THE NONRESIDENT REAL ESTATE WITHHOLDING: AN EXIT TAX IN DISGUISE?

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INTRODUCTION

You and your spouse both recently turned sixty-six years old. After living in the same home and working the same job for over thirty years, you are ready to retire and move to a lower-tax jurisdiction—perhaps Florida or Nevada. You begin planning the move. You arrange for storage, find a realtor in your destination state, and calculate how much cash you will have immediately following the sale of your current home. Finally, you secure a buyer and schedule the closing. Although you expect to pay a capital gains tax on the sale, you do not expect to do so until filing your year-end tax return.

The day before closing, your closing agent sends you the final closing sheet. As you skim the sheet, one line item suddenly grabs your attention: "Nonresident Real Estate Withholding Tax." You scan the row and find that the corresponding amount is four times the capital gains tax that you owe at year-end. Immediately, you reach for the phone and call your closing agent, demanding to know why this number is so much greater than your actual tax liability. Her response: "You're leaving New Jersey."

Currently, seventeen states require some form of real estate withholding tax at closing, forcing exiting residents and nonresidents to pay their capital gains tax at the time of sale rather than year-end.[1] In certain circumstances, states such as New Jersey require a withholding that exceeds the actual tax liability. Excess payments are returned either in the following year upon filing a year-end tax return or some time after filing a return for overpayment.[2]

The alleged purpose of these laws is to prevent nonresidents and exiting residents from evading the state capital gains tax upon the sale of real property.[3] Critics, however, suspect an ulterior motive: a desire to discourage

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1 This number is based on the author's review of the tax codes of the fifty states, as of July 2018.

2 *See, e.g.*, MARIA E. ZIELINSKI, HAW. DEP'T OF TAXATION, TAX INFORMATION RELEASE NO. 2017-01: WITHHOLDING OF STATE INCOME TAXES ON THE DISPOSITION OF HAWAII REAL PROPERTY 9 (2017), http://files.hawaii.gov/tax/legal/tir/tir17-01.pdf.

3 *See* Karin Price Mueller, *Bamboozled: Understanding N.J.'s Misunderstood "Exit Tax,"* NJ.COM (Mar. 24, 2016, 12:06 PM), https://www.nj.com/business/2016/03/bamboozled_overtaxed_in_nj_heck_yeah_but_the_exit.html.

residents from exiting the state in the first place.[4] And the critics may be right; as of 2017, a majority of the states with the highest income tax rates imposed a nonresident real estate withholding.[5] This suggests that high-tax states are attempting to preserve large tax revenues by keeping residents from leaving.[6]

Regardless of the states' intent, a nonresident real estate withholding is not truly an exit tax—at least not on its face.[7] But, in some circumstances, the withholding may act as either a partial or complete bar to permanent relocation.[8] A closer examination of such circumstances is necessary to determine whether certain nonresident real estate withholding statutes bar exit and, if so, how the state in question might remedy the statute to ensure constitutional validity.

This Comment maintains that the nonresident real estate withholding statutes of Hawaii, Maine, New Jersey, and Vermont inhibit permanent relocation and are therefore unconstitutional under both the Privileges or Immunities Clause of the Fourteenth Amendment and Article I, Section 10 according to the holding in *Crandall v. Nevada*.[9] Further, this Comment argues that by withholding amounts greater than nonresidents' and exiting residents' actual tax liabilities, the Hawaii, Maine, and New Jersey real estate withholding statutes also violate the Privileges and Immunities Clause of Article IV.

Part I of this Comment provides a broad overview of the two prevailing methods of calculating nonresident real estate withholdings and examples of outcomes under each method. The purpose of this Part is to understand how nonresident real estate withholdings work and to examine the adverse effects of certain withholding schemes.

Part II provides a background of the constitutional framework. This Part focuses on the evolution of interstate mobility as both a right inherent in the Constitution and a right protected under the Privileges or Immunities Clause of the Fourteenth Amendment. Part II also examines the Supreme Court's approach to assessing the constitutionality of state tax laws that discriminate based on residency—especially those that utilize a nonresident withholding to do so.

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4 *See* Leslie Kwoh, *N.J.'s Exit Tax: So Baffling, Even Officials Can't Explain It*, NJ.COM (Oct. 18, 2010, 11:09 AM), https://www.nj.com/business/2010/10/nj_exit_tax_has_real_estate_at.html.

5 The ten states with the highest marginal tax rates in the country are California (13.3%), Oregon (9.9%), Minnesota (9.85%), Iowa (8.98%), New Jersey (8.97%), Vermont (8.95%), New York (8.82%), Hawaii (8.25%), Wisconsin (7.65%), and Idaho (7.40%). Morgan Scarboro, *State Individual Income Tax Rates and Brackets for 2017*, TAX FOUNDATION (Mar. 9, 2017), https://taxfoundation.org/state-individual-income-tax-rates-brackets-2017. Of these ten states, seven require nonresidents to withhold real estate taxes at close.

6 *See* Brian Davis, *The Growing Specter of State "Exit Taxes" as Residents Abandon High-Tax States*, EZ LANDLORD FORMS (Oct. 13, 2015), https://www.ezlandlordforms.com/articles/news/360/the-growing-specter-of-state-exit-taxes-as-residents-abandon-high-tax-states/.

7 *See* Mueller, *supra* note 3.

8 *See* Davis, *supra* note 6.

9 73 U.S. (6 Wall.) 35, 49 (1867).

Finally, Part III determines whether certain nonresident real estate withholdings violate implied constitutional rights, the Privileges or Immunities Clause of the Fourteenth Amendment, or the Privileges and Immunities Clause of Article IV. To the extent available, Part III also provides remedies to cure such constitutional violations.

I. THE NONRESIDENT REAL ESTATE WITHHOLDING STATUTES

Although there is considerable variation in nonresident withholding schemes, each state may be classified as either a gross-proceeds state or a net-proceeds state.[10] Generally, the gross-proceeds states require nonresidents to withhold an amount based on the total sale price, while the net-proceeds states base the withholding on the sale price less any outstanding debt tied to the property.[11] Notably, the true tax owed under either scheme is based on the capital gain on the sale of the property, which seldom equals gross proceeds or net proceeds.[12] Thus, both schemes create a potential mismatch between the tax withheld from a nonresident at the time of sale and the actual tax owed upon year-end filing. The extent of that mismatch is critical to assessing the impact of such withholdings on nonresidents and exiting residents and the constitutionality of nonresident real estate withholdings in general.

Before making that assessment, however, two preliminary discussions are necessary. First, one must understand who a "nonresident" is for purposes of nonresident real estate withholdings. Generally, a nonresident is any person who maintains his principal residence outside the state or any individual who does not intend to maintain a "permanent place of abode . . . on or after

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10 This taxonomy has been developed for purposes of this Comment to provide clarity. Note, however, that a state classified as a gross-proceeds state may have provisions for an alternative calculation, as shown herein. For example, this Comment classifies Vermont's nonresident real estate withholding calculation as a gross-proceeds scheme, but the state permits an alternative calculation when the actual tax owed is less than the standard withholding. *See* VT. STAT. ANN. tit. 32, § 5847(c) (2018).

11 The gross-proceeds states refer to the withholding base as either the "consideration paid" or the "amount realized on the disposition." *See, e.g.*, HAW. REV. STAT. § 235-68(b) (2018); VT. STAT. ANN. tit. 32, § 5847(a) (2018). Both are synonymous with the term *sale price*, at least for purposes of this Comment. I.R.C. § 1001(b) (2012). Conversely, the net-proceeds states use a withholding base that is the sale price less the "debts of the transferor secured by a mortgage or other lien on the property being transferred that are being paid upon the sale or exchange of the property . . . ." MD. CODE ANN., TAX–GEN. § 10-912(a)(2) (LexisNexis 2018).

12 The term *capital gain* is used interchangeably with *taxable gain* throughout this Comment. In states with a nonresident real estate withholding statute, all persons, both resident and nonresident, must eventually pay capital gains on the sale of real estate, if any. *See* Mueller, *supra* note 3. A capital gain is "the difference between the adjusted basis in the asset and the amount . . . realized from the sale . . . . Generally, an asset's basis is its cost to the owner . . . ." INTERNAL REVENUE SERV., TOPIC NO. 409, CAPITAL GAINS AND LOSSES (2018), https://www.irs.gov/taxtopics/tc409.

the day of transfer."[13] Ultimately, the place of domicile—which focuses on the individual's intent—is the prevailing standard.[14] Therefore, any person living permanently outside the state or any person intending to permanently relocate, like an exiting resident, is a nonresident and is subject to the nonresident real estate withholding.[15]

Second, one must understand the interplay between the Internal Revenue Code and state real estate tax withholding statutes. When a taxpayer sells her principal residence,[16] the Federal Government provides a full exclusion for gains not exceeding $250,000 and $500,000 for single and married taxpayers, respectively.[17] Most states provide the same exclusion.[18] To illustrate, consider a married couple who purchases a home for a price of $100,000. They reside there for the next ten years and then sell the property for a price of $600,000. Because the gain is only $500,000, they owe $0 in federal tax and $0 in state tax. Had the gain exceeded the federal principal residence exclusion, the couple would have paid a state capital gains tax on the portion of the gain in excess of the exclusion.[19]

Generally, withholding schemes in both the gross-proceeds states and the net-proceeds states adopt the federal principal residence exclusion amount when figuring the statutory nonresident real estate withholding for exiting residents.[20] This means that if an exiting resident sells his principal residence and the gain is below the exclusion amounts outlined above, no withholding is required at close.[21] Disparities arise, however, when the gain on the sale *exceeds* the federal exclusion amount. The following Section explores those disparities more closely.

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13 N.J. DEP'T OF THE TREASURY, FAQS ON GROSS INCOME TAX (GIT) FORMS REQUIRED FOR SALE OR TRANSFER OF REAL PROPERTY IN NEW JERSEY, http://www.state.nj.us/treasury/taxation/gitrepfaqs.shtml (last visited Sept. 9, 2018).

14 *See, e.g.*, HAW. REV. STAT. § 235-1.

15 This definition is consistent with the Black's Law Dictionary definition of domicile: "The place at which a person has been physically present and that the person regards as home; a person's true, fixed, principal, and permanent home, to which that person intends to return and remain even though currently residing elsewhere." *Domicile*, BLACK'S LAW DICTIONARY (10th ed. 2014).

16 For purposes of the principal residence exclusion under the Internal Revenue Code, a "principal residence" is one that has been used as one's primary residence for at least two of the last five years just prior to sale. I.R.C. § 121(a) (2012).

17 I.R.C. § 121(b)(1)–(2).

18 *See, e.g.*, HAW. REV. STAT. § 235-68(d)(2) (2018); MD. CODE ANN., TAX–GEN. § 10-912(d)(5) (LexisNexis 2018).

19 *See* I.R.C. § 121(b)(2)(A) (2012).

20 Hawaii's nonresident real estate withholding statute provides a somewhat typical example of what the principal residence withholding exemption looks like in the gross-proceeds states. *See* HAW. REV. STAT. § 235-68(d)(2) (2018). Maryland's nonresident real estate withholding statute provides a typical example for the net-proceeds states. *See* MD. CODE ANN., TAX–GEN. § 10-912(d)(5) (LexisNexis 2018).

21 *See, e.g.*, HAW. REV. STAT. § 235-68(d)(2) (2018); MD. CODE ANN., TAX–GEN. § 10-912(d)(5) (LexisNexis 2018).

A. *The Gross-Proceeds States*

Of the seventeen states that require a nonresident real estate withholding, Hawaii, Maine, New Jersey, and Vermont apply the gross-proceeds method of calculation.[22] This method puts these states at high risk of running afoul of the constitutional provisions discussed herein, because the basis of measurement—the sale price—is almost always larger than both the net proceeds and the taxable gain. This creates two problems. First, more tax may be withheld at closing than is actually owed because the sale price is always greater than the gain. Second, the tax withheld may exceed the net proceeds generated from the sale, requiring the exiting resident to front additional cash at closing. Although each of these four states provides withholding exemptions to address these two issues, the potential to inhibit the exiting resident's departure still exists in each.

