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The Constitution and the Legislature

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Constitutional Restrictions on Taxation of Nonresidents

Since nonresidents can't vote and often are perceived to be high-income investors, they provide a tempting target to raise revenues or curtail the cost of tax benefits. Legislators often wish to impose higher taxes on nonresidents or to deny them benefits granted to residents, such as credits or deductions. Tax issues relative to nonresidents can arise in these contexts:

- Individual income tax on income derived from real property or Minnesota businesses owned by nonresidents
- Income tax on earnings of nonresidents (e.g., professional athletes or entertainers)
- Property tax on vacation homes owned by nonresidents
- Property tax on farms owned by nonresidents

Federal constitutional rules generally require non-residents to be taxed as favorably as residents. Three constitutional provisions, the Privileges and Immunities Clause, the Commerce Clause, and the Equal Protection Clause, may invalidate differential tax rules for nonresidents. In addition, a nonresident must have sufficient contact with the state to be subject to tax under the due process clause—e.g., a state's income tax can only apply to a nonresident's income from in-state sources.

The Privileges and Immunities Clause provides

> The citizen of each State shall be entitled to all of the Privileges and Immunities of Citizens of the several States. U.S. Const. Art. IV § 2.

The Privilege and Immunities Clause generally prohibits a state from imposing higher tax rates or taxes on nonresidents than it imposes on residents. Although its language refers to "citizens," the Supreme Court has held that provisions discriminating against nonresidents also discriminate against citizens of other states. The clause does not absolutely prohibit discrimination against nonresidents; it permits states to provide different rules for nonresidents if there is a "valid independent reason for" the treatment. Also, it only applies to interests that are "fundamental," i.e., bear on "the vitality of the Nation as a single entity." A fee or tax on pursuing a trade or business is covered. *Toomer v. Witsell*, 334 U.S. 385, 395 (1948). Differential fees on nonresidents for recreational hunting and fishing are not. *Baldwin v. Fish and Game Commission of Montana*, 436 U.S. 371 (1978). In general, differential income or property tax rules are covered, since they affect the right to "reside in" or "to pursue trade, agriculture, [or] professional pursuits." Corporations are not protected by the clause, since they are not considered "citizens."

Examples of laws held to violate the privileges and immunities clause include:

- Denial to nonresidents of personal deductions under the individual income tax. *Travis v. Yale & Towne Mfg. Co.*, 252 U.S. 60 (1920) (personal exemption); *Lunding v. N.Y. Tax Appeals Tribune*, 522 U.S. 287 (1998) (alimony deduction).
- A "commuter income tax" applying only to nonresidents working in the state. *Austin v. New Hampshire*, 420 U.S. 656 (1975).
- A property tax credit that was limited to farms owned by residents. *Borden v. Selden*, 146 N.W.2d 306 (Iowa 1966).

The Equal Protection Clause. The Equal Protection Clause of the federal constitution prohibits states from denying "the equal protection of the law." Courts use two standards to review laws under the Equal Protection Clause:

- **Strict scrutiny** applies to "suspect classifications" (such as race) or to denial of fundamental rights (such as the right to vote).

- A **rational basis** test applies to all other classifications. Since residency is not a "suspect classification," tax laws that treat nonresidents differentially from residents will be subject to rational basis review. Differential treatment of nonresidents must be rationally related to the state's objective. In general, this gives the legislature considerable flexibility. However, analysis of the Supreme Court decisions suggest that it is not as deferential toward residency classifications as to other nonsuspect classifications, because of the federalism concerns. The Court has explicitly stated it is not doing so, but many legal scholars find this is the only way to explain the results in some cases.

The Court has invalidated laws that distinguish between residents and nonresidents on equal protection grounds. Corporations are also protected by the clause, unlike the Privileges and Immunities Clause. The Court has invalidated:

- An Alaska law that paid rebates to residents, graduated based on the years they lived in Alaska, *Zobel v. Williams*, 457 U.S. 55 (1982);
- An Alabama law that taxed out-of-state insurance companies at a higher rate than in-state companies, *Metropolitan Life Insurance Co. v. Ward*, 470 U.S. 869 (1985); and
- A law denying a property tax exemption to an out-of-state charity, *WHYY, Inc. v. Borough of Glassboro*, 393 U.S. 117 (1968).

The Commerce Clause. Although the Commerce Clause is a grant of power to Congress, the Supreme Court has held that the clause also prohibits states from imposing undue burdens on or interfering with interstate commerce. Imposing higher taxes on nonresidents who conduct business or own property in the state than on residents in the same circumstances will likely be held to unconstitutionally burden interstate commerce. Such provisions will discourage nonresidents from making investments, restricting or burdening the flow of interstate commerce. Some examples include:

- The Supreme Court has held unconstitutional a Maine law denying a property tax exemption to charitable institutions that primarily serve nonresidents. *Camp Newfound Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564 (1997).
- A number of cases have invalidated imposition of higher taxes or license fees on nonresident solicitors than on residents.

Recent case authority on the extent to which the Commerce Clause restricts a state's ability to tax residents, including determining who qualifies as a resident (e.g., based on presence in or extensiveness of contacts with the state, rather than domiciliary intent to make the state home) is sparse. However, the Supreme Court has held that state taxes must be "internally consistent." With regard to residency, this requires determining that the state tax, if imposed by all states, would not impose higher burdens on individuals (residents or nonresidents) with out-of-state income. *Comptroller v. Wynne*, 135 S.Ct. 1787 (1915) (invaliding income tax imposing higher burdens on residents with out-of-state income).

Under any of the constitutional provisions, states generally have more flexibility in limiting benefits under direct spending programs, as compared with tax preferences, to residents. For example, the Court has upheld lower tuition at state higher education institutions for residents, paying bounties for scrap cars, and access to products or services provided by state-run businesses. In part, the Court may be influenced by the fact that these types of benefits are financed mainly by taxes paid by residents and the state needs to restrict access to nonresidents to maintain the economic viability of the programs.

For more information: See the House Research short subjects on the Commerce Clause and equal protection, September 2018.