[23]252 U.S. 37 (1919).

[24]252 U.S. at 57.

Professor Schoettle is unhappy with the result in Shaffer and invites the Court to disregard it.[25] In what is apparently a criticism of New York law, he states that "[A] rule that permitted New York to ignore out-of-state losses in computing a nonresident's income taxpaying ability but to use such losses in computing a resident's income taxpaying ability would systematically tilt the playing field to favor residents. In many cases such a rule would grant lower marginal tax rates to residents than to nonresidents."[26]

The Shaffer dicta and New York law, however, are entirely consistent with free-trade values. Under New York law, the income derived by a nonresident taxpayer from an out-of-state investment unrelated to any New York activities is not taxable by New York. That is, if the investment produces a gain, the gain is exempt from tax. Concomitantly, if there is a loss, the loss is not deductible. We do not understand why Schoettle does not view this pair of results as economically neutral, nor do we understand why he prefers instead an asymmetrical rule whereby New York would allow nonresidents to deduct out-of-state losses but would be prevented from taxing out-of-state gains.

Indeed, under Professor Schoettle's preferred approach, nonresidents would favor risky investments over safer investments, thereby offending the free-trade values he espouses. To illustrate, assume that NR, a nonresident of New York, earns wages in New York of $100,000, taxable at a rate of 8 percent. NR is contemplating two investments in some state other than New York. The first investment is expected to produce income of $50,000, with no risk of loss. The second is expected to produce income of $100,000 with a 50 percent risk of a loss of $100,000. Aside from taxes, NR would properly view these investments as economically equivalent in that the risky investment, discounted for the risk, and the safe investment would each produce an expected gain of $50,000.

If New York were to follow Professor Schoettle's advice, however, by abandoning the Shaffer rule and allowing a deduction for unrelated out-of-state losses, the nonresident would now favor the risky investment, which then would have an expected yield, after discounting for the risk of loss, of $54,000 ($100,000 minus 50 percent of $92,000). Under Professor Schoettle's free-trade principles, two investments that are economically equivalent on a pretax basis should also be economically equivalent on a posttax basis. That goal is achieved under the Shaffer rule.[27]

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[25]Schoettle, supra note 1, at 1127.

[26]Id.

[27]Professor Schoettle suggests that the Shaffer rule would encourage a nonresident taxpayer with out-of-state losses and New York income to want to become a New York resident. This incentive, he asserts, shows that the Shaffer rule is not neutral. Schoettle, supra note 1, at 1127 (asserting that the Shaffer rule favors residents over nonresidents, which is equivalent to saying that it would cause a nonresident to prefer for tax purposes to be a resident). Schoettle misses the point of his own hypothetical. No taxpayer engaging in real economic transactions is seeking to achieve losses. Losses are simply a downside outcome of risky but potentially lucrative investments. In judging whether the Shaffer rule is neutral, therefore, Schoettle should have focused on a nonresident individual contemplating an investment either in or out of New York, when he obviously would not know the outcome of the investment. Because the nonresident investor would expect gains, he would prefer, from the perspective of New York taxation only, to remain a nonresident and invest outside New York. This nonneutrality has nothing to do with the Shaffer rule; it is caused by the inability of New York to tax nonresidents on their out-of-state income. Repeal of the Shaffer rule would magnify rather than eliminate this nonneutrality. We also note that the inherent nonneutrality of source taxation is largely

Professor Schoettle may also misunderstand the application of New York law when a nonresident has unrelated out-of-state losses. He poses the situation in which an out-of-state taxpayer earns $100,000 in New York and has losses of $500,000 elsewhere.[28] Schoettle believes that the nonresident should be allowed to deduct the out-of- state losses, notwithstanding the dicta in Shaffer, because the nonresident has no ability to pay taxes. New York, however, has anticipated and properly responded to the equity issue raised by his hypothetical. [*1638]

As explained above, a nonresident individual is taxed at the average rate of tax applicable to a resident having the same amount of federal adjusted gross income. In the hypothetical, that average rate of tax would be zero because a resident would report a net loss. That zero rate of tax is the rate that would be applicable to the nonresident's New York-source income of $100,000. In other words, although the nonresident has a positive amount of New York-source income ($100,000), the tax rate applied to that income is zero, reflecting the lack of taxpaying ability of the nonresident. Competitive equity, a concern of Professor Schoettle's under his free-trade principles, is addressed because the New York resident competing with the nonresident receives no tax advantage. The resident pays no tax and the nonresident pays no tax. Contrary to Professor Schoettle's suggestion, the metaphorical playing field is metaphorically level and is not tilted to favor residents.