1. Hawaii

In Hawaii, exiting residents are required to withhold 5% of the sale price of their principal residence at closing if the sale price exceeds $300,000 and the realized gain exceeds the federal principal residence exclusion under I.R.C. § 121(b)(2)(A).[23] However, Hawaii's principal residence withholding exemption is all or nothing. If the realized gain on the sale exceeds the federal principal residence exclusion amounts, 5% of the sale price must be withheld; the withholding base is not reduced or adjusted.[24] Thus, an exiting resident must qualify for the principal residence exemption either in full or not at all.

To illustrate, assume that exiting resident *A* is a married couple who has a basis in their principal residence of $400,000.[25] Intending to relocate

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22 HAW. REV. STAT. § 235-68(b) (2018); ME. STAT. tit. 36, § 5250-A(2) (2018); N.J. STAT. ANN. § 54A:8-9(a) (West 2018); VT. STAT. ANN. tit. 32, § 5847(a) (2018).

23 HAW. REV. STAT. §§ 235-68(b) to (f) (2018). Note that "realized gain" and "taxable gain" represent two different figures. A "realized gain" is the total gain before factoring in any exclusions, such as the principal residence exclusion. A "taxable gain" (also known as a recognized gain) is the gain left after accounting for exclusions. *Understanding Realized vs. Recognized Gain in 1031 Exchanges*, CWS CAPITAL PARTNERS: INSIGHTS (Sept. 5, 2017), https://www.cwscapital.com/insights/understanding-realized-vs-recognized-gain-in-1031-exchanges.

24 *See* ZIELINSKI, *supra* note 2, at 5 ("If any amount of gain remains after applying the exclusion, Form N-288B cannot be used. The transferee/buyer is required to withhold the full 5 percent of the amount realized.").

25 "Basis is the amount of your investment in property for tax purposes. [Taxpayers] [u]se the basis of property to figure depreciation, amortization, depletion, and casualty losses. [They] [a]lso use it to figure gain or loss on the sale or other disposition of property." INTERNAL REVENUE SERV., IRS PUB. NO. 551, BASIS OF ASSETS (2017), https://www.irs.gov/pub/irs-pdf/p551.pdf. For purposes of this Comment, basis includes the original amount paid for property plus any capital improvements. Basis does not include refinancing subsequent to the original purchase.

outside the state, *A* sells the property to *B* for $1,000,000. Because the realized gain of $600,000 exceeds the federal principal residence exclusion from I.R.C. § 121, Hawaii requires a withholding of $50,000 at closing. The withholding is calculated by multiplying the sale price of $1,000,000 by the 5% nonresident withholding rate. Had the realized gain been $500,000 or less, the withholding would have been completely exempt.[26]

Remarkably, the taxable gain in the above transaction is only $100,000;[27] when multiplied by Hawaii's capital gains tax rate of 7.25%, the true tax liability amounts to $7,250—not $50,000.[28] This result is problematic for two reasons. First, the effective withholding rate in this transaction is 50%—well above the state's capital gains rate of 7.25%.[29] As a result, the State withheld $42,750 more at closing than *A* actually owed. Second, *A* leaves the transaction with $50,000 less cash than would a Hawaii permanent resident, who is not subject to the withholding at all.[30] Although *A* can apply for an early refund for excessive payment post-sale, *A* is at a complete loss if *A* needs those funds immediately for relocation. And even if *A* does apply for an early refund for excessive payment, *A* is deprived of $7,250 that a permanent resident would otherwise enjoy until filing the couple's year-end tax return in the following year.

Hawaii's withholding scheme is both unique and perplexing in several respects. First, Hawaii is one of only two states to employ an all-or-nothing approach to the principal residence exemption.[31] As shown above, this can result in drastic overpayment at closing. Second, even if exiting residents have the wherewithal to prepay more than they owe, it is unclear why they should. Absent evidence to the contrary, all necessary information is present at closing to calculate the actual capital gains tax owed. What purpose does the overpayment truly serve?

Another peculiar aspect of Hawaii's scheme lies in its withholding exemption for insufficient net proceeds. To illustrate, assume again that exiting resident *A* is a married couple, but this time *A* purchased their principal

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26 Note that this outcome is just as likely for a single taxpayer exiting the state. The examples herein distinguish between single and married taxpayers only for the purposes of knowing which principal residence exclusion amount applies. Otherwise, the distinction has no bearing on the analysis.

27 Unlike the realized gain, the taxable gain factors in the principal residence exclusion amount from I.R.C. § 121, calculated as follows: First, take the $1,000,000 sale price and subtract the $400,000 adjusted basis to find the $600,000 realized gain. Then, subtract the $500,000 principal residence exclusion from the realized gain to arrive at a taxable gain of $100,000.

28 The uppermost capital gains right for individuals in Hawaii is 7.25%. HAW. REV. STAT. § 235-51(f) (2018).

29 The effective withholding rate is calculated by dividing the total withholding amount of $50,000 by the taxable gain of $100,000. *See Effective Tax Rate*, BLACK'S LAW DICTIONARY (10th ed. 2014).

30 ZIELINSKI, *supra* note 2, at 3 (explaining that residents are completely exempt).

31 New Jersey also employs an all-or-nothing approach to the principal residence withholding exemption. N.J. DEP'T OF THE TREASURY, *supra* note 13 ("[I]f your entire gain cannot be excluded from your gross income, you do not qualify for the exemption.").

residence twenty years earlier for $80,000 and made capital improvements of $20,000. *A* also refinanced the property twice, resulting in a current mortgage of $700,000. Notably, the basis in the home is only $100,000—additional borrowings from refinancing do not impact property basis.[32] Such borrowings do, however, impact the sale proceeds available to pay the real estate withholding tax at closing.

A sells the property to *B* for $720,000. This results in a $620,000 realized gain, calculated by subtracting the basis from the sale price. Because the realized gain exceeds the federal principal residence exclusion of $500,000, Hawaii requires that 5% of the sale price, or $36,000, be withheld from the proceeds wired to *A* at closing. This leaves *A* with only $684,000 to pay a $700,000 outstanding mortgage, meaning *A* must produce an additional $16,000 to complete the sale. Like the prior example, the true tax liability is only $8,700, meaning *A* overpaid $27,300 at closing.[33] In this example, however, the withholding left insufficient net proceeds to pay off the mortgage. Notice that this outcome may be particularly common where the exiting resident has engaged in substantial refinancing of the property prior to sale, as refinancing does not increase a property's basis.[34]

To avoid this outcome, the state has a mechanism that provides some relief. If *A* can convince the Department of Taxation that the withholding is "extremely burdensome" and "without an adjustment the transaction cannot occur," the Department may reduce or eliminate the withholding entirely.[35] But the mechanism seems intentionally vague. What conditions must be shown to meet a standard of "extremely burdensome?" Is the seller's net worth or liquidity a factor? Is it appropriate or fair to consider property status? These questions warrant further attention.

The foregoing illustrations reveal three characteristics of Hawaii's withholding scheme that must be examined for constitutional validity. First, exiting residents with gains in excess of the federal principal residence exclusion may be subject to effective withholding amounts much greater than the tax owed. This leaves them with significantly less cash immediately after closing to use for permanent relocation. Second, exiting residents who have refinanced their principal residences prior to relocation may not generate enough proceeds to pay both the withholding and the outstanding mortgage. Although such persons can request that the withholding be adjusted, the standard they must meet to do so is unclear. Third, the withholding deprives

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32 Increases to property basis include (1) "construction or other improvements"; (2) "special assessments for local improvements"; and (3) "amounts you spent to repair damage to your home." INTERNAL REVENUE SERV., IRS PUB. NO. 523, SELLING YOUR HOME (2018), https://www.irs.gov/pub/irs-pdf/p523.pdf. Notably, additional borrowing from refinancing does not increase basis.

33 Calculated as follows: first, take the sale price of $720,000 and subtract the property's basis of $100,000 to find the realized gain of $620,000. From the realized gain, subtract the $500,000 federal principal residence exclusion to get a $120,000 taxable gain. Finally, multiply this amount by the state capital gains rate of 7.25% to get a tax liability of $8,700.

34 *See* INTERNAL REVENUE SERV., *supra* note 32.

35 ZIELINSKI, *supra* note 2, at 6.

exiting residents from enjoying the cash withheld between the time of sale and the time the tax would normally be due if they were permanent residents. Depending on the current interest rate, the time of sale, and the amount withheld, this disparity may be substantial.

2. Maine and Vermont

Unlike Hawaii, Maine and Vermont provide an exception when the gross-proceeds method of measurement results in a withholding that is more than the actual tax liability.[36] To illustrate, assume that the following transaction took place in Maine: *A*, a married couple, decides to relocate outside the state. *A*'s basis in their principal residence is $400,000. *A* sells their principal residence to *B* for $1,000,000. This results in a realized gain of $600,000 and a taxable gain of $100,000, after accounting for the correlative principal residence exclusion of $500,000. If Maine were to apply a strict gross-proceeds scheme like Hawaii, the withholding due at close would be $25,000, calculated by multiplying Maine's statutory rate of 2.5% by the sale price of $1,000,000.[37] This is $17,850 more than the actual $7,150 tax liability.[38]

Instead, Maine provides an alternative calculation for this circumstance. Rather than use gross proceeds as the withholding base, *A* may multiply their true, taxable gain of $100,000 by a statutory percentage of 10.15%, bringing the withholding down to $10,150 instead of $25,000.[39] But this modification only reduces the overpayment; it does not eliminate it. This is because the 10.15% alternative statutory rate is still greater than Maine's highest capital gains rate of 7.15%.[40] Thus, *A* still overpays at close by approximately $3,000. Vermont's withholding scheme would treat the transaction in a similar manner, but it would adjust the withholding to the precise tax owed on the transaction, eliminating the overpayment altogether.[41]

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36 ME. STAT. tit. 36, § 5250-A(4) (2018); VT. STAT. ANN. tit. 32, § 5847(b)(2)(A) (2018).

37 Maine and Vermont both apply a 2.5% statutory rate to the sale price. ME. STAT. tit. 36, § 5250-A(2) (2018); VT. STAT. ANN. tit. 32, § 5847(a) (2018).

38 The true tax liability is calculated by taking the $100,000 taxable gain and multiplying it by Maine's uppermost income tax and capital gains rate of 7.15%. ME. STAT. tit. 36, § 5111(3-F) (2018).

39 *Request for Exemption or Reduction in Withholding of Maine Income Tax on the Disposition of Maine Real Property*, Maine Revenue Services, Form REW-5 (2016), https://www.maine.gov/revenue/forms/rew/19_rew5_.pdf.

40 *See* ME. STAT. tit. 36, § 5111(3-F) (2018).

41 *Vermont Withholding Tax Return for Transfer of Real Property*, Vermont Department of Taxes, Form RW-171 (2014), http://tax.vermont.gov/sites/tax/files/documents/RW-171.pdf ("A withholding certificate may be issued by the Commissioner of Taxes to reduce or eliminate [the] withholding . . . . if . . . [r]educed withholding is appropriate because the 2.5% amount exceeds the seller's maximum tax liability.").

At first glance, Maine and Vermont seem to employ a more reasonable withholding scheme than that of Hawaii. But the first glance is deceiving. Unlike Hawaii, neither Maine nor Vermont have an insufficient net-proceeds provision in their statutes or tax forms. To illustrate the impact, consider the following example. Assume that *A* is a married couple intending to relocate outside Vermont. *A* purchased a principal residence thirty years prior to sale for $80,000 and made capital improvements of $20,000, bringing the property's adjusted basis to $100,000.[42] *A* also refinanced the property three times, resulting in a current mortgage of $900,000.

A then sells the property in the current year to *B* for $915,000. Because Vermont requires nonresidents and exiting residents to withhold 2.5% of the sale price ($22,875), *A* is left with $892,125 to pay the $900,000 outstanding mortgage on property.[43] Unlike a permanent resident, who would not pay the capital gains tax until filing in the following year, *A* must produce an additional $7,875 to complete the transaction. If *A* does not have the additional funds, the sale cannot take place. *A* may not be able to relocate outside the state.

In sum, the foregoing illustrations reveal two characteristics of the Maine and Vermont withholding schemes that must be examined for constitutional validity. First and foremost, neither state permits an exemption from withholding for insufficient net proceeds. This may act as a complete barrier to relocation for exiting residents, especially those who previously engaged in substantial refinancing. Second, like Hawaii, the withholding deprives exiting residents from enjoying the cash withheld between the time of sale and year-end filing. Although Maine and Vermont do withhold an amount much closer to the true tax burden—and sometimes even less than the true tax burden—the withholding itself is still a deprivation of funds not suffered by the permanent resident.

3. New Jersey

Few withholding laws in the United States have attracted such attention as that of New Jersey, known to citizens and critics as the "exit tax."[44] The *Star-Ledger*, a Newark-based online newspaper, reports that "this elusive tax has achieved urban legend status. Many aren't quite sure what it entails, how much of it has been collected or whether it really even exists. Even state officials are scratching their heads."[45] Of course, no state—not even New Jersey—may charge an exit tax, at least not without some clever engineering of

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42 For purposes of this Comment, "adjusted basis" refers to the original purchase price plus capital improvements.

43 *See* VT. STAT. ANN. tit. 32, § 5847(a) (2018).

44 *See* Mueller, *supra* note 3.

45 Kwoh, *supra* note 4.

the tax code.[46] But the public apparently believes that the Garden State comes close, as its withholding consists of several aggressive features also seen in the Hawaii, Maine, and Vermont withholding schemes.

First, instead of using a standard gross-proceeds withholding base like Hawaii or a lesser-of-gross-proceeds-or-taxable-gain base like Vermont, New Jersey requires exiting residents to withhold the *greater* of 2% of the sale price or the actual taxable gain.[47] Second, New Jersey employs an all-or-nothing principal residence exemption.[48] Finally, unlike any other state, New Jersey requires the nonresident withholding even when the transaction results in a taxable loss.[49]

Much like Hawaii, New Jersey's method of calculating the nonresident real estate withholding base combined with the all-or-nothing principal residence exemption potentially runs afoul of the U.S. Constitution. To illustrate, again assume that exiting resident *A* is a married couple but is located in New Jersey. *A* purchased their principal residence ten years ago for $1,000,000 and made capital improvements to the home of $400,000, bringing the property's adjusted basis to $1,400,000. In the current year, *A* sells the property to *B* for $2,000,000, resulting in a realized gain of $600,000.

Because the realized gain exceeds the $500,000 federal and correlative state principal residence exclusion, New Jersey denies *A* the principal residence withholding exemption in its entirety. Without the exemption, *A* is forced to withhold the greater of 2% of $2,000,000 (the sale price) or the taxable gain (8.97% of $100,000) at close.[50] Thus, *A* pays 2% of the sale price, or $40,000, which is $31,030 greater than the actual tax owed of $8,970. This creates an effective withholding rate of 40%, which is well above the state's highest marginal tax rate of 8.97%.[51] Although *A* can apply for a refund for excessive payment post-sale, *A* is still deprived of at least $8,970 between the date of sale and the date of filing—a deprivation not suffered by the permanent resident.[52]

Unlike Maine and Vermont, New Jersey does provide a complete withholding exemption for exiting residents and nonresidents if there are

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46 *See* Crandall v. Nevada, 73 U.S. (6 Wall.) 35, 49 (1867); Davis, *supra* note 6.

47 N.J. STAT. ANN. § 54A:8-9(a) (West 2018).

48 *See generally* N.J. DEP'T OF THE TREASURY, *supra* note 13; *see also* N.J. STAT. ANN. § 54A:8-10(f).

49 *See* N.J. STAT. ANN. § 54A:8-9(a) ("[T]he estimated tax payment shall not be less than 2% of the consideration for the sale or transfer stated in the deed affecting the conveyance."); Mueller, *supra* note 3.

50 Capital gains are taxed at the same rate as regular income tax in New Jersey; thus, 8.97% represents the uppermost marginal income tax rate. *NJ Income Tax – Capital Gains*, N.J. DEP'T OF THE TREASURY (last updated Feb. 13, 2018), http://www.state.nj.us/treasury/taxation/njit9.shtml; *see also* Scarboro, *supra* note 5.

51 Scarboro, *supra* note 5.

52 *See* N.J. STAT. ANN. § 54A:8-10(a); N.J. DEP'T OF THE TREASURY, *supra* note 13 (explaining that a nonresident seller can file form A-3128 for a refund with the Division's Taxpayer Accounting Branch).

insufficient net proceeds following sale.[53] This provision ensures that exiting residents can sell and relocate even if the sale does not generate sufficient cash to pay the capital gains tax immediately. Thus, the only persons at risk of paying more than the actual tax owed are exiting residents and nonresidents who generate sufficient proceeds from the sale to do so.

Based on the foregoing illustrations, two characteristics of New Jersey's withholding must be examined for constitutional validity. First, exiting residents with sufficient sale proceeds may be required to pay more than their actual tax liability at close, leaving them with less cash to relocate immediately following the sale. Second, exiting residents are deprived of the time value of money since they must pay the capital gains tax at the time of sale. If they fail to file for an early refund for overpayment, they are also deprived of amounts paid in excess of their true tax liability until they file their year-end tax return.

B. *The Net-Proceeds States*

To calculate the nonresident real estate withholding, the remaining thirteen states use either the net proceeds or the lesser of the net proceeds or the taxable gain as the withholding base.[54] A net-proceeds withholding base is calculated by subtracting any outstanding debt on the property from the sale price.[55] For example, if *A* sells a home for $800,000 with a $600,000 mortgage attached, the withholding base is $200,000. Because this amount does not represent the taxable gain, however, discrepancies arise between the withholding amount and the actual tax owed.

Generally, the net-proceeds states provide more lenient exemptions and exceptions to the withholding, which eliminate many of the obstructions to exit seen in the gross-proceeds states.[56] This Section examines the withholding laws in Maryland and South Carolina, both of which are representative of typical net-proceeds withholding schemes. For purposes of this Comment, the following illustrations are sufficient to perform a constitutional analysis on all net-proceeds states.

Maryland requires nonresidents to withhold 7.5% of net proceeds at closing, although the seller may file for a modified withholding based on the taxable gain twenty-one days prior to closing.[57] If there is no taxable gain,

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53 *Seller's Residency Certification/Exemption*, N.J. DEP'T OF THE TREASURY, Form GIT/REP-3 (2015), http://www.state.nj.us/treasury/taxation/pdf/other_forms/tgi-ee/gitrep3.pdf.

54 *E.g.*, MD. CODE ANN., Tax–Gen. § 10-912(c)(1) (2016); S.C. CODE ANN. § 12-8-580(A)(1) (Supp. 2008).

55 *E.g.*, MD. CODE ANN., Tax–Gen. § 10-912(a)(1) (2016).

56 *E.g.*, *id.* § 10-912(d).

57 Peter Franchot, *Maryland's Withholding Requirements*, COMPTROLLER OF MD. 3–4, 7 (2017), http://forms.marylandtaxes.com/current_forms/Withholding_requirement.pdf.

the Comptroller fully exempts the withholding.[58] Maryland also grants a full exemption for exiting residents selling their principal residence, regardless of whether the gain exceeds the federal principal residence exclusion.[59] This is significant for exiting residents because it ensures that relocation is never impaired by withholding.

South Carolina, however, does not grant a full exemption for the sale of a principal residence.[60] It requires the exiting resident to withhold the lesser of 7% (the uppermost state capital gains rate) of net proceeds or 7% of the taxable gain.[61] Thus, gains in excess of the principal residence exclusion are subject to withholding upon close.[62] To illustrate, assume *A*, a single taxpayer, purchased her principal residence for $200,000 ten years ago, which represents the property's basis. The property has a $150,000 outstanding mortgage attached. *A* sells the property to *B* for $650,000, resulting in net proceeds of $500,000 ($650,000 minus the outstanding $150,000 mortgage) and a taxable gain of $200,000 ($650,000 minus the $200,000 basis minus the principal residence exclusion of $250,000). At closing, *A* must withhold 7% of the lesser of the taxable gain or the net proceeds. In this case, *A* withholds 7% of the taxable gain, or $14,000, which represents *A*'s true tax liability.

The South Carolina outcome demonstrates two important aspects of net-proceeds withholding schemes that do not provide a full principal residence withholding exemption. First, exiting residents close with less cash immediately following close compared to permanent residents in the same situation. Second, although the withholding is required to complete the sale, the withholding will never exceed the true tax liability. Therefore, even in net-proceeds states such as South Carolina that withhold taxes on the sale of principal residences, the only aspect of the withholding that must be examined for constitutionality is the timing of remittance, not the amount. This stands in contrast to the withholding statutes in gross-proceeds states, which must be examined for timing of remittance, amount of remittance, and, in some cases, remittance despite insufficient net proceeds from the sale.

II. THE CONSTITUTIONAL FRAMEWORK

Nonresident real estate withholding statutes present two constitutional problems: (1) the withholdings may inhibit permanent relocation, which courts may view as an abridgment to interstate mobility; and (2) nonresident

58 *See id.* at 5.

59 *Id.* at 3–4.

60 *Withholding on Sales of Real and Associated Tangible Personal Property by Nonresidents*, S.C. DEP'T OF REVENUE 1, 4–5 (Oct. 14, 2009), https://dor.sc.gov/resources-site/lawandpolicy/Advisory%20Opinions/RR09-13.pdf.

61 S.C. CODE ANN. § 12-8-580(A)(1) (Supp. 2008).

62 *See* S.C. DEP'T OF REVENUE, *supra* note 60, at 4.

real estate withholdings broadly discriminate against nonresidents and exiting residents as a class because they require that nonresidents and exiting residents close with less cash than their permanent resident peers. While neither federal nor state courts have addressed the constitutionality of nonresident real estate withholdings specifically, there is sufficient case law to provide a basis for an analysis.

Generally, state laws that inhibit interstate travel or discriminate against nonresidents are challenged under the following provisions of the Constitution: the Privileges and Immunities Clause of Article IV; the Privileges or Immunities Clause of the Fourteenth Amendment; the Due Process Clauses of the Fourteenth and Fifth Amendments; the Equal Protection Clause of the Fourteenth Amendment; the Commerce Clause; or any combination thereof.[63] For the sake of brevity, this Comment assesses the constitutionality of nonresident real estate withholdings only under the Privileges and Immunities Clause of Article IV and the Privileges or Immunities Clause of the Fourteenth Amendment. Although good arguments may exist under the other provisions, these are reserved for another article.

A. *Interstate Mobility and the Privileges or Immunities Clause of the Fourteenth Amendment*

The notion that citizens are entitled to unabridged interstate mobility predates the Constitution.[64] The Articles of Confederation, adopted ten years prior to the Constitution, guaranteed this right as among the "privileges and immunities" of citizenship.[65] The first portion of the Privileges and Immunities Clause of the Articles of Confederation read:

> The better to secure and perpetuate mutual friendship and intercourse among the people of the different States in this Union, the free inhabitants of each of these States . . . shall be entitled to all privileges and immunities of free citizens in the several States; and the people of each State shall have free ingress and regress to and from any other State, and shall enjoy therein all the privileges of trade and commerce, subject to the same duties, impositions, and restrictions, as the inhabitants thereof . . . .[66]

Although the Privileges and Immunities Clause of the Constitution was purportedly drafted "exactly upon the principles of the 4th article of the . . . Confederation," it did not enumerate the "privileges and immunities" as did

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63 *State Taxation of Interstate Travel: Alternative Constitutional Limitations*, 5 U. RICH. L. REV. 167, 171–72 (1970); *see also* Lunding v. N.Y. Tax Appeals Tribunal, 522 U.S. 287, 293 (1998); Edwards v. California, 314 U.S. 160, 171 (1941).