In discussing the above hypothetical, Professor Schoettle asserts that the Court in *Lunding* "should focus on the marginal tax rate that New York imposes on out-of-state taxpayers."[29] Professor Schoettle's imprecision in his discussion of marginal tax rates leads him into serious difficulties. He asserts that under the Court's Commerce Clause jurisprudence, "similarly situated taxpayers should bear identical marginal tax rates."[30] This assertion cannot be taken seriously and is apparently not taken seriously by Schoettle, who makes no attempt to support it. If it were taken seriously, it would mean that the states would be foreclosed under the Commerce Clause from seeking to achieve a fair distribution of tax burdens among their taxpayers because fairness in taxation is a function of the overall burdens of taxation, not of the taxes that might be assessed at the margin.

In addition, Schoettle's asserted goal of equalizing marginal tax rates among similarly situated taxpayers is unattainable even if it were desirable. Marginal tax rates are hypothetical tax rates computed for the purpose of evaluating alternative investment choices at a particular point in time. No taxing statute imposes a "marginal tax rate" on a taxpayer, except metaphorically. The marginal tax rate applicable to a taxpayer is typically computed by making predictions about the taxes that a taxpayer would be required to pay if he earns an additional dollar of income.

Consider, for example, a nonresident earning wages of $100,000 in New York. Assume that the New York rate schedule imposes tax at a rate of 8 percent for income up to

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eliminated when the nonresident individual is taxable on a residence basis in his home state. Of course most states have income taxes and do tax their residents on their worldwide income.

[28] Schoettle, supra note 1, at 1127.

[29] Schoettle, supra note 1, at 1126.

[30] Schoettle, supra note 1, at 1126.

$100,000 and at 10 percent thereafter. Assume also that the nonresident has $50,000 of income from an unrelated out-of-state investment. If the taxpayer's wages are assumed to be constant and the out-of-state investment is treated as the variable, the marginal rate of tax on the investment income would be zero because New York would not, and constitutionally could not, tax such income. If, however, the out-of-state investment is viewed as the constant and the wage income is the variable, then the nonresident would face a marginal tax rate of 8 percent because all of the wage income is from New York sources and is fully taxable at that rate.

In any particular case, an individual's marginal tax rate would depend on assumptions made about the income that the taxpayer otherwise would be expected to earn at a particular point in time. A taxpayer's marginal tax rate changes when the assumptions used in calculating it change, and those assumptions could change many times throughout the course of a taxable year. No taxing statute can hope to equalize the marginal tax rates applicable to a single taxpayer, and certainly it could not equalize marginal rates applicable to more than one taxpayer.

The proper treatment of losses is relevant for purposes of deciding *Lunding* because Mr. Lunding's alimony payments have been analogized by the state to losses on out-of-state investments. In both cases, the deductions are not incurred to earn income taxable by New York, and in both cases the expenditures reflected by the deduction reduced the taxpayer's ability to pay taxes under some normative tax policy criteria. As discussed in section 1, above, the tax policy argument made by the taxpayer in *Lunding* is flawed because it fails to take account of the tax treatment of the recipient of the alimony. Thus New York should prevail in *Lunding* under our analysis whatever the fate of the dicta in Shaffer. If, however, the Shaffer rule is upheld, New York has two independent grounds for supporting the statutory rule under challenge in *Lunding*.

Professor Schoettle commits the same error as the taxpayer in *Lunding* by not analyzing together the payer of alimony and the recipient and instead viewing in isolation only one of the parties. According to Schoettle, the taxpayer's case in *Lunding* "has limited visceral appeal" because Mr. Lunding would pay far less in taxes than a similarly situated taxpayer even if the case is decided against him.[31] The appealing case, according to Schoettle, is a nonresident taxpayer who earns all of his income in New York and who is denied an alimony deduction under the New York taxing statute. We argued above that even this case should have no visceral appeal to analysts once they have focused on the favorable treatment that New York affords to the recipients of alimony payments and have appropriately conveyed their awareness of that treatment to their innards.