64 ARTICLES OF CONFEDERATION of 1781, art. IV, para. 1.

65 *Id.*

66 *Id.*

the Articles of Confederation.[67] This left the clause open to interpretation. Did it grant the same rights as the Articles of Confederation, or something more?[68] Justice Washington set out to answer this question in *Corfield v. Coryell*.[69]

In *Corfield*, Justice Washington held that the privileges and immunities guaranteed by the Constitution were narrower than every benefit a state might accord its own citizens, but broad enough to guarantee "fundamental" rights to citizens of free governments.[70] Such rights, according to Justice Washington, included those enumerated in the Articles of Confederation, the first among them "[t]he right of a citizen of one state to pass through, or to reside in any other state, for purposes of trade, agriculture, professional pursuits, or otherwise."[71] Although Justice Washington refused to formulate an exhaustive list of privileges and immunities, he made clear that states could not inhibit interstate travel of out-of-state citizens.[72]

But an important question remained: did the Constitution permit a state to deny its *own* citizens the fundamental rights of free inhabitants, especially the right of free regress and ingress?[73] The Supreme Court would later answer this question in *Crandall v. Nevada*.[74] There, Nevada brought suit against Crandall, an agent for a stage coach company, for failing to collect and pay a $1 capitation tax on both nonresidents and residents exiting the state by common carrier.[75] Because the law did not discriminate based on residency, however, the Court needed to find a constitutional provision besides Article IV to strike down the statute.[76]

One option was the Commerce Clause.[77] The Court could have invoked the federal government's "dormant" commerce power and argued that the State exceeded the residual powers left to it following ratification.[78] But the notion of a "dormant" commerce power was heavily debated since it first appeared in *Gibbons v. Ogden*;[79] whether the federal government's power to

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67 Austin v. New Hampshire, 420 U.S. 656, 661 n.6 (1975) (quoting 3 RECORDS OF THE FEDERAL CONVENTION 112 (Max Farrand ed. 1911) (address by Charles Pinkney)).

68 *See* Paul Brest et al., *Process of Constitutional Decisionmaking* 241–42 (5th ed. 2015).

69 6 F. Cas. 546, 551 (C.C.E.D. Pa. 1823) (No. 3230).

70 *Id.* at 551–52.

71 *Id.* at 552.

72 *Id.* at 551–52.

73 *See* Slaughter-House Cases, 83 U.S. (16 Wall.) 36, 97 (1873) (Field, J., dissenting).

74 Crandall v. Nevada, 73 U.S. (6 Wall.) 35, 49 (1867).

75 *See Brest*, *supra* note 68, at 243.

76 *See* Edwards v. California, 314 U.S. 160, 180–81 (1941) (Douglas, J., concurring).

77 *See Crandall,* 73 U.S. (6 Wall.) at 49 (Clifford, J., concurring).

78 *See* Gibbons v. Ogden, 22 U.S. (9 Wheat.) 1, 227 (1824).

79 22 U.S. (9 Wheat.) 1 (1824).

regulate interstate commerce was exclusive was not yet settled.[80] The option was still a viable one, however, and the concurrence seized the opportunity.[81]

But Justice Miller, writing for the majority, chose a structural argument.[82] Justice Miller held that Nevada could not impose the tax because it prevented the efficient functioning of the federal government.[83] The federal government, he held, reserved the right to call on the citizens of the states to execute the functions of government.[84] That right could not "depend upon the pleasure of a State over whose territory [citizens] must pass to reach the point where these services must be rendered."[85]

Crucially, the opinion probably could have ended there and stood on its own. Justice Miller could have struck down the tax solely on the basis that it acted to dismantle an implied federal power, which would put it squarely in conflict with *McCulloch v. Maryland*.[86] Instead he went further, granting national citizens the following "correlative" rights to those of the Federal Government:

> [I]f the government has these rights on her own account, the citizen also has correlative rights. He has the right to come to the seat of government to assert any claim he may have upon that government, or to transact any business he may have with it. To seek its protection, to share its offices, to engage in administering its functions. He has a right to free access to its seaports, through which all the operations of foreign trade and commerce are conducted, to the sub-treasuries, the land offices, the revenue offices, and the courts of justice in the several States, and this right is in its nature independent of the will of any State over whose soil he must pass in the exercise of it.[87]

Ironically, there is no evidence that the passengers in *Crandall* were in pursuit of any such activities.[88] But the Court recognized that all citizens derive implied rights from the Constitution that are "fundamental to the national character of our Federal government."[89] Principal among them was the freedom of travel.[90] Thus, in challenging state laws, claimants no longer needed to show disparity or discrimination between in-state citizens and out-of-state citizens; they only needed to show that the State abridged an implied

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80 *See id.* at 194.

81 *Crandall,* 73 U.S. (6 Wall.) at 49.

82 *See id.* at 43–44.

83 *Id.*

84 *Id.*

85 *Id.* at 43.

86 17 U.S. (4 Wheat.) 316, 330 (1819) (holding that a state may not pass a tax that would destroy an implied or express federal power).

87 *Crandall*, 73 U.S. (6 Wall.) at 44.

88 Edwards v. California, 314 U.S. 160, 178 (1941) (Douglas, J., concurring).

89 *Id.*

90 *See Crandall*, 73 U.S. (6 Wall.) at 47 ("If the right of passing through a State by a citizen of the United States is one *guaranteed to him by the Constitution*, it must be as sacred from State taxation as the right derived by the importer from the payment of duties to sell the goods on which the duties were paid." (emphasis added)); Charles Fahy, *The Right to Travel*, 6 NAT. L.F. 109, 113 (1961).

constitutional right. Uncertainty surrounding this proposition was quelled one year later with the passage of the Fourteenth Amendment, which appeared to codify *Crandall's* holding.[91] Section 1 states, "No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States."[92]

The meaning of "privileges or immunities" was soon tested again in the *Slaughter-House Cases*.[93] There, a butchers' association challenged a Louisiana statute that confined slaughtering to one facility in New Orleans, effectively creating a monopoly.[94] The State argued that the statute was a valid exercise of police power, while the butchers argued it violated the Thirteenth Amendment and various provisions of the Fourteenth Amendment.[95]

In addressing whether the law violated the Privileges or Immunities Clause of the Fourteenth Amendment, Justice Miller first recognized a difference between state citizenship and national citizenship, noting that the clause protected only "fundamental" rights of national citizenship.[96] He then defined those rights as those enumerated both in Article IV of the Articles of Confederation and in *Corfield*.[97] Although this narrow interpretation rendered the clause all but dead letter, it left the holding in *Crandall* intact;[98] that is, national citizens are protected from state laws that inhibit interstate mobility.[99]

More recent opinions in the lower courts and the Supreme Court suggest that this right is absolute.[100] Such was the case in *Northwest Airlines, Inc. v. Joint City-County Airport Board*,[101] where the Supreme Court of Montana struck down a Montana law charging commercial aircrafts $1 for every passenger boarding a plane at a public airport.[102] Citing *Crandall* and the fundamental rights guaranteed by the Fourteenth Amendment, Justice Castles wrote, "[T]he states have been completely deprived of power to tax or

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91 *See Edwards*, 314 U.S. at 178 (Douglas, J., concurring).

92 U.S. CONST. amend. XIV, § 1.

93 83 U.S. (16 Wall.) 36 (1873).

94 *Id.* at 59–60.

95 *Id.* at 58, 62.

96 *Id.* at 75–76.

97 *Id.* at 75–76.

98 *See Brest*, *supra* note 68, at 386.

99 Crandall v. Nevada, 73 U.S. (6 Wall.) 35, 49 (1867); *see also* Saenz v. Roe, 526 U.S. 489, 503 (1999) ("Despite fundamentally differing views concerning the coverage of the Privileges or Immunities Clause of the Fourteenth Amendment . . . it has always been common ground that this Clause protects the third component of the right to travel.").

100 *See* Nw. Airlines, Inc. v. Joint City-Cty. Airport Bd., 463 P.2d 470, 473 (Mont. 1970) (explaining that the constitutional protection of regress and ingress is "absolute"). *But see* Edwards v. California, 314 U.S. 160, 184 (1941) (Jackson, J., concurring) ("The right of the citizen to migrate from state to state . . . is not . . . an unlimited one. . . . He may not, if a fugitive from justice, claim freedom to migrate unmolested, nor may he endanger others by carrying contagion about.").

101 463 P.2d 470 (Mont. 1970).

102 *See Nw. Airlines*, 463 P.2d at 472–73.

otherwise regulate the act of entry to the United States, even in aid of valid police *or revenue collection concerns of the states*."[103] So too, according to Justice Castles, was true of any State action attempting "to tax or regulate the departure from or entrance into a state."[104]

Likewise, the Supreme Court declared the right to free regress and ingress effectively absolute in *Saenz v. Roe*.[105] There, welfare recipients challenged a California law that required recipients to reside in California for one year before receiving full welfare benefits.[106] The State argued that the purpose was to make a "modest reduction in its vast welfare budget," while welfare recipients argued that it aimed to reduce the number of recipients entering the state.[107] Finding the law unconstitutional, Justice Stevens wrote that "the right [to travel] is so important that it is 'assertable against private interference as well as governmental action . . . a virtually unconditional personal right, guaranteed by the Constitution to us all.'"[108] *Saenz* also stands for the proposition that a state law may be invalid per se even if it does not reference interstate travel at all. This is implicit in the opinion, as the California statute made no mention of limiting the inflow of welfare recipients.[109] Ultimately, the Court looked beyond the language of the statute and focused instead on its effect.[110]

But is the right to travel truly absolute? The concurrence in *Edwards v. California*[111] suggests there are exceptions.[112] Recognizing that the right of travel must not be "unlimited," Justice Jackson wrote that a State may bar interstate travel to prevent the spread of fugitives or contagion.[113] This shows that at a minimum, the Court allows States to regulate regress and ingress should the public health require it. However, because *Edwards* involved a California statute preventing the ingress of "indigents," Justice Jackson was careful to qualify his public health exception.[114] "Any measure which would divide our citizenry on the basis of property . . . ," he wrote, "is not only at war with the habit and custom by which our country has expanded, but is also a short-sighted blow at the security of property itself."[115] Thus, the right to travel freely remains unabridged by property status.[116] This is similar to the

103 *Id.* at 473 (emphasis added).
104 *Id.* (citations omitted).
105 526 U.S. 489 (1999).
106 *Id.* at 493.
107 *Id.* at 493–94.
108 *Id.* at 498 (alteration in original) (quoting Shapiro v. Thompson, 394 U.S. 618, 643 (1969)).
109 *Id.*
110 *See id.* at 504.
111 314 U.S. 160 (1941).
112 *Id.* at 184 (Jackson, J., concurring).
113 *Id.*
114 *See id.*
115 *Id.* at 185 (Jackson, J., concurring).
116 *See id.*

proposition in *Saenz*, which stated that budget and revenue concerns are not legitimate reasons for abridgement of free travel.[117]

B. *Nonresident Discrimination and the Privileges and Immunities Clause of Article IV*

Although *Corfield* laid the groundwork for interpreting the Privileges and Immunities Clause of Article IV, it did not address whether States could levy taxes on residents and nonresidents disproportionately. Was disparate taxation valid as long as the tax did not abridge the privileges and immunities enumerated in the Articles of Confederation? This question was partially answered in *Ward v. Maryland*.[118]

In 1871, Ward, a citizen of New Jersey, challenged a Maryland law requiring nonresident traders to pay a $300 license fee to operate in the State of Maryland, while residents paid only between $12 and $150.[119] Ward claimed that the law violated the Privileges and Immunities Clause of Article IV because it disproportionately charged nonresidents fees for licensure.[120] The Supreme Court agreed.[121] In addition to the protections for out-of-state citizens enumerated in *Corfield*, the Court held that the clause also protected them against "any higher taxes or excises than are imposed by the State upon its own citizens."[122]

But the Court's analysis of discriminatory tax laws would not remain so black and white; questions remained over whether the Privileges and Immunities Clause acted as a complete bar to inequitable state taxation or whether partial inequity was permitted.[123] The Court settled this in *Travellers' Insurance Co. v. Connecticut*.[124] There, Connecticut brought suit against Travellers' Insurance Company for failing to collect a tax exclusively imposed on its nonresident stockholders.[125] Although the law appeared discriminatory on its face, the Court found that it did not violate Article IV because resident stockholders were exclusively subject to a municipal tax of a similar amount.[126] This created a "fair distribution of burdens" within the tax scheme between residents and nonresidents, since nonresidents enjoyed local facilities without having to pay local taxes.[127] Ultimately, the Privileges and

117 Saenz v. Roe, 526 U.S. 489, 507 (1999).
118 79 U.S. (12 Wall.) 418 (1871).
119 *Id.* at 419–20.
120 *Id.* at 421.
121 *Id.* at 430.
122 *Id.*
123 *See, e.g.*, Lunding v. N.Y. Tax Appeals Tribunal, 522 U.S. 287, 293 (1998).
124 185 U.S. 364 (1902).
125 *See id.* at 365–66.
126 *Id.* at 371.
127 *Id.*

Immunities Clause of Article IV does not require "[a]bsolute equality" in taxation but only a fair distribution of the tax burden between residents and nonresidents.[128]

Travellers', however, did not provide a concrete framework to assess discriminatory state laws; it only shed light on whether residents and nonresidents were entitled to precise taxation.[129] The Court would not develop a concrete framework until *Toomer v. Witsell*.[130] There, nonresident fishermen challenged a South Carolina law charging nonresident shrimping boats a $2,500 licensure fee, while residents paid only $25.[131] Holding the statute invalid, the Court ruled that nonresidents were not the "peculiar source of the evil" at which the law was aimed, nor was there a "reasonable relationship between the danger represented by non-citizens, as a class, and the severe discrimination practiced upon them."[132] Notably, the *Toomer* Court never reached the question of whether the nonresident license fee created substantial equality as required in *Travellers'*; answering that question was unnecessary given the disconnect between the statute's purpose and the means of achieving it.[133]

The *Toomer* approach evolved into a two-part test that became the prevailing legal doctrine for assessing discriminatory state laws under Article IV, referred to herein as the "Substantial Reason Test," which the Court officially adopted in *Supreme Court of New Hampshire v. Piper*.[134] For a discriminatory state law to be constitutional, the State must show that there is (1) "a substantial reason" for the discriminatory law and (2) "a substantial relationship" between the treatment of nonresidents and the "State's objective" of the law.[135] This test applies to both general discriminatory state laws and discriminatory state tax laws alike.[136]

C. *The Nonresident Withholdings Cases*

While numerous cases brought under Article IV challenge disproportionate tax burdens between residents and nonresidents, far fewer challenge

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128 *Id.* (quoting Tappan v. Merchants' Nat'l Bank, 86 U.S. (19 Wall.) 490, 504 (1873)).
129 *Id.*
130 334 U.S. 385 (1948).
131 *Id.* at 389.
132 *Id.* at 398–99.
133 *See id.* at 399.
134 470 U.S. 274 (1985).
135 *Id.* at 284.
136 *Compare, e.g.*, United Bldg. & Constr. Trades Council of Camden Cty. & Vicinity v. Mayor of Camden, 465 U.S. 208, 222 (1984) (applying the *Piper* test to discriminate state labor law), *with* Lunding v. N.Y. Tax Appeals Tribunal, 522 U.S. 287, 298 (1998) (applying the *Piper* test to discriminate state tax law).

disproportionate withholdings.[137] This is because withholding statutes, unlike other tax statutes, have no impact on a taxpayer's *final* tax liability.[138] Following withholding, the exact amount owed is reconciled when the taxpayer files his year-end tax return.[139] Thus, discrimination from nonresident withholdings stems not from the final amount owed but from the deprivation of funds between withholding and filing after year-end.[140] The effects are amplified when the withholding amount exceeds the true tax liability.

The Supreme Court has not had occasion to decide whether nonresident withholdings and the temporary deprivation of funds are constitutional per se.[141] One of the earliest discriminatory withholding cases, *Travis v. Yale & Towne Manufacturing Co.*,[142] suggests that discriminate withholdings are permissible as long as the nonresident's underlying tax liability is equivalent or substantially equivalent to that of the resident.[143] A later case, *Austin v. New Hampshire*,[144] suggests the same, although it appears more open to the idea that the time value of money is a constitutional consideration, especially if the withholding rate exceeds the underlying tax rate.[145] Unfortunately, the withholding claims in both cases were ancillary to claims of disproportionate taxation; neither provides a definitive analysis of the constitutionality of nonresident withholdings by themselves.[146] More recently, however, at least two lower courts have followed dicta from *Austin*, signaling a change in how courts approach nonresident withholdings.[147]

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137 *See, e.g.*, Austin v. New Hampshire, 420 U.S. 656, 659 n.4 (1975); Travis v. Yale & Towne Mfg. Co., 252 U.S. 60, 79 n.1 (1920); Panhandle Producers & Royalty Owners Ass'n v. Oklahoma Tax Comm'n, 162 P.3d 960, 967 n.18 (Okla. Civ. App. 2007), *cert. denied*, 552 U.S. 1062 (2007).

138 *See* Alaska Steamship Co. v. Mullaney, 180 F.2d 805, 814 (9th Cir. 1950) ("[W]ithholding provisions . . . are merely a collection adjunct of an otherwise valid tax.").

139 *See Travis*, 252 U.S. at 76 ("[The withholding] does not in any wise increase the burden of the tax upon non-residents, but merely recognizes the fact that as to them the State imposes no personal liability, and hence adopts a convenient substitute for it.").

140 *See Austin*, 420 U.S. at 659 n.4 ("[T]he withholding requirement deprives [plaintiffs] of the use value of the excess withheld over their ultimate tax liability, if any.")

141 *See Travis*, 252 U.S. at 76 (ruling that a withholding is constitutional if linked to a legitimate underlying tax).

142 252 U.S. 60 (1920).

143 *Id.* at 76.

144 420 U.S. 656 (1975).

145 *Austin*, 420 U.S. at 659 n.4 (ruling that the deprivation of funds between the time of withholding and filing "adversely effects" nonresidents and, at minimum, is a constitutional consideration).

146 *But see* Alaska Steamship Co. v. Mullaney, 180 F.2d 805, 812 (9th Cir. 1950) (ruling solely on the constitutional merits of a withholding, not the underlying tax).

147 *See* Panhandle Producers & Royalty Owners Ass'n v. Oklahoma Tax Comm'n, 162 P.3d 960, 970 (Okla. Civ. App. 2007) (holding that a withholding cannot exceed the underlying tax rates), *cert. denied*, 552 U.S. 1062 (2007); Fisher v. Dep't of Rev., 16 Or. Tax 323, 330–31 (Or. T.C. 2001) (holding that a nonresident withholding statute was unconstitutional because it deprived nonresidents of the time value of money).

Neither the Supreme Court nor lower courts have heard a case in which a tax withholding potentially inhibited interstate travel. Therefore, the following case law is useful only in assessing whether states are permitted—under the Privileges and Immunities Clause of Article IV—to tax nonresidents and exiting residents earlier than permanent residents engaged in identical real estate transactions. These cases do not provide insight into the constitutionality of nonresident real estate withholdings in terms of their impact on interstate mobility.

1. The *Travis* Approach

In *Travis v. Yale & Towne Manufacturing Co.*, Yale & Towne Manufacturing challenged a New York statute imposing an exclusive 1% income-tax withholding on the first $10,000 that nonresident employees earned in New York.[148] Although the withholding itself did not impose any additional tax on nonresidents, it deprived them of the use of the withholding amount between the date the income was earned and the date of filing their year-end return.[149] The Court held that the withholding provision was constitutional under Article IV because it did not "increase the burden of the tax upon nonresidents."[150] Instead, it provided a "convenient substitute" for collecting taxes before the income left for jurisdictions where the State could not exercise its authority.[151]

Although *Travis* firmly held that the nonresident withholding was constitutional, the decision might be different if the Court heard the case today. This is because the validity of the withholding was largely based on New York's overriding interest in collecting the tax before the income left the state.[152] In 1920, this concern was certainly warranted given the absence of electronic filing.[153] In the modern era, however, the Court may find the State's collection concerns unwarranted, since tax compliance is largely an automated process.[154]

148 Travis v. Yale & Towne Mfg. Co., 252 U.S. 60, 79 n.1 (1920).

149 *See id.* at 76.

150 *Id.*

151 *Id.*

152 *See id.* (holding that the withholding was a "convenient substitute" for year-end collection).

153 *See generally Efile History - Electronic Tax Filing in the United States*, EFILE.COM, https://www.efile.com/efile-electronic-tax-filing-history (last visited Jan. 3, 2018) (explaining that electronic filing did not begin until 1986).

154 *See* Jorge Martinez, *Effect of Changes in Technology on Tax Compliance*, DELOITTE (2017), https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/gx-effect-of-changes-in-technology-on-tax-compliance.pdf.

Further, *Travis* was decided before the Court's adoption of the Substantial Reason Test from *Piper*.[155] Therefore, the holding in *Travis* does not represent the Court's current approach to assessing discriminatory state law under the Privileges and Immunities Clause of Article IV.[156] *Travis* does, however, show that the Supreme Court of the early twentieth century would not consider the time value of money as a basis for nonresident discrimination.[157]

2. The *Austin* Approach

Fifty-five years after *Travis*, the Supreme Court revisited the constitutionality of nonresident withholdings in *Austin v. New Hampshire*. There, nonresidents argued that a New Hampshire law which imposed a "Commuters Income Tax" and associated withholding exclusively on nonresidents violated the Privileges and Immunities Clause of Article IV.[158] Although nonresidents could credit taxes paid to other states to arrive at their final tax liability, they could not recover overpayments resulting from the withholding until year-end filing.[159]

Notably, residents were not subject to income tax at all.[160] New Hampshire argued that the statute was valid because after factoring the credit for income taxes paid to their home states, nonresidents' New Hampshire tax liability was equivalent to the tax they would have paid to their home states had the income been earned there.[161] Accordingly, nonresidents had no standing to sue because they were not "adversely affected."[162]

The majority, however, disagreed.[163] Writing for the Court, Justice Marshall first addressed New Hampshire's argument regarding the absence of any adverse effect.[164] He found that even if the out-of-state credit was valid, the withholding created an adverse effect because "at the very least" it deprived nonresidents of "the use value of the excess withheld over their ultimate tax liability, if any."[165] Justice Marshall then ruled that the statute violated the Privileges and Immunities Clause because (1) the underlying tax was imposed exclusively on nonresidents and (2) there was no evidence that the tax maintained "substantial equality" between residents and

155 *See* Supreme Court of New Hampshire v. Piper, 470 U.S. 274, 284 (1985) (decided sixty-five years after *Travis*).

156 *See id.*

157 *See Travis*, 252 U.S. at 76.

158 Austin v. New Hampshire, 420 U.S. 656, 657 (1975).

159 *See id.* at 658.

160 *Id.* at 659.

161 *Id.* at 666–67.

162 *Id.* at 659 n.4 (quoting Sierra Club v. Morton, 405 U.S. 727, 740 (1972).

163 *Id.* at 665.

164 *See Austin*, 420 U.S. at 659 n.4.

165 *Id.*

nonresidents.[166] An in-depth time-value-of-money analysis was ultimately unnecessary, since the underlying tax was clearly discriminatory.[167] But unlike the ruling in *Travis*, the Court signaled that the time value of money was a consideration in assessing the constitutionality of state tax laws.[168]

3. Recent Cases in the State Courts

Although the Supreme Court has not provided additional clarity on the constitutionality of nonresident withholdings, the state courts have.[169] Instead of examining only whether the underlying tax maintains substantial equality between residents and nonresidents, two courts have focused on the timing and method of collection.[170] Both provide valuable insight into how a court might apply the Substantial Reason Test to a nonresident real estate withholding statute.[171]

a. Panhandle Producers & Royalty Owners Ass'n v. Oklahoma Tax Commission

In 2007, the Civil Court of Appeals of Oklahoma heard *Panhandle Producers & Royalty Owners Ass'n v. Oklahoma Tax Commission*,[172] in which a trade association for mineral royalty holders challenged a statute that imposed a royalty withholding tax of 5% exclusively on nonresidents.[173] Although the underlying tax (also 5% of royalty income) was the same for residents and nonresidents, the trade association argued that the statute violated the Privileges and Immunities Clause of Article IV "by depriving non-residents of the time value of money between the time the taxes are withheld and the receipt of any refund."[174]

Applying the Substantial Reason Test from *Piper*, the court found that the withholding was constitutional because (1) Oklahoma had a "substantial

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166 *Id.* at 665–66.

167 *Id.*

168 *See id.* at 659 n.4.