3. Conclusion

Professor Schoettle has used the *Lunding* case as a point of embarkment for a free-flowing and loosely argued essay on free-market principles. As Schoettle acknowledges, those principles are primarily relevant to a Commerce Clause analysis of *Lunding*. The only issue properly before the Court in that case, however, involves the

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[31]Schoettle, supra note 1, at 1128.

Privileges and Immunities Clause. Schoettle seems to concede that the state has the better of the argument on that latter issue. [*1639]

In his brief, the taxpayer in *Lunding* raises the possibility that a nonresident payer of alimony could pay more in New York tax than an identically situated resident. To be sure, this hypothetical taxpayer is not meant to describe Mr. Lunding, who actually paid less than half the New York tax that an equivalently situated resident would pay. But a nonresident who, unlike Lunding, earned all his income in New York would have paid more in New York tax than a resident with the same income who paid the same amount of alimony. Professor Schoettle makes much of this hypothetical case in suggesting that a decision for the taxpayer has some intuitive appeal on fairness grounds.

The proper treatment of alimony should not be analyzed, however, by viewing either the alimony payer or the recipient in isolation. One of the goals of the alimony deduction is to tax once — and only once — the income out of which the alimony is presumed to be paid. Whether this goal has been realized obviously cannot be determined by examining only the payer half of the alimony transaction.

New York's system of granting a deduction for alimony to resident payers in conjunction with the taxation of the resident recipient of alimony is similar in function to its system of providing marital income splitting to the members of intact marriages. The merits of marital income splitting cannot be assessed meaningfully by examining the tax consequences for only one marital partner. Marital income splitting is a controversial policy because it implicates values that not everyone shares and rests on certain empirical assumptions that not everyone is willing to indulge.[32] It is unquestionably a rational and constitutional system, nevertheless, for imposing tax on marital partners with respect to the marital income sources that they consume or save.

States that employ a marital income-splitting system do not permit splitting when one of the spouses is a nonresident. To do so would be to convert a system intended to tax income at the rate of the beneficiary into a system that exempted from tax the portion of family income that is considered to have been enjoyed by the nonresident spouse. Nonresident married couples lose the rate relief that often accompanies marital income splitting, but they are not taxed on more income than similarly situated resident married couples.

The same basic pattern of taxation applies to pairs of formerly married individuals who are sharing income through the payment of alimony. When the two formerly married individuals are both residents, an alimony payment is deductible to the payer and taxable to the recipient. When they are both nonresidents, the recipient is exempt from tax and the payer is taxable without the allowance of an alimony deduction. The result is one and only one tax on the income out of which the alimony is presumed to be paid. The system is more complicated and less elegant when one of the parties to the alimony transaction is a

[32]For discussion of the value judgments and empirical assumptions implicit in a marital income-splitting system, see Michael J. McIntyre, "Marital Income Splitting in the Modern World: Lessons for Australia From the American Experience," in John G. Head and Richard Krever, eds., Chapter 1, Tax Units and the Tax Rate Scale 1-33, 2-4 (1996).

resident and the other is a nonresident. As argued in detail in section 1, above, that system generally produces results that are acceptable from a tax policy perspective; it also promotes comity with sister states and does not produce any systematic bias against nonresidents.

The focus of Professor Schoettle's analysis is on the Commerce Clause aspects of *Lunding*. Schoettle properly reminds us that Commerce Clause values are implicated when a state attempts to overreach in its taxation of nonresidents to the potential detriment of sister states and free-market values. The Court's Privileges and Immunities Clause jurisprudence is more akin to a heightened equal protection analysis, requiring that a substantial reason exist for the difference in treatment between residents and nonresidents and that the alleged discrimination against nonresidents bear a substantial relationship to the state's legitimate tax policy objectives.[33] We believe that New York's coherent, principled, and carefully thought-out approach to income splitting for dissolved marriages meets that test.

As noted in section 2, above, we agree with some aspects of Professor Schoettle's Commerce Clause analysis and disagree with other aspects. Most of what Schoettle has to say about the Commerce Clause in his article is irrelevant to the *Lunding* case, which is before the Court on a Privileges and Immunities Clause challenge. We find it telling, nevertheless, that the several hypotheticals that Schoettle has framed to expose what he sees as weaknesses in New York's defense of its position in *Lunding* actually give powerful support to that position.

[33]Supreme Court of New Hampshire v. Piper, 470 U.S. 274, 284 (1985).