169 *See* Panhandle Producers & Royalty Owners Ass'n v. Oklahoma Tax Comm'n, 162 P.3d 960, 970 (Okla. Civ. App. 2007) (holding that a withholding cannot exceed the underlying tax rates), *cert. denied*, 552 U.S. 1062 (2007); Fisher v. Dep't of Rev., 16 Or. Tax 323, 330–32 (Or. T.C. 2001) (holding that a nonresident withholding statute was unconstitutional because it deprived nonresidents of the time value of money).

170 *See Panhandle*, 162 P.3d at 970; *Fisher*, 16 Or. Tax at 330–32.

171 *See Panhandle*, 162 P.3d at 967–68 (applying the Substantial Reason Test to a royalty withholding exclusively imposed on nonresidents); *Fisher*, 16 Or. Tax at 328 (applying the Substantial Reason Test to an exemption granted exclusively to residents for like-kind exchanges).

172 162 P.3d 960 (Okla. Civ. App. 2007).

173 *Id.* at 962–63.

174 *Id.* at 966.

reason" for imposing the tax—namely, that it provided a reasonable method of collection before the income left the state; (2) the withholding "necessarily [bore] a substantial relationship to the state's objective;" and (3) the underlying tax was "of like character and not more onerous in effect than taxes charged to residents for income earned in the taxing state."[175] The court did, however, make one significant qualification: "[t]hat withholding may result in the temporary loss of use of the withheld amounts has not been found to be a constitutionally protected interest (*at least so long as the amount withheld is not greater than the tax rates, as suggested by* Austin)."[176]

This qualification—critical to the analysis in Part III—warrants further explanation, as it appears to be inconsistent with the overall opinion. The court first permitted the State to withhold amounts in excess of nonresidents' royalty income tax liability but then stated that the withholding amount could not exceed the underlying "tax rates."[177] How could the court permit the State to withhold more than nonresidents truly owed while simultaneously stating the amount withheld could not exceed the underlying tax rates?

The likely answer is that at the end of the year, certain exemptions and deductions are factored into taxpayers' true tax liability to bring their effective tax rate on taxable income below a state's bracketed rates.[178] Therefore, even though the statutory withholding percentage might be less than or equal to the underlying tax rate—as it was in *Panhandle*—the withholding could still result in more withheld than is truly owed—and permissibly so.[179] A State may not, however, withhold an amount that is more than the underlying bracketed tax rate times the underlying gross income.[180] For example, Oklahoma could not withhold 6% of nonresident royalty income if nonresidents were subject only to a 5% statutory tax rate for that income.

b. Fisher v. Department of Revenue

The Oregon Tax Court's approach to timing and collection is best demonstrated in *Fisher v. Department of Revenue*.[181] There, nonresidents challenged a statute that exclusively denied them like-kind-exchange treatment for property sold in Oregon.[182] They argued that the Oregon statute violated Article IV because while residents enjoyed the benefit of deferring

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175 *Id.* at 967–68 (quotation omitted).

176 *Id.* at 970 (emphasis added) (citation omitted).

177 *Id.*

178 *See Effective Tax Rate*, supra note 29.

179 *See Panhandle*, 162 P.3d at 970.

180 Gross income represents the amount of income prior to factoring in exclusions or deductions. *See Gross Income*, OXFORDDICTIONARIES.COM, https://en.oxforddictionaries.com/definition/gross (last visited Jan. 3, 2018).

181 16 Or. Tax 323 (Or. T.C. 2001).

182 *Id.* at 325.

their tax burdens, nonresidents paid capital gains in the year of sale even if they immediately repurchased like-kind property.[183]

Oregon argued that the statute was not discriminatory because the difference in treatment was "merely one of timing"; residents would eventually pay capital gains tax when they sold their real estate and did not repurchase like-kind property.[184] And even if the statute was discriminatory, the State's interest in collecting tax revenues before the income left the state was a "substantial reason" in accordance with *Piper* and its progeny.[185]

The court disagreed. It held that the statute violated the Privileges and Immunities Clause of Article IV for two reasons.[186] First, the statute was discriminatory because "timing is of considerable importance to many taxpayers, which explains the frequency and intensity with which taxpayers litigate accrual versus cash method accounting for tax purposes and like-kind exchange gain deferrals."[187] Second, the State failed to show a "substantial" reason for enacting the statute.[188] The only reason provided—that nonresidents posed "collection difficulties" for the State—was unsupported by evidence.[189]

Although not a nonresident withholding case itself, *Fisher* is significant to the constitutional analysis of nonresident withholdings. The case challenges the previously and widely accepted notion that States have a "substantial reason" for taxing nonresident income before it leaves the state because of collection or enforcement difficulties.[190] If other courts adopted the *Fisher* approach, nonresident withholdings may not survive constitutional scrutiny under the Privileges and Immunities Clause of Article IV.

Additionally, *Fisher* held that a tax statute was void entirely on the basis of timing, notwithstanding the fact that the underlying tax burden was identical between residents and nonresidents.[191] If widely adopted, this too would have significant implications on nonresident withholdings, as *Fisher* suggests that a collection method that exclusively deprives nonresidents of

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183 *Id.* at 328, 330–31.

184 *Id.* at 330.

185 *Id.* at 328.

186 *See Fisher*, 16 Or. Tax at 330–34.

187 *Id.* at 330.

188 *Id.* at 331.

189 *Id.*

190 *See* Travis v. Yale & Towne Mfg. Co., 252 U.S. 60, 76 (1920) ("[The withholding] does not in any wise increase the burden of the tax upon non-residents, but merely recognizes the fact that as to them the State imposes no personal liability, and hence adopts a convenient substitute for it."); Wilson v. Dep't of Rev., 302 Or. 128, 727 P.2d 614, 619 (Or. 1986) ("We conclude that the purpose of the statute was not to keep money and business within the state, as taxpayers argue. The statute was enacted in recognition of the difficulties in collecting deferred taxes if the property owner leaves the state after having exchanged Oregon property for out-of-state property.").

191 *Fisher*, 16 Or. Tax at 330.

amounts owed in the future is unconstitutional.[192] This appears to be a minority view, however, as *Travis*, *Austin*, and *Panhandle* do not completely bar disparities in the timing of collection.

III. THE CONSTITUTIONALITY OF NONRESIDENT REAL ESTATE WITHHOLDINGS

The case law yields three principles applicable to the present analysis. First, in the absence of public health concerns, statutes that bar interstate travel through taxation or other means are generally unconstitutional.[193] Second, tax statutes are generally upheld as long as the tax maintains "substantial equality" between residents and nonresidents; precise equality is not required.[194] If there is not precise equality, however, the State must show that (1) "there is a substantial reason for the difference in treatment" and (2) "the discrimination practiced against nonresidents bears a substantial relationship to the State's objective."[195] Third, nonresident withholdings, as a class, are constitutional as long as the withholding amount does not exceed the actual tax rate applied to the underlying gross income.[196]

This Part first addresses whether nonresident real estate withholding statutes inhibit free travel and, if so, whether such statutes are constitutional based on *Crandall* and the Privileges or Immunities Clause of the Fourteenth Amendment. Next, this Part examines whether nonresident real estate withholdings discriminate against nonresidents and whether such statutes would survive judicial scrutiny under the Substantial Reason Test. To the extent the following analysis renders certain statutes unconstitutional, this Part includes recommendations to remedy the violation.

A. *Nonresident Real Estate Withholdings and Interstate Mobility*

Although laws that inhibit interstate mobility of nonresidents may be challenged under Article IV, stronger arguments for unconstitutionality exist under the Fourteenth Amendment and the implied rights of national

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192 *See id.* at 330–31.

193 *See* Saenz v. Roe, 526 U.S. 489, 498 (1999); Edwards v. California, 314 U.S. 160, 184 (1941) (Jackson, J., concurring); Crandall v. Nevada, 73 U.S. (6 Wall.) 35, 49 (1867).

194 *See* Austin v. New Hampshire, 420 U.S. 656, 665 (1975).

195 *See* Supreme Court of New Hampshire v. Piper, 470 U.S. 274, 284 (1985); *Fisher*, 16 Or. Tax at 329 (explaining that absolute equality is not required as long as "the State [can] defend . . . [its different treatment of nonresidents] with a substantial justification . . ., including an explanation of how the discrimination relates to the State's justification" (quoting Lunding v. New York Tax App. Trib., 522 U.S. 287, 298 (1998)) (second, third, and fourth alterations in original)).

196 *See* Panhandle Producers & Royalty Owners Ass'n v. Oklahoma Tax Comm'n, 162 P.3d 960, 970 (Okla. Civ. App. 2007), *cert. denied*, 552 U.S. 1062 (2007).

citizenship outlined in *Crandall*. This is because the right to move freely among the states is virtually absolute;[197] national citizens do not need to prove residence-based discrimination to prevail, nor can States justify an abridgement to such rights with a substantial reason as would otherwise be permitted under Article IV.[198] Therefore, this Section focuses on arguments under *Crandall* and its progeny and the Privileges or Immunities Clause of the Fourteenth Amendment.

The following analysis divides nonresident real estate withholding statutes into three groups. The characteristics of each group hold constitutional relevance and in some cases are dispositive of the statutes' constitutional validity. The first group consists of Hawaii and New Jersey, both of which apply a gross-proceeds method of withholding and provide relief for insufficient net proceeds. The second group consists of Maine and Vermont, both of which withhold an amount relatively close to the actual tax owed, but neither of which provide relief for insufficient net proceeds. The third and final group consists of the net-proceeds states, all of which provide a full or partial principal residence exemption and withhold only if there are sufficient net proceeds.

1. Hawaii and New Jersey

Recall the key provisions of Hawaii's and New Jersey's nonresident real estate withholding statutes. Both States require exiting residents to withhold at closing a statutory percentage of the sale price if the transaction results in a realized gain in excess of the federal principal residence exclusion.[199] As demonstrated *supra* Part I, this may result in exiting residents paying more than the tax owed at withholding. Although exiting residents can file for a refund for overpayment, they cannot do so until the sale is completed.[200]

Both States do, however, have mechanisms to reduce or eliminate the withholding if there are insufficient net proceeds, and both also charge nonresidents and residents the same underlying capital gains tax rate.[201] Thus, the

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197 *See Saenz*, 526 U.S. at 498.

198 *See id.* at 503 ("There may be a substantial reason for requiring the nonresident to pay more than the resident for a hunting license or to enroll in the state university, but our cases have not identified any acceptable reason for qualifying the protection afforded by the Clause for the citizen of State A who ventures into State B to settle there and establish a home." (citations and quotation omitted)).

199 HAW. REV. STAT. §§ 235-68(b) to (f) (2008) (providing Hawaii's nonresident withholding rule and rate); N.J. STAT. ANN. § 54A:8-9(a) (West 2017) (providing New Jersey's nonresident withholding rule and rate).

200 ZIELINSKI, *supra* note 2, at 9 (explaining the refund process in Hawaii); N.J. DEP'T OF TREASURY, *supra* note 13 (explaining the refund process in New Jersey).

201 Form GIT/REP-3, *supra* note 53 (explaining that nonresidents are exempt if there are insufficient net proceeds); ZIELINSKI, *supra* note 2, at 6 (explaining that nonresidents may request a withholding adjustment if the withholding is "extremely burdensome"); *see also* HAW. REV. STAT. § 235-51(f)(1)

main issue here is whether it is constitutional to require exiting residents to pay more tax than actually owed as a precondition to completing the sale. Because the differences between the New Jersey and Hawaii statutes do not make a material difference in the analysis, the following applies to both.

To determine whether the nonresident withholding schemes above are constitutional, it is helpful to apply the constitutional framework to a hypothetical statute that is less convoluted but constructively similar. Assume that instead of a nonresident real estate withholding, Hawaii passed a statute that required residents who are permanently relocating to pay a refundable "exit fee" prior to relocation.[202] Like the overpayment of the nonresident real estate withholding, the exit fee will be returned in full either at the end of the year or several weeks after exit. In addition, the fee can be avoided if the exiting resident shows that the fee would be "extremely burdensome." Would such a statute survive judicial scrutiny under *Crandall* and the Privileges or Immunities Clause of the Fourteenth Amendment?

First and foremost, *Crandall* and the Fourteenth Amendment protect citizens against more than just complete barriers to exit; both protect against virtually any barrier to exit.[203] This is evident from the facts of *Crandall* itself. The $1 exit tax represented the cost of only twenty-two miles of rail travel—an amount likely immaterial to the cost of an interstate rail trip.[204] But neither the amount nor the taxpayers' capacity to pay swayed the Court's final determination that the statute was unconstitutional.[205] With this in mind, the hypothetical statute presented here is unequivocally unconstitutional. No matter how large or small the amount, the "exit fee" would act as a barrier to relocation. Both Hawaii and New Jersey's nonresident real estate withholding statutes are unconstitutional on the same grounds; both permit each State to withhold more tax than is owed.

Further, that the "exit fee" in this hypothetical is refundable makes no difference. This is because the holding in *Crandall* turned not on any

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(providing the underlying capital gains tax rate); Mueller, *supra* note 3 (explaining that both residents and nonresidents must pay the underlying capital gains tax).

202 This fee is analogous to the overpayment of the capital gains tax that can result from the withholding.

203 *See Saenz*, 526 U.S. at 498.

204 In the late 1800s, traveling by rail in Nevada cost approximately $0.045 per mile. *Clyde H. Freed,* THE STORY OF RAILROAD PASSENGER FARES 273 (1942). Thus, a $1 exit tax represented the cost of only about twenty-two miles of travel by rail.

205 *See* Crandall v. Nevada, 73 U.S. (6 Wall.) 35, 46 (1867) ("It will be observed that *it was not the extent of the tax in that case which was complained of, but the right to levy any tax of that character*. So in the case before us it may be said that a tax of one dollar for passing through the State of Nevada, by stage coach or by railroad, cannot sensibly . . . *deprive a citizen of any valuable right*. *But if the State can tax a railroad passenger one dollar, it can tax him one thousand dollars*. If one State can do this, so can every other State. And thus one or more States covering the only practicable routes of travel from the east to the west, or from the north to the south, may totally prevent or seriously burden all transportation of passengers from one part of the country to the other." (emphasis added)).

particular dollar amount paid but on the payment itself as a precondition to exit.[206] The Court reinforced this point in the *Slaughter-House Cases*, noting that the Fourteenth Amendment entitled national citizens to "free" and unabridged regress and ingress.[207] Nowhere in *Crandall* or the *Slaughter-House Cases* does the Court suggest that exit fees are permitted as long as those amounts are returned later. The same holds true for Hawaii's and New Jersey's nonresident real estate withholdings. Requiring exiting residents to overpay their capital gains tax as a precondition to relocation acts as a barrier to exit and is unconstitutional. Regardless of whether the State eventually returns the overpayment, the exiting resident is still required to furnish the overpayment to relocate, which *Crandall* explicitly prohibits.[208]

If challenged, Hawaii and New Jersey would likely present the following counterarguments. First, the overpayment is refundable and is required only when taxpayers are able to pay the withholding using the sale proceeds. This renders the statute substantially different from the statute challenged in *Crandall*, so *Crandall* provides no basis for comparison. But *Edwards* suggests otherwise.[209] There, the concurrence clearly advanced the proposition that limiting regress and ingress on the basis of property status is strictly forbidden.[210] Because Hawaii and New Jersey require the withholding only for exiting residents who have the capacity to pay, each uses property status as a determinant. Therefore, the nonresident withholding statutes of both states are unconstitutional.

Second, both States would argue that there are legitimate collection concerns associated with nonresidents and exiting residents.[211] Again, this argument is insufficient. While collection difficulty may count as a "substantial reason" for justifying discriminatory laws under Article IV,[212] it does not satisfy the requirements of *Crandall* or the Privileges or Immunities Clause of the Fourteenth Amendment.[213] As noted in *Northwest*, the right to free travel is virtually "absolute."[214] It may not be abridged, even in the presence of "revenue collection" concerns.[215]

Hawaii and New Jersey have two remedies available to modify their nonresident real estate withholding statutes to comply with *Crandall* and the Fourteenth Amendment. First, both States could grant a full principal

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206 *Id.*

207 Slaughter-House Cases, 83 U.S. (16 Wall.) 36, 75 (1873).

208 *See Crandall*, 73 U.S. (6 Wall.) at 46.

209 *See* Edwards v. California, 314 U.S. 160, 185 (1941) (Jackson, J., concurring).

210 *Id.*

211 *See* Form GIT/REP-3, *supra* note 53 (explaining that nonresidents are exempt if there are insufficient net proceeds); ZIELINSKI, *supra* note 2, at 6 (explaining that nonresidents may request a withholding adjustment if the withholding is "extremely burdensome").

212 *See* Panhandle Producers & Royalty Owners Ass'n v. Oklahoma Tax Comm'n, 162 P.3d 960, 968 (Okla. Civ. App. 2007), *cert. denied*, 552 U.S. 1062 (2007).

213 *See* Slaughter-House Cases, 83 U.S. (16 Wall.) 36, 76 (1873); *Crandall*, 73 U.S. (6 Wall.) at 46.

214 Nw. Airlines, Inc. v. Joint City-Cty. Airport Bd., 463 P.2d 470, 473 (Mont. 1970).

215 *Id.* at 473.

residence exemption. This would ensure that the withholding presented no barriers to relocation, as any taxes owed on the transaction would be paid upon filing a year-end tax return. Second, both Hawaii and New Jersey could modify their method of calculating the withholding to ensure that the amount was never greater than the tax owed. This would require both States to abandon withholding calculations based on the sale price and instead use the taxable gain. Although exiting residents under this alternative would still be required to produce more cash than permanent residents at closing, the States could argue that the taxable event occurred, so exiting residents were liable for the exact amount due.

Notably, the second remedy is riskier. This is because the mere presence of a withholding at closing affects relocation. If a court were to strictly interpret the rulings in *Crandall*, *Edwards*, and *Saenz*, then practically any statute limiting free regress or ingress would be prohibited, with the exception of certain statutes as described in *Edwards*.[216] Further, the second remedy would not insulate Hawaii or New Jersey from a Privileges and Immunities claim under Article IV, since residents would still be fully exempt from the withholding while nonresidents would not.[217] Therefore, to ensure constitutional validity under the provisions discussed herein, the safest remedy is the first; both States should provide full withholding exemptions for the sales of principal residences.

2. Maine and Vermont

Recall the nonresident withholding schemes of Maine and Vermont. Both require exiting residents to pay their approximate tax burden prior to departure.[218] Because both states lack an insufficient net proceeds exemption, however, exiting residents may be completely prevented from selling their principal residence before departing, especially when the property has been refinanced numerous times. Exiting residents in such circumstances must either save enough cash to pay the tax owed at closing or forego selling their principal residence altogether. Left with only these two alternatives, the exiting resident may choose not to relocate at all.

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216 *See* Edwards v. California, 314 U.S. 160, 184 (1941) (Jackson, J., concurring) ("The right of the citizen to migrate from state to state . . . is not . . . an unlimited one. . . . He may not, if a fugitive from justice, claim freedom to migrate unmolested, nor may he endanger others by carrying contagion about.").

217 *See* Paul v. Virginia, 75 U.S. (8 Wall.) 168, 180 (1869) ("It was undoubtedly the object of the [Privileges and Immunities Clause] to place the citizens of each State upon the same footing with citizens of other States, so far as the advantages resulting from citizenship in those States are concerned.").

218 *See* VT. STAT. ANN. tit. 32, § 5847(c) (2015); Form REW-5, *supra* note 39. Unlike Vermont, Maine does not withhold the exact tax amount owed. Maine withholds 10.15% of the taxable gain, which is three percentage points greater than the state's uppermost capital gains rate of 7.15%. *See* ME. STAT. tit. 36, § 5111(3-F).

The case law is less definitive in determining the constitutionality of withholding that requires payment of the exact tax burden as a precondition to relocation. A preliminary question is this: would the outcome in *Crandall* have been different if the Nevada statute required persons to pay outstanding property taxes owed prior to exit? On the one hand, a strict interpretation of *Crandall* and the Privileges or Immunities Clause would lead one to conclude "no."[219] As a general matter, States may not use taxation as a tool to abridge interstate travel under the Fourteenth Amendment, whether they intend to or not.[220] And based on the concurrence in *Edwards*, it appears that if the Court even suspects that a statute inhibits free travel, the statute is unconstitutional.[221] On the other hand, the Court may choose to carve out exceptions like those in *Edwards*;[222] perhaps at a minimum, exiting residents *should* be required to pay their exact tax obligations prior to relocation. This remains to be seen.

Regardless, Maine and Vermont have several remedies available to settle any doubt as to the constitutionality of their nonresident real estate withholding statutes. First and foremost, both States could grant a full principal residence exemption. This would allow all persons attempting to relocate to do so without issue. Alternatively, both could grant an insufficient net-proceeds exemption. This would ensure that an exiting resident would never be completely prohibited from relocation since he would be required to withhold only if the sale generated enough cash to do so. But this remedy would not insulate the states from challenges under the Privileges and Immunities Clause of Article IV. Therefore, granting a full principal residence exemption is a safer option.

3. The Net-Proceeds States

Recall that net-proceeds states such as South Carolina do not grant a full principal residence exemption.[223] Similar to Maine and Vermont, South Carolina requires exiting residents to withhold 7% of their taxable gain, including any amounts in excess of the principal residence exclusion,[224] but only to

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219 *See* Crandall v. Nevada, 73 U.S. (6 Wall.) 35, 46 (1867) ("It will be observed that *it was not the extent of the tax in that case which was complained of, but the right to levy any tax of that character*." (emphasis added)).

220 *Id.*

221 Note that hard evidence need not be procured; the Court in *Crandall* was willing to strike down the Nevada statute even though no showing was made that the passengers in question were limited in their travels. *See Edwards*, 314 U.S. at 178 (Douglas, J., concurring).

222 *Id.* at 176.

223 *See* S.C. CODE ANN. § 12-8-580(A)(1) (Supp. 2008).

224 *Id.* § 12-8-580(A)(1)(a).

the extent that there are net proceeds following the sale.[225] Where the transaction yields no net proceeds, no withholding is required.[226] Effectively, this type of scheme ensures that exiting residents pay only their actual tax liability upon closing and always have the wherewithal to pay, since the withholding is charged only if there are sufficient net proceeds.

As previously mentioned, it may be that *any* withholding scheme that does not provide a full principal residence exemption—such as the one in South Carolina—is unconstitutional under *Crandall* and the Privileges or Immunities Clause of the Fourteenth Amendment.[227] But for States charging exiting residents only their exact tax liability and exempting the withholding for insufficient net proceeds, a more compelling argument exists under the Privileges and Immunities Clause of Article IV. The next Section explores the merits of this argument.

B. *Nonresident Discrimination Under the Privileges and Immunities Clause of Article IV*

Given the presence of residence-based discrimination, nonresident real estate withholdings, as a class, may violate the Privileges and Immunities Clause of Article IV.[228] This is because exiting residents and nonresidents selling real estate must pay the underlying capital gains tax at closing, while residents are permitted to pay at year-end.[229] Further, certain States require nonresidents and exiting residents to withhold more than they actually owe.[230]

As a result, any challenge to a nonresident real estate withholding statute would likely include a claim under Article IV. If brought by an exiting resident, however, that claim would be ancillary to the interstate mobility claim discussed *supra* Section III.A. Regardless, the Article IV claim would trigger the two-step Substantial Reason Test from *Piper*, requiring the State to show that (1) "there is a substantial reason for the difference in treatment"

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225 This is inherent in the fact that South Carolina requires nonresidents and exiting residents to withhold the lesser of the net proceeds or the gain. *Id.* § 12-8-580(A)(1). If there are no net proceeds, there is no withholding.

226 *See id.* § 12-8-580(A)(1).

227 *See* Saenz v. Roe, 526 U.S. 489, 502 (1999) ("There may be a substantial reason for requiring the nonresident to pay more than the resident for a hunting license or to enroll in the state university, but our cases have not identified any acceptable reason for qualifying the protection afforded by the Clause for the citizen of State A who ventures into State B to settle there and establish a home." (citations and quotation omitted)).

228 *See* Paul v. Virginia, 75 U.S. (8 Wall.) 168, 180 (1869) ("It was undoubtedly the object of the [Privileges and Immunities Clause] to place the citizens of each State upon the same footing with citizens of other States, so far as the advantages resulting from citizenship in those States are concerned.").

229 *E.g.*, HAW. REV. STAT. § 235-68(d)(1) (2008) (stating that residents are exempt from withholding).

230 *E.g.*, *id.* § 235-68(b) (stating that nonresidents "shall deduct and withhold a tax equal to five per cent of the amount realized on the disposition of Hawaii real property").

and (2) "the discrimination practiced against nonresidents bears a substantial relationship to the State's objective."[231] Before subjecting the withholding to this test, however, the State must make a preliminary showing that the underlying tax maintains substantial equality between residents and nonresidents.[232] Here, the nonresident real estate withholding does not change the underlying tax burden because residents and nonresidents eventually pay the exact same tax.[233] Therefore, nonresident real estate withholdings do achieve substantial equality. The remaining question, then, is whether nonresident real estate withholdings would hold up under the two-step *Piper* test.

For ease of analysis, this Section groups states into two categories: those imposing a withholding less than or equal to the underlying capital gains rate and those imposing a withholding greater than the underlying capital gains rate. Given the rulings in *Austin* and *Panhandle*, states in the latter category are at greater risk for running afoul of the Privileges and Immunities Clause of Article IV. [234]

1. Withholdings That Are Less than or Equal to the Underlying Tax Rate

Except for Hawaii, Maine, and New Jersey, all States with nonresident real estate withholdings withhold less than the tax owed or the precise tax owed.[235] Notably, whether the withholding is less than or equal to the actual amount owed holds no constitutional relevance; the only relevant factor is that these States do not withhold *more* than the actual amount owed.[236]

In determining whether such a nonresident real estate withholding is constitutional under Article IV, a court would first determine whether there is a "substantial reason" for the disparate treatment.[237] For the sake of brevity, this Comment assumes that collection difficulties associated with nonresidents is a "substantial reason" for nonresident withholdings. Although this

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

232 *See* Fisher v. Dep't of Rev., 16 Or. Tax 323, 330 (Or. T.C. 2001) ("The upshot of these cases is that there must be substantial equality in treatment between residents and nonresidents and where a disparity exists there must be a substantial reason for the difference in treatment beyond the mere fact of nonresidency and the degree of discrimination must bear a close relationship to the concern the statute is intended to address.").

233 *See* Mueller, *supra* note 3 (explaining that a nonresident real estate withholding is an early payment of one's capital gains tax).

234 *See* Panhandle Producers & Royalty Owners Ass'n v. Oklahoma Tax Comm'n, 162 P.3d 960, 970 (Okla. Civ. App. 2007) (stating that a withholding cannot exceed the applicable underlying tax rate), *cert. denied*, 552 U.S. 1062 (2007).

235 *E.g.*, S.C. CODE ANN. § 12-8-580(A)(1) (Supp. 2008) (stating that the withholding amount is the lesser of the tax owed or the net proceeds).

236 *See Panhandle*, 162 P.3d at 970.

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

may be an outdated concern, it appears to be widely accepted.[238] Therefore, it is assumed that the first prong of the Substantial Reason Test is satisfied.

Next, a court would determine whether there is a "substantial relationship to the State's objective."[239] The State's objective is to ensure the capital gains tax is collected from exiting residents and nonresidents prior to the income leaving the state.[240] In accordance with *Austin* and *Panhandle*, a withholding is a reasonable means to that end as long as "the amount withheld is not greater than the [underlying] tax rates."[241] Therefore, a nonresident real estate withholding that withholds less than or equal to the actual tax burden satisfies the second prong. Except for Hawaii, Maine, and New Jersey, all other states' nonresident real estate withholdings withhold no more than one's actual tax liability and are therefore constitutional under the Privileges and Immunities Clause of Article IV.[242]

2. Withholdings That Are Greater than the Underlying Tax Rate

Because Hawaii, Maine, and New Jersey use the sale price as the basis for calculating the nonresident real estate withholding, circumstances arise where the withholding amount exceeds the underlying tax rate. *Austin* and *Panhandle* suggest that this fact renders the statutes unconstitutional.[243] However, neither *Austin* nor *Panhandle* actually involved a withholding amount exceeding the underlying tax rate. Thus, the nonresident real estate withholdings of Hawaii, Maine, and New Jersey present a case of first impression.

Recall taxpayer *A*'s dilemma upon exiting Hawaii. *A* sold their principal residence to *B* for $1,000,000, resulting in a $600,000 realized gain and $100,000 taxable gain. Because the realized gain exceeded the principal residence withholding exclusion, Hawaii withheld 5% of the sale price, or

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238 *Panhandle*, 162 P.3d at 968 ("Avoidance of that burden and expense is a substantial reason for the different treatment; directing operators to withhold the taxes before the royalties leave the state necessarily bears a substantial relationship to the state's objective."); *see also* Travis v. Yale & Towne Mfg. Co., 252 U.S. 60, 76 (1920) ("[The withholding] does not in any wise increase the burden of the tax upon nonresidents, but merely recognizes the fact that as to them the state imposes no personal liability, and hence adopts a convenient substitute for it."). *But see* Fisher v. Dep't of Rev., 16 Or. Tax 323, 331 (Or. T.C. 2001) ("There is no evidence substantiating the department's claim of collection difficulties.").

239 *Piper*, 470 U.S. at 284.

240 *See* Austin v. New Hampshire, 420 U.S. 656, 659 n.4 ("[T]he withholding requirement deprives [plaintiffs] of the use value of the excess withheld over their ultimate tax liability, if any."); *Panhandle*, 162 P.3d at 970 (stating that a withholding cannot exceed the applicable underlying tax rate).

241 *Panhandle*, 162 P.3d at 970.

242 *Austin*, 420 U.S. at 668; *Panhandle*, 162 P.3d at 970. Note that this has no bearing on whether the statutes are unconstitutional under *Crandall* and Section 1 of the Fourteenth Amendment; that analysis is entirely separate.

243 *Panhandle*, 162 P.3d at 970 ("That withholding may result in the temporary loss of use of the withheld amounts has not been found to be a constitutionally protected interest (at least as long as the amount withheld is not greater than the tax rates, as suggested by *Austin*.") (citation omitted)).

$50,000.[244] This was true even though the actual tax liability was only $7,250—calculated by multiplying the capital gains rate of 7.25% times the taxable gain of $100,000—meaning *A* is entitled to a refund of $42,750.[245]

Although *A* has the capacity to withhold the $50,000, *A* decides the withholding is excessive and sues Hawaii. Applying the Substantial Reason Test, the Court would first establish that collection difficulty arising from nonresident taxpayers constitutes a "substantial reason." [246] Because this notion is widely accepted, the first prong of the test is satisfied.[247] But would a withholding amount that is $42,750 greater than the tax owed satisfy the second prong, which requires that the discriminatory measure bear a "substantial relationship to the State's objective"?[248] Surely not. If the stated reason for the discriminatory measure is to ensure collection of the tax owed, how could Hawaii justify a withholding that exceeds the amount owed by $42,750? The statute fails the second prong and is therefore unconstitutional under the Privileges and Immunities Clause of Article IV. This conclusion is supported by the rule in *Panhandle*, which requires that "the amount withheld is not greater than the [underlying] tax rates, as suggested by *Austin*."[249]

The outcome in New Jersey would be the same, though the case would be stronger because withholdings are required even when the sale results in a loss. The outcome in Maine, however, may be different. Maine's uppermost capital gains rate is 7.15%, while the withholding rate per the statute is the lesser of 2.5% of the sale price or 10.15% of the capital gain.[250] Under this rule, the most an exiting resident or nonresident would ever pay in excess of the true tax liability is 3%. This represents the difference between the 10.15% withholding rate and the 7.15% capital gains rate.

Under a strict application of *Austin* and *Panhandle*, the Maine statute is clearly unconstitutional because the withholding amount could exceed the underlying tax rate.[251] But the second prong of the Substantial Reason Test requires only that the discrimination bear "a *substantial* relationship to the State's objective."[252] Since the word "substantial" is one of degree, a court could find that a 3% difference results in a withholding approximate enough

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244 HAW. REV. STAT. §§ 235-68(b) to (f) (2018).

245 *See id.* § 235-51(f).

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

247 *See Panhandle*, 162 P.3d at 968 ("Avoidance of that burden and expense is a substantial reason for the different treatment . . . .").

248 *Piper*, 470 U.S. at 284.

249 *Panhandle*, 162 P.3d at 970.

250 *See* ME. STAT. tit. 36, § 5111(3-F) (2010) (providing Maine's uppermost capital gains rate); Form REW-5, *supra* note 39 (explaining that the withholding may be calculated by applying 10.15% to the taxable gain).

251 *Panhandle*, 162 P.3d at 970 ("That withholding may result in the temporary loss of use of the withheld amounts has not been found to be a constitutionally protected interest (at least so long as the amount withheld is not greater than the tax rates, as suggested by *Austin*.") citation omitted)).

252 *Piper*, 470 U.S. at 284 (emphasis added).

to the actual tax liability to satisfy the second prong. This is unlikely, however, given the definitive rule set forth in *Panhandle*.[253]

The remedy here is simple. Hawaii, Maine, and New Jersey should adjust the withholding amount of their nonresident real estate withholding to match the actual tax owed on the transaction. If there is insufficient information at closing to calculate the actual amount, the withholding scheme should err on the side of caution and withhold only that which is sure not to exceed the true tax liability. Without such modification, the statutes likely run afoul of the Privileges and Immunities Clause of Article IV, as the second prong of the Substantial Reason Test cannot be satisfied.

CONCLUSION

Seventeen states have enacted nonresident real estate withholding laws, which require nonresidents to pay their state capital gains tax at the time property is sold rather than at year-end. The alleged reason for these laws is to provide a "convenient substitute" for collection before income leaves the state.[254] But critics suspect an ulterior motive: the desire to prevent residents from leaving in the first place.[255] A closer examination of several state withholding schemes suggests this suspicion is warranted. Under certain circumstances, three states require exiting residents to withhold amounts greater than the tax owed, leaving exiting residents with less cash for relocation and potentially preventing the sale altogether.

These withholding schemes are unconstitutional under several constitutional provisions. First, state laws inhibiting interstate mobility violate the implied rights of national citizenship and the rights of national citizenship guaranteed under the Privileges or Immunities Clause of the Fourteenth Amendment. Because the nonresident withholding statutes in Hawaii, Maine, New Jersey, and Vermont present circumstances that make relocation more difficult, these laws are categorically unconstitutional. Second, nonresident withholdings, as a class, violate the Privileges and Immunities Clause of Article IV if the amount withheld exceeds the underlying tax rates. In certain instances, the real estate withholding schemes in Hawaii, Maine, and New Jersey all demand withholdings greater than the underlying tax rates and are therefore unconstitutional. Further, the discriminatory measures imposed on nonresidents in those states do not bear a substantial relationship to the states' collection concerns.

The remedies to cure these constitutional violations are simple. First, to ensure that exiting residents can freely relocate, Hawaii, Maine, New Jersey,

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253 *Panhandle*, 162 P.3d at 970.

254 *See* Travis v. Yale & Towne Mfg. Co., 252 U.S. 60, 76 (1920); Mueller, *supra* note 3 ("[T]he tax is really just an estimated tax payment required at the time of a real estate closing to prevent non-residents from evading tax on the sale of second properties or investment homes.")

255 *See* Kwoh, *supra* note 4.

and Vermont must provide a full withholding exemption for the sale of principal residences. Doing so guarantees that exiting residents have sufficient cash to sell their homes in one state so they can immediately relocate and buy a new home in another state. Without this remedy, the states truly impose an exit tax in disguise.

Second, to ensure that nonresident real estate withholdings are not discriminatory, Hawaii, Maine, and New Jersey must ensure that the withholding amount is less than the underlying capital gains rate. The easiest way to achieve this is to modify the withholding calculation so the taxable gain—not the sale price—is the basis for withholding. Doing so ensures that nonresidents enjoy the privileges and immunities guaranteed to them under Article IV.